AMERICA'S FISCAL AND ECONOMIC OUTLOOK:

Where Do We Go From Here?

PETER G. PETERSON FOUNDATION

A Note From Michael Peterson

Chairman and CEO of the Peterson Foundation

With our economy in recovery, our debt rising unsustainably, and our nation still grappling with a devastating pandemic, America faces many critical questions for its future. *Where do we go from here?*

To help illuminate and improve the understanding of this important moment, the Peterson Foundation has convened twelve leading experts to share their views on the answer to this fundamental question. These outstanding authors bring a range of diverse viewpoints and deep experience, providing creative and thoughtful solutions to help guide citizens and policymakers through this uniquely challenging time.

The pandemic not only accelerated our existing fiscal challenges significantly, it exposed longstanding inequities in our society. A secure fiscal foundation is a necessary part of addressing this core challenge of capitalism, yet our budget remains on a dangerously unsustainable path. Further, America will face a range of evolving known and unknown future threats that will challenge coming generations — we should not also burden them with paying for the problems of the past.

In the wake of the COVID crisis, we have an important responsibility to examine, with clear eyes, our fiscal and economic condition and what steps we need to take to ensure broad based prosperity for the future. These respected experts outline a range of recommendations for making America more prepared and better positioned for growth, with the resources we need to confront the challenges of tomorrow. In doing so, they light a path to building the inclusive and moral economy that the next generation deserves.

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About the Project

We asked twelve leading experts with diverse views from across the political spectrum to share their perspectives on the opportunities, challenges, and way forward for America's economic and fiscal future. Their insightful observations and proposed policy solutions are set forth below:

1. How does America's unsustainable, long-term fiscal outlook impact our economy, budget, risk exposure, and global leadership position?

2. The pandemic has exposed a range of new and longstanding concerns about disparities in economic security and opportunity across the nation. Looking ahead, how does our long-term fiscal outlook threaten vulnerable populations, and how can fiscal policy help address this core challenge of capitalism?

3. America faces a range of significant, ongoing challenges that will require resources, including climate change, health and retirement security, evolving global threats, and infrastructure needs here at home. What is the best way to build a sustainable fiscal outlook, while also enabling the U.S. to have the resources it needs to address its greatest challenges over the long run?

Smart Fiscal Policies For A Better Future:

By Wendy Edelberg,
Brookings Institution

"This is the moment to strengthen the social insurance system and to enact an ambitious federal investment package, while raising tax revenue and cutting back on spending in ways that would largely offset those costs."

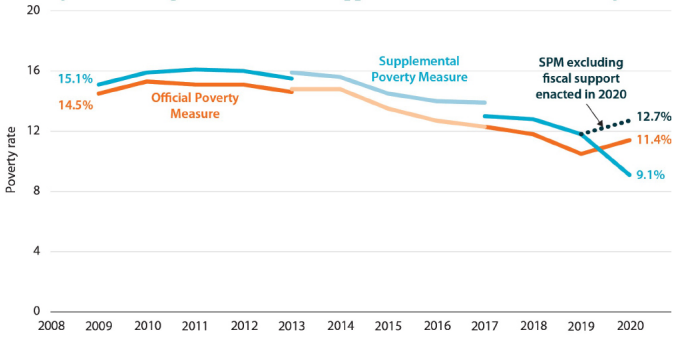
This is the moment to strengthen the social insurance system and to enact an ambitious federal investment package, while raising tax revenue and cutting back on spending in ways that would largely offset those costs. Together, those policy changes would make the US economy more resilient and productive over the longer term. Additionally, they would broaden the degree to which prosperity in the United States is shared across workers and families. The current rapid economic recovery and expected slowing over the next year creates risks that policymakers should heed. Nonetheless, the policy proposals that Congress is currently considering would not notably add to those risks. Nor would the policies worsen the long-term challenge created by the projected fiscal trajectory under current law. That challenge would be best addressed by policies put in place over the next decade to raise substantial revenue and reform certain mandatory spending programs.
Now, the situation has changed and the relative importance of different components of the solution has changed as well.

Changes to the Social Insurance System

Nearly everyone in the United States directly benefits from the social insurance system at some point in their lives. Moreover, everyone indirectly benefits from it — either from knowing the system would be there for them during some unexpected hardship or simply because it helps to support the overall economy.

How does the social insurance system reduce income inequality and poverty?

FIGURE 7.
Poverty Rates Using the Official and Supplemental Measures of Poverty



Source: Census Bureau 2021a.

Note: The Supplemental Poverty Measurement (SPM) was revised in 2019 with the implementation of revised methodology, in 2017 with the implementation of an updated processing system, and in 2013 with redesigned income questions. Estimate for SPM excluding stimulus provided by Census Bureau removes the first two rounds of stimulus payments issued under CARES Act and CRRSA Act of 2020. For additional detail, refer to the Supplemental Poverty Measure: 2020 report appendix.

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Using a measure of poverty that includes benefits from federal programs (the Supplemental Poverty Measure, or SPM), data show that in recent years social insurance programs had cut the SPM poverty rate in half after post-tax-and-transfer income is taken into account. As a result of the enormous fiscal support provided to households in 2020, the percentage

of the US population in poverty, as measured by the SPM, fell from 12 percent to 9 percent; if Congress had not enacted relief for families, SPM poverty would have risen to 13 percent rather than falling to 9 percent.

With respect to children, in 2019 the child poverty rate before benefits and taxes was 20 percent. After benefits and taxes are taken into account, the child poverty rate was 13 percent. In 2020, owing to the robust fiscal support in the face of a massive economic shock, the SPM poverty rate for children fell to 10 percent. Nonetheless, for some groups of children, poverty rates after taxes and transfers remained very high. Data from 2015 highlights the disparities: the National Academy of Sciences found that in that year, child poverty rates for Black and Hispanic children were more than twice as high as non-Hispanic white children. The same report found that children of single parents endure double the poverty rate of a two-parent household (NAS, 2019).

In 2021, continued fiscal support — particularly the full refundability of and the increase in the child tax credit and increases to the Supplemental Nutrition Assistance Program (SNAP) maximum benefit — as well as the continued labor market recovery should help to lift households out of poverty.

How would the proposed policies alleviate poverty, reduce inequality, improve well-being, and make the economy more resilient?

The successes in 2020 and 2021 of expanding and improving our social insurance system show some of the potential of making improvements in policy. Making some policies permanent would make sustained progress in reducing post-tax-and-transfer poverty and provide more insurance protection to families.

In this section, I summarize evidence for the benefits of reforming and expanding the social insurance system in the following illustrative areas: the Child Tax Credit, child care, paid leave, the Earned Income Tax Credit, and health care.

Child Tax Credit (CTC). Extending the changes that the American Rescue Plan (ARP) made to the CTC for 2021 — most importantly, making permanent the full refundability of the tax credit — would lock in place the enormous good this policy is doing for child poverty rates. Those changes the ARP made to the CTC, along with the other measures in the ARP, are projected to reduce poverty among children in

2021 from 14 percent to 8 percent (CPSP 2021). Indeed, more than 400 economists signed onto a letter supporting this change, based on evidence that CTC reduces child poverty and improves academic and long-term outcomes for children without affecting parental labor supply (Hoynes and Schanzenbach 2021).

Child care. The current policy proposal would make permanent the recent expansion of the Child and Dependent Care Tax Credit (CCDTC) and grants and tax subsidies aimed at raising wages of child-care providers. Those changes would help families with earnings too low to owe federal income tax afford child care and would improve the quality of child care and early childhood education, the benefits of which are well-documented. Together, the changes would boost the labor supply of parents of young children.

Paid leave. Standing up a federal paid family and medical leave program would improve children's health, reduce worker turnover, and increase labor force participation with perhaps the largest effects for disadvantaged children and mothers.

Earned Income Tax Credit (EITC). The current proposal would make permanent the recent expansion of the EITC for adults without children. Doing so would reduce poverty and income inequality and increase labor force participation.

Health insurance. If Congress made permanent the expansions to health-insurance premium tax credits and cost-sharing subsidies included in the ARP, the uninsured rate would fall by 13.6 percent (4.2 million) and lower-income households would be more financially secure (Banthin et al. 2021). Further expansions in access to Medicaid would do more to extend access to health care, where we have ample evidence that access increases annual health-care use among child and adults and improves the quality of life.

The effect on the economy of the reconciliation package and the bipartisan infrastructure package

The effective expansion of the social insurance system, some right-sizing in tax revenues, and investments in social and physical infrastructure would make the economy more productive and resilient over the longer term and lead to greater well-being and more equitably shared growth.

Moreover, the reconciliation package in combination with the bipartisan infrastructure package would not create notable inflation risk in the near term. The recent increase in inflation is largely attributable to the recent burst in consumer demand, which has outpaced supply, and also to various disruptions in global supply chains. Policymakers across many countries are rightfully paying attention. The timing of spending and revenue changes created by the policies under consideration would mean that consumer demand would be boosted only modestly, on net, over the next year or two.

Fiscal trajectory little changed but still a challenge

Policymakers have stated their goal is to include increases in tax revenues and decreases in spending that would fully offset the decreases in revenue and increases in spending. If something close to a full offset is achieved, the reconciliation package would do little to the projected debt trajectory.

Still, the US faces long-term fiscal challenges reflected in the trajectory of federal borrowing under current law — and, more importantly, the expectation of that trajectory by households and financial market participants. Empirical evidence suggests that with higher levels of deficits and debt, private domestic investment shrinks and the interest rate that the US pays on Treasury securities rises (Gamber and Seliski, 2019). However, those magnitude of those consequences is relatively modest in the context of the overall US economy. More of concern, observers worry that if those lending to the US government develop long-term worries about significant inflation risk or the value of the US dollar, that could lead to an abrupt increase in interest rates and trigger a fiscal crisis.

Nonetheless, in the decades before the pandemic, despite sometimes alarming long-term projections of federal borrowing, interest rates were on an overall downward trajectory. The recent episode has highlighted that interest rates on Treasury securities are determined by many factors in addition to the extent of US borrowing. Despite a run-up in the debt as a share of GDP from 79 percent in fiscal year 2019 to an estimated 103 percent in 2021, the yield on 10-year Treasury securities fell from 1.8 percent in the fourth quarter of 2019 to 1.3 percent in the third quarter of 2021. Over the next decade, debt as a share of GDP is projected to rise only modestly under current law. And, notably, that baseline includes roughly a doubling of the 10-year rate. So, an increase in interest rates is not, on the face of it, a risk to that debt trajectory;

an increase in rates is already reflected in that trajectory. In sum, the fiscal trajectory is not an urgent challenge that policymakers need to take on in this legislative effort.

Beyond the next decade, debt as a share of GDP is indeed projected to rise — with rising interest costs and rising spending on major health care programs coupled with relatively flat revenues as a share of GDP. However, this reconciliation package — even if the estimates end up showing it would modestly increase the cumulative deficit over the next decade — would not meaningfully worsen those challenges. To take on the long-term fiscal challenges, over the next decade policymakers should enact significant increases in tax revenues and reform mandatory spending programs.

The long-term economic effects

An essential aspect of a federal budget is raising revenue, and it is virtually impossible to raise revenue without creating some negative incentives to work or to invest. The tax provisions that raise revenue that are were put forward by the House Ways and Means Committee would raise substantial revenue and have only modest negative effects on incentives.

Because the policies would undo some of the changes enacted as part of the 2017 tax act, it is instructive to consider how those prior changes were estimated to affect the economy. CBO, as well as a broad consensus of other groups, estimated that the 2017 tax act boosted the level of projected economic output in the longer term by less than 1 percent, with essentially no effect on the long-term growth rate. More specifically, CBO estimated that positive incentive effects on spending on nonresidential fixed investment raised the level of GDP after several years by less than one-half percent (CBO 2018).Economists are currently debating whether effects on investment following the enactment of the 2017 tax act were smaller than projected (Gale and Haldeman 2021; Gravelle and Marples 2019; Kopp et al. 2019). One reason for that debate — and why it won't ever be definitively settled — is that the projected effects were themselves small relative to the size of the US economy. As a result, it is difficult to disentangle what happened to investment from the tax act or from the many other effects and economic developments.

Similarly, consider how the 2017 tax act cut effective marginal tax rates on labor income — averaged among all workers in the US — by a little over 2 percentage points at its peak. That was estimated to increase average hours supplied by the workforce by about a quarter of a percent. The House Ways and Means Committee proposal includes a similarly sized increase in the effective marginal tax rates on labor income — but only for a small portion of the labor force comprised of the highest income people. If that increase in tax rates were enacted, the aggregate effect on labor supply would be small enough that we likely could not separately identify it.

Nonetheless, the increase in effective marginal tax rates for the highest income earners is not the only aspect of the reconciliation package that would dampen incentives to work. To some degree, people work as many hours as they do because they are financially desperate, or because they fear financial hardship owing to such events as losing a job or suffering from a health event. Although the vast majority of people who benefit from the social insurance system work for pay (for example, well over 90 percent of families receiving the Child Tax Credit [Goldin and Michelmore 2020]), a lessening of those factors could reduce hours worked per week. To put such effects in context, policymakers should focus on what a policy's primary goal is: providing insurance, improving well-being, increasing labor force participation and hours worked per week, or raising revenue.

While the revenue raisers in the reconciliation package would have muted negative effects on incentives to work and invest, other policies would increase the incentives to work and invest. For example, improving access to high-quality and affordable child care and ensuring that workers have access to paid family leave would lower the cost of working among parents of young children and thus increase their supply of labor. It would also, over the longer term, improve the earning potential of those children who benefit. As another example, expanding the EITC would increase labor force participation. In addition, with a larger and more productive workforce, firms would have greater incentives to invest in the US and expand the capital stock.

Conclusion

Although I have focused on the fiscal effects and the aggregate economic effects of the policies under consideration, those should not be the only — and perhaps not even the primary — points of consideration. The tax provisions being proposed, and

indeed many of the policies being proposed, would improve well-being and ensure that our prosperity is more widely shared. GDP estimates and net deficit effects attract attention because they are numbers with seemingly a lot of precision. And numbers have power. However, I urge policymakers to step back from those estimates and consider whether the policies they are debating would move us closer to the kind of society we want to live in.

About the Author:

Wendy Edelberg is the director of The Hamilton Project and a senior fellow in Economic Studies at the Brookings Institution. Edelberg joined Brookings in 2020, after more than fifteen years in the public sector. She is also a Principal at WestExec Advisors. Most recently, she was Chief Economist at the Congressional Budget Office. Prior to working at CBO, Edelberg was the executive director of the Financial Crisis Inquiry Commission, which released its report on the causes of the financial crisis in January 2011. Previously, she worked on issues related to macroeconomics, housing, and consumer spending at the President's Council of Economic Advisers during two administrations. Before that, she worked on those same issues at the Federal Reserve Board.

Edelberg is a macroeconomist whose research has spanned a wide range of topics, from household spending and saving decisions, to the economic effects of fiscal policy, to systemic risks in the financial system. In addition, at CBO and the Federal Reserve Board, she worked on forecasting the macroeconomy. Edelberg received a Ph.D. in economics from the University of Chicago, an M.B.A. from the University of Chicago, and a B.A. from Columbia University.

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A Path To Economic Prosperity:

By Jason J. Fichtner and Shai Akabas

Bipartisan Policy Center

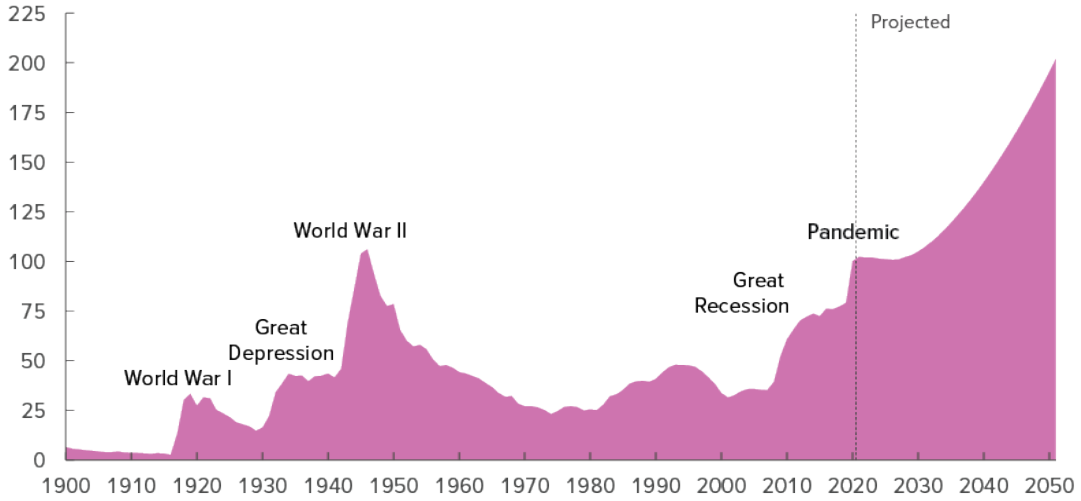
"With debt held by the public relative to the size of the economy now higher than at any point since World War II and only projected to climb further, it is paramount that policymakers across the political spectrum recognize their responsibility to secure a sustainable economic future for the next generation."

Over the years, the United States has moved from a nation of creditors to a nation of debtors; from a nation of savers to a nation of consumers. Recent events have made this reality abundantly clear. The federal government quickly responded to the economic fallout from COVID-19 by funneling trillions of dollars into Americans' bank accounts. Although this financial relief made the personal savings rate jump, it also exposed the reality that pre-pandemic, more than 40% of households said they would struggle to afford an unexpected $400 expense.[1] Tens of millions of households were living paycheck to paycheck, with little or nothing saved up.

Meanwhile, the $6 trillion pandemic response authorized by Congress accelerated another worrying trend: The national debt is soaring to unprecedented levels. Our annual shortfall, or dissavings, is captured by the federal deficit, which totaled $2.8 trillion in fiscal year 2021.

The Bipartisan Policy Center (BPC) has long been concerned with the trajectory of our public debt. In 2010, BPC convened a Debt Reduction Task Force of 19 former elected officials, private stakeholders, and experts — since then, their consensus final report has guided our work of encouraging fiscal responsibility. With debt held by the public relative to the size of the economy now higher than at any point since World War II and only projected to climb further, it is paramount that policymakers across the political spectrum recognize their responsibility to secure a sustainable economic future for the next generation.

Federal Debt Held by the Public, Percentage of GDP, 1900 to 2051



Source: Congressional Budget Office, 2021.

The Challenge of Rising Public Debt

Policymakers struggle with reining in red ink. Even during recent periods of economic growth, the federal government ran large and growing budget deficits, near $1 trillion per year. Now, the federal debt will only continue climbing as mandatory spending and interest payments on the debt grow faster than revenues. At the current rate, the Congressional Budget Office (CBO) estimates that our debt could be double the size of the U.S. economy within 30 years.[2]

With interest rates on U.S. debt near historic lows, some suggest that it is an ideal time for the government to borrow more money. This view is misguided for several reasons. First, it ignores the real potential that interest rates will increase, subjecting the federal government to higher annual interest payments. In 2021, the U.S. spent $413 billion on interest payments alone.[3] At today's debt levels, each 1 percentage point rise in the interest rate would increase annual interest spending by approximately $225 billion.[4]

This untroubled view also assumes that if and when interest rates do rise, policymakers will quickly compromise on the difficult choices necessary to restore fiscal order. Such an assumption runs counter to all existing evidence from recent U.S. history, where for example, trust funds for several major programs have remained starkly out of balance for years with no timely action by Congress in sight. Likewise, it overlooks the fact that the more palatable and equitable ways to address our debt burden involve gradual changes, rather than abrupt adjustments to tax or benefit programs. Implementing these reforms soon will provide adequate time to phase them in and avoid unnecessary economic and financial disruption.

Further, focusing only on the current low interest rate environment not only ignores the potential for a future interest rate shock, but also glosses over the fact that our nation's greatest fiscal problems lie ahead. Interest spending is on track to become the largest federal program by 2045.[5] Health care cost growth has been relatively muted over the past few years, but the ongoing retirement of baby boomers will continue to put more pressure on Social Security and Medicare finances; the return to more "normal" economic times after the pandemic subsides and the Federal Reserve winds down its bond-buying policies will likely bring higher interest payments as rates return closer to historical averages. Higher interest payments owed on the national debt will eventually force the government to make difficult fiscal tradeoffs, impacting

every American household: Spending on other national priorities could decrease as it is relatively deprioritized against meeting our interest obligations, jeopardizing the very programs and services that millions of Americans — and especially vulnerable populations — depend on to sustain their livelihoods.

Such a scenario would pose great risk to the economy, as well as the nation's global reputation, for years to come. Our country's ability to lead on the global stage is determined, in part, by our economic competitiveness. Competitiveness demands that a nation's producers contend within a global marketplace, and doing so successfully depends on an ability to employ its economic resources productively. While some debt-financed spending can be conducive to economic growth, high levels of debt can undermine competitiveness, particularly if sovereign debt becomes so large that servicing it redirects resources away from productive activity.

This crowding-out effect can impact not only federal spending but also private investment, as deficit financing borrows from and consumes capital that would otherwise be used by the private sector and the public to invest. The subsequent decrease in private investment would have spillover effects into the labor market, as employees ultimately bear the cost, through depressed wages and lower productivity, disincentivizing their participation in the labor force and contributing to a contraction of economic growth.

Directly related and perhaps most concerning — especially in the wake of the COVID-19 pandemic — is that the growing federal debt could handcuff our ability to combat the next national or global emergency. Our capacity to respond effectively both at home and abroad could be severely inhibited by our incapacity to responsibly finance the nation's needs. Ultimately, our high and rising debt burden risks exacerbating recessions or even triggering a financial crisis, as it could erode confidence in the fiscal position of the U.S. and deter lawmakers from using deficit financing as a prudent expansionary fiscal tool.[6]

The Path Forward

As we consider solutions, it is important to acknowledge that fiscal responsibility is far from the only goal of economic policy. Among other challenges, the pandemic has accentuated and exacerbated many longstanding issues of income inequality and

uneven economic opportunity that need to be addressed. The U.S. is thus at a crucial juncture to improve financial security and close equity gaps. Doing so with bipartisan support ensures that policies are sustained by their principles, not their politics.

At the height of the pandemic, emergency programs established by the federal government provided an instant financial buffer that helped reduce poverty by 21%.[7] But beneath the macroeconomic success of expansionary fiscal policies that cradled the economy with enhanced unemployment benefits, expanded tax credits, rental assistance, and direct stimulus checks to households, among others, existed microeconomic inequities in the very systems designed to help those most in need. For example, people of color who filed for unemployment insurance saw their claims approved at much lower rates than white workers; households were more likely to experience delayed or missed stimulus checks if they had family incomes below 100% of the federal poverty level or if they were Black or Hispanic, and particularly if they were Hispanic and in families with noncitizens. [8,9]
Such examples highlight the stark disconnect between the intent of federal government support and its outcomes. This not only disproportionately impacts the welfare of vulnerable populations but undermines confidence in the government's ability to meet its basic objective to protect its citizens. Bipartisan solutions are therefore needed to correct socioeconomic imbalances and to ensure that government programs and services create, and not crowd out, economic opportunity for Americans.

Given the size of our nation's debt, any new investments or expansions in this space — and other critical areas like climate change and national security — should be paid for.10 To achieve this, Congress must enact structural reforms that reduce the growth in spending on our federal entitlement programs, update our federal tax code, and modernize social welfare programs to better promote personal savings and wealth creation and incentivize labor market participation.

Attacking the ever-unpopular waste, fraud, and abuse in government programs will not be enough. The only way to get our fiscal house in order is for federal policymakers to weigh competing priorities and make tangible yet difficult choices among them. A new fiscal agenda structured in a prudent way that induces strong economic growth, increases revenues, and protects low- and middle-income Americans is what will bring stability to the long-term budget outlook.

Conclusion

The nation faces a key challenge in providing economic opportunity for every American. While we cannot turn our back on the needed investments the country requires today, we also cannot ignore our $29 trillion (and growing) gross debt. We are on a dangerous path, spending far more than we raise in revenues. At some point, the fiscal dam will break. Over the past 15 years, BPC has found that securing early wins helps build momentum for bipartisan action in various policy areas. We firmly believe that a new fiscal order is needed — one that reflects the important priorities of both political parties and simultaneously tackles equity, competitiveness, investment, and fiscal responsibility. Moreover, such an agenda must be accomplished through achievable changes to the structures in place today.

The U.S. fiscal ship is large and takes some time — both politically and economically — to turn. However, the future health of the economy and the financial wellbeing of Americans will be damaged if we do not act.

Notes

[1] Board of Governors of the Federal Reserve, "Report on the Economic Well-Being of U.S. Households in 2020 - May 2021," May 2021.

[2] Congressional Budget Office, "The 2021 Long Term Budget Outlook," March 2021.

[3] Congressional Budget Office, "Monthly Budget Review: September 2021," October 8, 2021.

[4] Committee for a Responsible Budget, "How High Are Federal Interest Payments?" March 10, 2021.

[5] Congressional Budget Office, "The 2021 Long Term Budget Outlook," March 2021.

[6] Ibid.

[7] Jeehoon Han, Bruce Meyer, and James Sullivan, "Income and Poverty in the COVID-19 Pandemic," American Enterprise Institute, June 22, 2020.

[8] Ben Gitis, "Survey Points to Potential Racial Disparities in Approval Rates for Unemployment Insurance Claims," Bipartisan Policy Center, July 30, 2020.

[9] Janet Holtzblatt and Michael Karpman, "Who Did Not Get the Economic Impact Payments by Mid-to-Late May, and Why?" Urban Institute, July 2020.

[10] Luci Manning, "Reconciliation Must Adhere to Guiding Principles," Bipartisan Policy Center, October 18, 2021.

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The Economic and Fiscal Road Ahead:

By William Gale,
Brookings Institution

*"The most precious asset the nation has is its people.
But we are leaving far too many behind"*

In 2019, I wrote that the nation faced two intertwined problems on the fiscal front (Gale 2019). First, projections of rising long-term debt threatened to reduce the growth of GDP and living standards. Second, tax and spending programs were designed poorly. Government spending left too many holes in the safety net and was too oriented toward consumption. Likewise, our tax system could be fairer and more efficient and could produce more revenue. The solution was to bring down the debt by implementing structural tax reforms that raise revenue and reducing the growth rate of current entitlement spending while also investing heavily in both public infrastructure and human capital, broadly defined.

Now, the situation has changed and the relative importance of different components of the solution has changed as well.

The spread of the novel coronavirus (COVID-19) led to economy-wide shutdowns in March 2020. In response, policymakers have implemented several pieces of sweeping legislation designed to provide relief measures to cushion the economic and public health impact of the pandemic and stimulus policies to help the economy recover. These measures, combined with widespread public health measures, have helped revive the economy and protect many households from the worst of the economic crisis (Sheiner et al. 2021).

But there is much more to be done. Although GDP recovered to pre-pandemic levels by June 2021, it has not returned to the pre-COVID growth path. Unemployment remains higher than before the pandemic and remains elevated for Black men and women. And the spread of COVID has revealed or unleashed a number of additional problems. Differences in exposure to the virus and access to health care have made the public health effects of the pandemic far worse for low-income Americans and people of color. Economic inequities have cost lives and opportunities. The pandemic exacerbated trends in income and wealth inequality and made more salient and urgent several related issues that have been simmering for a long time, including holes in the safety net, health care inadequacies, and the need for racial equity. At the same time, it moved the "Overton Window" on expectations for what policy can do. Extensive interventions became more acceptable, allowing policymakers to take immediate and substantial action against the pandemic and its economic fallout.

Where does that leave us? How should policy makers think about the situation going forward? The most precious asset the nation has is its people. But we are leaving far too many behind. Economic growth is a prerequisite for raising incomes, but the patterns in the last several decades history show that aggregate growth alone does not ensure that Americans at all income levels have a reasonable chance to improve their standards of living.

To make Americans more productive and expand opportunity, we need more public investment — in education, health, childcare, nutrition, public infrastructure, and scientific research. Investing more in children should be a high national priority, for both equity and efficiency reasons. Children are not responsible for the obstacles to advancement that they face, and they are the future of the country. There is now significant evidence that providing struggling individuals and families with cash, food, health care, childcare, education, jobs, and appropriate incentives help the beneficiaries and pay off for the economy as a whole over time. Savings from better health outcomes, increased productivity, and lower crime rates more than offset costs of smart investments in people. One study estimated that for every dollar spent on eliminating child poverty, the country would save over seven dollars by reducing the costs associated with child poverty (McLaughlin and Rank 2018). Expanding social programs can also improve health outcomes, increase financial security, and reduce inequality (see Finkelstein, Hendren, and Luttmer 2015; Brevoort, Grodzicki, and Hackmann 2017; East et al. 2021; and Miller, Johnson, and Wherry 2021).

Recent legislation has begun to move in this direction. The American Rescue Plan expanded the Child Tax Credit to $3,600 annually for children under 6 and $3,000 for children between 6 and 17 and made the credit fully refundable. This expansion will, astonishingly, reduce the child poverty rate by almost half while it is in effect, but it applies only in 2021.

The House Build Back Better reconciliation proposal would continue these expansions through 2025 and would make progress in investing in people and reducing inequality. It would aid needy individuals and families, support and incentivize education, and encourage infrastructure investment and a shift towards more climate-friendly energy policy. Congress should enact that bill or a very close cousin (and eliminate the debt limit).

There is much more that could be done, however. While the current proposal takes important steps in improving public investment, it is significantly less than we can and should invest in reducing poverty, achieving climate goals, and improving education and training. To capitalize on these opportunities, we should provide significantly higher spending to invest in people, strengthen social insurance, increase opportunity, and reduce inequality. In Gale (2019), I proposed an increase of 1 percent of GDP to be spent on social programs.

Can we afford it? Good question; my answer is yes for three reasons. First, a better question would be whether we can afford *not* to invest. The costs of failing to make those investments would be significant. The nation has increasingly split into a fractured society with groups separated by disparities in income, education, and opportunity. This growing divide is both inequitable and inefficient and has been exacerbated by the pandemic. Investing in people and infrastructure would benefit the economy so much that we cannot choose not to.

Second, the economy is more important than the budget. Saving the budget but hurting the economy would be a pyrrhic victory. In addition, although the COVID-related packages added $4.2 trillion (about 19 percent of 2021 GDP) to the federal debt and federal debt is expected to continue to rise for the next several decades, the "debt problem" actually seems less urgent today than in the past. Low current and projected interest rates provide "elbow room" and time that can be used to pursue important public initiatives.

Of course, low current interest rates do not eliminate concerns around the long-term fiscal outlook — and there are many concerns. The full-employment deficit is already high and is expected to remain at elevated levels in the absence of policy changes; in the past, it only spiked on a temporary basis. Social Security and health care outlays will continue to rise as the population ages. The budget is largely on autopilot, with mandatory programs accounting for an increasing share of federal outlays over time. The political system seems broken, with political leaders unable to muster the co-operation and trust — or even the interest — that bipartisan fiscal agreements require. The Fed has indicated interest in unwinding its vast portfolio of federal debt.

Because of these considerations, even those economists who argue most strongly for the salience of current low interest rates for various policy choices (Blanchard 2019a, 2019b; Elmendorf 2019; Elmendorf and Sheiner 2017; Furman and Summers 2019, 2020; Auerbach and Gale 2021) do not dismiss the long-term fiscal situation. If interest rates rise in line with historical determinants but remain below the growth rate, interest payments will nevertheless rise steadily to over 6 percent of the economy — as large as Social Security outlays — and the debt will double to more than 200 percent of GDP in 30 years (Gale 2019). By combining concern for the long-term fiscal outlook with recognition that low current interest rates give more flexibility in the budget, the government can both maintain a sustainable level of debt and address the urgent needs of people and the economy.

Third, the way to avoid catastrophic debt and still take advantage of current low rates is to raise taxes. There is plenty of scope to boost revenues and help distribute tax burdens more fairly both within and across generations. While adhering to the Biden Administration's pledge not to tax people with income below $400,000 is inadvisable, the government could raise significant revenues in a highly progressive manner without hurting aggregate economic activity by reducing tax evasion, putting a price on carbon, and taxing capital income more comprehensively — particularly taxing capital gains at death, eliminating subsidies for unincorporated businesses, and providing a smaller estate tax exemption. The OECD and the US are also taking the lead on raising revenues from solidifying the corporate tax base. With low interest rates, capital income taxes have smaller negative effects (Auerbach and Gale 2021).

Policymakers face a significantly more challenging set of circumstances and expectations than existed before COVID. But there are policies available that could address many societal needs and improve standards of living for broad swaths of the population. The critical constraint is not a lack of ideas but the dysfunctionality of the current political environment.

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William Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy and a senior fellow in the Economic Studies program at the Brookings Institution. His research focuses on tax policy, fiscal policy, pensions, and saving behavior. He is co-director of the Tax Policy Center, a joint venture of the Brookings Institution and the Urban Institute. He is also director of the Retirement Security Project.

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His research has been published in several scholarly journals, including the American Economic Review, Journal of Political Economy, and Quarterly Journal of Economics. In 2007, a paper he co-authored was awarded the TIAA-CREF Paul A. Samuelson Award Certificate of Excellence.

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A Valuation Approach to Government Balance Sheet:

By Zhengyang Jiang,
Kellogg School

"If we regard the U.S. government as a firm, this firm is in a sticky situation in which the valuation of its cash flows is below the amount of its outstanding liability."

Some Simple Fiscal Arithmetic

There are nearly 30 trillion dollars' worth of outstanding U.S. government debt. Who pays for it when it expires? Let us approach this problem from a practical perspective. The payment has to come from two sources. First, the government can raise tax revenue in excess of spending needs, and use the excess revenue to pay back the debt. Second, the government can issue new debt to investors, and use the proceeds to retire the expiring debt. In practice, governments use a mixture of both approaches. Sometimes, when the spending needs overwhelm the tax revenue the government is willing to or able to collect, the government needs to issue even more debt to both fund the spending and repay the expiring debt.

The first approach gives rise to simple fiscal arithmetic: once we know the government is able to gather enough tax revenue when the current debt expires, we know the debt is safe. No more questions asked. The second approach, on the other hand, requires a bit more thoughts. The debtholders need to look further into the future, and ask how the new debt that is issued to pay back the current debt is going to be paid back. If the government cannot honor the new debt in the more distant future, debt market investors will refuse to finance its issuance in the first place, which in turn questions the government's ability to pay back the current debt outstanding. This inquiry into the ever more distant future only stops when we find a horizon by which the government is able to collect enough fiscal cash flows to honor the outstanding debt. In other words, to evaluate the government's fiscal situation today, we need to examine the fiscal cash flows today, next year, and potentially all the way into the distant future. What this also means is that the value of government debt is ultimately backed by government tax revenue in excess of spending, although the government has limited ability to delay the timing at which these cash flows are collected.

How do we aggregate these fiscal cash flows across time? This is where a financial valuation method can be useful. In corporate finance, we face a very similar question: how to determine the valuation of a firm based on the aggregation of its current and future cash flows? While the specific methods differ based on the situation, the basic idea is always to (i) assess the amount of expected cash flows, and (ii) assign appropriate discount rates for these future cash flows based on their risk characteristics. We can apply a very similar valuation method to evaluating the government balance sheet.

The Public Debt Valuation Gap

To implement this valuation method, we need to know (i) the amount of future tax revenue and government spending we expect in the future and (ii) the levels of the appropriate discount rates that we assign to these fiscal cash flows. To figure out the expected cash flows, the data since WWII suggest that the U.S. on average has similar levels of tax revenue and government spending as fractions of the GDP. If we zoom into the past 15 years, government spending surpassed tax revenue by a large margin. Feeling optimistic, let us assume the U.S. fiscal cash flows will revert to the historical norm over time, exhibiting a similar magnitude in the average tax revenue and government spending.

To figure out the appropriate discount rates, we note that the standard interest rates are not the right ones to use. The financial valuation method holds that riskier cash flows need to be discounted at higher rates, and the riskiness is primarily determined by how the cash flows comove with the business cycles. Specifically, cash flows are risky if they tend to be higher during economic expansions and lower during economic recessions. The stock market is a good example. As corporate revenues decline dramatically during economic recessions and financial crises, investors regard stocks as risky assets and therefore require a high compensation to hold them. This is why stocks tend to have higher returns than risk-free bonds over a long enough time period, and why, for the purpose of valuation, corporate cash flows are discounted at much higher rates than the standard interest rates. The data since WWII suggest that the U.S. tax revenue also exhibits a cyclical behavior, which warrants high discount rates on the tax revenue. In comparison, the U.S. government spending exhibits the opposite cyclicality: it tends to increase during recessions, as unemployment benefits and other welfare payments tend to be higher in the downturns. The government may also decide to spend more on public projects to stimulate the economy. This means that the U.S. government spending is a stream of counter-cyclical cash flows, and therefore deserves lower discount rates.

To put everything together, we need to compute the difference between the expected tax revenue and government spending, discounted at their appropriate discount rates. As these cash flows have similar levels on average, while the tax revenue has higher discount rates than the government spending, then, the valuation of the tax cash flows should be lower than that of the spending cash flows. Noting that the fiscal resources

that pay off the debt comprise tax revenue minus government spending, we therefore conclude that they have a negative valuation. In other words, if we regard the U.S. government as a firm, this firm is in a sticky situation in which the valuation of its cash flows is below the amount of its outstanding liability. We call this gap between the valuation of government cash flows and the market value of outstanding government debt as the *U.S. public debt valuation gap.*

This valuation gap is a robust feature of the U.S. fiscal situation, as my coauthors and I confirm using more advanced valuation methods. It signifies a clash of different perspectives when we apply financial valuation methods designed for individual stock and bond securities to evaluating the aggregate U.S. government balance sheet. That said, we emphasize that this valuation gap does not necessarily show up in all governments' balance sheets. The valuation of fiscal cash flows can be consistent with the market value of government debt when the government either has higher average tax rate than spending rate, or different business cycle cyclicality and hence discount rates for the tax and spending processes.

What Does It Mean and Where Do We Go From Here?

Our analysis suggests this valuation gap of U.S. public debt has persisted for many decades, but will it continue to exist? To evaluate its sustainability, we need to move to the realm of economic intuitions from that of financial calculations. There are multiple views that are potentially useful for thinking about this valuation gap.

First, bubbles are always a candidate explanation when the fundamentals of an asset deviates from its valuation. In the context of government debt, this view has an additional appeal: cash is a bubble, since it's essentially a zero-interest debt that the government owes but never needs to pay back. Is it possible that the government debt is similarly special? Indeed, some economists have argued that government debt shares money-like properties because it provides valuable insurance to the risks that investors face. That said, the amount of cash is small relative to that of outstanding government debt, and there is evidence that the bubble-based premium vanishes as more money-like assets are supplied. Therefore, bubbles are unlikely to provide unconditional support for a large amount of government debt.

Moreover, this bubble-like property may have roots in the special status of the U.S. government debt as the reserve asset in the international monetary system, which enables the valuation of the U.S. government debt to escape its economic fundamentals. Consistent with this hypothesis, foreign investors have been playing a major role in financing the U.S. government debt. In particular, they purchase U.S. government debt precisely when the economy is in recession and the debt is expensive, and as a result earn low financial returns from their debt holdings. This flight to U.S. government debt finances the government spending during recessions, which helps support the debt valuation. However, alarmingly, this pattern seems to have reversed in the past decade, as foreign investors became net sellers of the U.S. government debt. So, once again, we have to be very careful when we extrapolate the bubble-based view to analyze a future scenario with even more debt outstanding.

Second, a dramatic tax hike and/or spending cut that raises government cash flows and pays down the government debt remains a possibility. Right now the U.S. government debt-to-GDP ratio is about 100%, and the U.S. tax-to-GDP ratio is about 25%. If the U.S. government raises tax revenue by 10% of the GDP, then, the outstanding debt can be paid down in 10 years. So, it is possible that investors are willing to purchase government debt because they expect a decade of extreme fiscal austerity. In practice, however, a higher tax rate may hurt the economy and reduce the tax base, which requires a much more drastic increase in the tax rate to raise the required revenue. Moreover, paying off the debtholders at the expense of taxpayers is politically unpopular, making this a challenging option.

Third, it is possible investors have been consistently mispricing the government debt. This is a variant of the second explanation, because the investors in this case wrongly expect fiscal consolidation that is unlikely to happen. This may be a more likely case, as my coauthors and I find evidence that fiscal forecasts have been overly optimistic in the past decades. If so, caution is needed when extrapolating to the future, since investors may eventually wake up to the fiscal facts and realize the mispricing. Such an event can greatly destabilize the Treasury market and the overall financial system, and the day of reckoning may come precisely when fiscal stability is needed the most.

In summary, we have discussed a couple of ways to interpret the observed valuation gap in the government debt. Despite the obvious differences in these views, they all suggest certain degrees of fragility in the valuation of the government debt. These

views do not support the claim that we can comfortably accumulate debt at the current pace, without facing repercussions from the financial markets.

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Debt Matters:

By Dana M. Peterson
and Lori Esposito Murray,
The Conference Board

"The answer to how to address the multitude of challenges and their disproportionate impact is to pay for it — set priorities and ensure there is revenue to meet those priorities — not through smoke and mirrors or budget gimmicks."

The public debt is growing unsustainably and, despite the growing refrains to the contrary — *Debt Matters*. The nation's fiscal health was deteriorating even before COVID-19 struck. In 2019, the year before the pandemic, the deficit was $984 billion. In 2020, with the cost of the response to the pandemic, it ballooned to $3.1 trillion. And by the end of 2020, the debt held by the public (not counting money that one part of the government owes to another part of the government) exceeded $21 trillion. At 100.1 percent of gross domestic product, that debt is slightly more than the size of the economy (GDP). The debt is on schedule to reach its highest level ever, the 106 percent of GDP of 1946 (the end of World War II), within the next 10 years. It would more than quadruple the subsequent minimum level of the debt burden at 23.2 percent at the end of fiscal year 1974. And that was before the government spent $5.3 trillion to fight COVID-19 and its catastrophic economic and public health effects.

Although the pandemic clearly added to the debt, it is by no means its primary driver. And even more importantly the nation has no looming economic boom to ease the burden, as it did immediately after WWII. Instead, with slowing labor-force growth from the retirement of the baby-boom generation, population aging generally, and trends to lower birth rates, long-term growth fundamentals are unfavorable. Indeed, by 2031 there will only be 3 working aged persons (ages 15-64) per retired person (ages 65 and over) and by 2041 just 2.8. These ratios are compared to 3.7 in 2011 and 5.4 in 2001. At the same time, the share of the total population aged 65 and over will rise from 17 percent presently to 22 percent a decade from now. Meanwhile, birth rates have already fallen from just above 2 children per woman a decade ago to roughly 1.8. This rate is expected to be unchanged for the foreseeable future. Also, the Congressional Budget Office anticipates that roughly 1.1 million immigrants may enter the US per year over the next 10 years, based upon historical trends. Still this pace is not expected to offset the shrinking natural increase (i.e., births minus deaths) in the population: with 1.0 million net births per year by 2030, compared to 1.4 million births currently.

The daunting demographic outlook points to a shrinking number of persons to support the tax base required for funding expanding annual federal budget deficits and mounting public debt. The primary drivers of the growth of debt, prior to the pandemic was the spending on Medicare and Social Security, as well as net interest on the public debt. These pressures on the US fiscal situation are expected to intensify as more baby-boomers retire, interest rates rise, and Social Security and Medicare l

exhaust their trust funds in 12 and four years, respectively.

Having the debt grow so much faster than the economy out of which it must be serviced is obviously unsustainable. The nation never in years generally characterized by peace experienced the debt explosion that we have had since 1981. High debt levels that are rapidly rising as a percentage of GDP slows the growth of economic output and recovery. A growing debt burden could undermine confidence in the U.S. dollar, challenging the US global leadership role and making it more costly to finance public and private activity in international markets. Debt must be serviced. The larger the debt, the larger the amount of debt service and the greater the risk to the lender — a large proportion of whom are foreign lenders — that adverse developments will render that debt-service obligation difficult or impossible to meet. Servicing the debt is already one of the biggest trouble spots in the national budget with net interest projected to be the fastest growing part of the budget. This year, servicing the debt will be nearly 9 percent of the federal budget — approximately $300 billion.

Presently, participants in the Fed's FOMC and many economists anticipate some increase in interest rates over the next three years. Indeed, the federal funds rate — the basis for most interest rates in the US — might start rising towards the end of 2022 or early 2023. These expectations are embedded in the FOMC's Summary of Economic Projections, as well as in surveys of market and academic economists. Those interest rises are accompanied by slower real GDP growth compared to 2021's near 6 percent annual pace. Still, expectations are for economic growth at or above 2.5 percent over the medium-term — the pace of growth that prevailed just before the pandemic struck the US.

However, if interest rates were to rise sooner or more rapidly — whether because of expectations of more rapid inflation, concerns about the ability or willingness of the federal government to meet its debt-servicing obligations, merely a return to rates that prevailed before the financial crisis, or any other reason — the huge debt will give those interest rates even greater leverage on the budget bottom line, ultimately risking a vicious cycle of rising deficits, debt, and debt-service costs. And if the economy were to grow more rapidly — the usually cited solution for our deficit-and-debt woes — that faster growth would directly lead to higher interest rates, which would erode the expected budget benefits from a stronger economy.

The American economy is still the largest and most important and innovative economy in the world and the American economy still regularly outperforms its peers in Europe and Japan. Through its reserve currency status, the dollar receives extra legitimacy in the eyes of domestic users, currency traders, and participants in international transactions and the fiscal weakness of the rest of the world has kept our fiscal problems from looking less troubling to the rest of the world. Nonetheless — as a recent IMF study warns about running large deficits--fiscal-policy crises that push interest rates sharply higher tend to come out of nowhere, even when rates are low--market expectations can turn quickly and abruptly. Though increased spending on infrastructure, education, social welfare, and the environment may be wise, and rising deficits may make sense some of the time, we really cannot borrow ceaselessly without risking real harm.

While the Administration and Congress should not focus on eliminating the deficit to the exclusion of solving other problems, Americans can and should expect leaders who can address both. This is especially true today. The global pandemic has had catastrophic impacts on the economy and the lives and livelihoods of all Americans. It has shown a spotlight on many needs in this country including access to healthcare, education, job training for an advanced economy, childcare, eldercare, climate, and infrastructure, to just name a few. But it has also lifted the veil on the disproportionate vulnerability of the underserved and underprivileged.

The answer to how to address the multitude of challenges and their disproportionate impact is to pay for it — set priorities and ensure there is revenue to meet those priorities — not through smoke and mirrors or budget gimmicks. This not only protects the nation from a fiscal crisis, it also makes the economy stronger and American lives better and more prosperous. The Congressional Budget office and Penn Wharton Budget Model both have estimated that paying for new investments over time will do more to boost wages and income than borrowing for investments. And that is how fiscal policy can directly confront and conquer the core challenges facing the nation and ensure that capitalism continues to provide prosperity and, most importantly, an equal opportunity for all Americans to share in that prosperity.

Also, it is important to emphasize that spending more and more money on a problem is not always the best solution. Reforms of current programs or expanded programs to ensure resources flow to meet the objectives of those programs, is at times as

important if not more important, whether it be education, health care, job training, or the roll-out of infrastructure modernization programs.

Recommendations

The nation needs a renewed awareness of the budget problem, and to apply that awareness in a serious and thorough legislative process. The next steps must include:

Make fiscal responsibility a priority.

It need not be the only consideration, but it should get its due along with the others addressed in the budget. Deficits and debt matter, and if uncontrolled they will eclipse the other benefits of the Administration's infrastructure policies. The net savings necessary to make our debt grow more slowly than our economy (instead of vice-versa) and ultimately reverse the growth of the ratio of the debt to the GDP, should be tallied alongside the cost of new spending in budget bills.

No gimmicks.

Be realistic and honest about costs instead of, for example, minimizing them by building in unrealistic end-dates for programs. Similarly, identify real budget savings, not just unspecified future spending cuts.

Set priorities.

Like any household or business, the nation must address its needs and wants in the context of a sustainable budget. Not everything will fit, so leaders will have to transparently prioritize. While the challenges are many, key among them is job training and upskilling to get Americans back to work with skills that can meet the demands of the advanced post-pandemic economy. Also, any increase in program funding should be accompanied by reforms of the delivery of those programs to make sure that regulations are streamlined, and programs are, in fact, achieving their objectives.

Leverage the private sector for collaboration.

The bi-partisan infrastructure bill serves an example that seeks to leverage more than previously, private-public collaboration in this much needed modernization effort.

Similar leverage of the private sector is applicable to many areas of public policy including healthcare, childcare, job training, among others and cannot only help regarding budget constraints but also can improve efficiency and effectiveness of government funding.

Don't just raise taxes, reform them.

Simply raising tax rates only increases the burden on those who already pay. Instead, use the opportunity to simplify and clean up the tax code. Tax neutrality also yields the most efficient allocation of both capital and labor, and therefore the strongest and most sustainable economic growth. A budget bill that pushes tax yields to the limit now while worsening the deficit problem will ensure a future budget crisis. Rising interest rates and inflation would quickly crowd out both public and private investment, and growth — wiping away economic benefits. And we would have used up all the tools (the budget savings) that could solve the problem.

Deal with the pandemic debt.

Handling the COVID-19 pandemic has cost the nation roughly $6.5 trillion in relief spending plus the recession's impact on the budget. Instead of simply tossing that debt into the existing ocean of red ink, we could create a separate federal financing authority and establish dedicated revenue sources to service and retire the debt.

Forbid the use of reconciliation to increase the deficit.

Reconciliation was created to help Congress take painful steps to reduce the deficit. The budget law should be amended to make explicit that reconciliation may be invoked for deficit reduction only. After undertaking such a reform in the budget rules, Congress should renew its commitment to the budget process, including timely budget resolutions that, as they were originally intended, call attention to the nation's fiscal situation, and plot a course to stability. Also, Congress should undertake a serious annual appropriations process, with 12 separate bills that allow true oversight of the federal agencies, enacted on time, without a long series of continuing resolutions until well after the beginning of the fiscal year.

Empanel a new fiscal responsibility and reform commission.

Sometimes Congress needs a helping hand in the form of experts beyond the reach of politics who can point them in the right policy direction.

While flawed, capitalism is the greatest economic system in history. It has incented massive innovation, created wealth, raised standards of living, and lifted more people out of poverty around the world than any economic system in history. For capitalism to continue to deliver on its promise of providing equal opportunity to share in prosperity, we need to address today's outsized challenges by starting with our fiscal foundation. It will require tough choices and discipline, but that is the essence of leadership. If our elected officials rise to the moment, they can set the country on a path to a holistic recovery and sustain capitalism to benefit of generations to come.

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Long-Term Fiscal Balance and the Social Security Trust Fund:

By James Poterba,
National Bureau of Economic Research

"The projected shortfall of future Social Security revenues is the result of political action, not the absence of policy options for addressing this issue. "

U.S. fiscal policy entered uncharted waters in responding to the COVID-19 pandemic. In July 2021, the Congressional Budget Office (CBO) projected that the federal deficit would be 13.4 percent of GDP for fiscal year 2021. This followed on the 14.9 percent deficit in 2020, a peacetime record. This bold fiscal response to the pandemic, the largest among industrial nations, helped to avoid what could have been a much sharper-than-observed decline in economic activity during the COVID-19 crisis. It also raised the debt-to-GDP ratio by nearly 30 percent in just two years. From a value of roughly 35 percent in 2007, on the eve of the global financial crisis, this ratio reached a value of just over 100 percent at the end of fiscal year 2021.

Most of the rise in the debt-to-GDP ratio in the last decade and a half can be attributed to the fiscal response to two extraordinary events: the financial crisis and the COVID-19 pandemic. The current structure of U.S. fiscal policy, however, suggests that further debt accumulation will be the norm, and that rather than returning to its historical average level, the debt-to-GDP ratio is likely to increase substantially in coming decades. The latest long-term budget projections from the CBO (2021) show federal revenues falling short of expenditures over the 30 year forecast horizon. The projection based on current law remaining in force suggests an average annual deficit of 9.7 percent of GDP between 2031 and 2051, a dramatic shift relative to the average of 3.3 percent over the last fifty years. The result is a projected debt-to-GDP ratio of 202 percent in 2051, nearly double the level of 2021. The CBO (2020) projected that to stabilize the debt-to-GDP ratio at 100 percent in 2050, the U.S. would need to raise revenues by 2.9 percent of GDP in every year beginning in 2025, or reduce spending by an analogous amount. If the fiscal adjustment did not begin until 2030, the required annual adjustment would be larger: 3.6 percent of GDP per year.

The rapid rise in the debt-to-GDP ratio in the last fifteen years has coincided with a period of falling real interest rates. This is an important consideration when evaluating debt burdens. Current forecasts by market participants, reflected in long-term interest rates, suggest that low rates may be a persistent feature of the U.S. and the global economy. Furman and Summers (2020) point out that the federal government's net interest payments as a share of GDP have declined in the last 15 years, from 1.7 percent in FY 2006 to 1.4 percent in FY 2021. CBO (2021) reports that the average value over the last fifty years was 2 percent. Going forward, however, the CBO forecasts a substantial increase: 2.4 percent in 2031, 5.2 percent in 2041, and 8.6

percent in 2051. The CBO baseline calls for rising average interest rates on the federal debt. That average interest rate was 4.9 percent in 2007, is 1.4 percent in 2021, and is projected to exceed 3 percent in 2034 and 4 percent in 2043.

There is great uncertainty in any forecast that spans a period of three decades. There are a number of risks, however, that make higher interest payments as a share of GDP, and higher debt-to-GDP ratios, a serious possibility. These include a rise in real interest rates from current levels and the enactment of new federal spending programs that are only partially funded. The U.S. political system has struggled in the last two decades to reign in deficit spending, even during times of robust economic growth. Low real interest rates today reduce the burden of higher debt-to-GDP ratios, but they do not provide a warrant for a fiscal policy that involves projections continuing and accelerating increases in both debt levels and budget deficits in future decades.

The standard macroeconomic analysis of government borrowing suggests that higher debt-to-GDP ratios translate into higher real interest rates, greater interest payments to foreign investors, reduced business investment, and lower consumer investment in durable goods. Gamber and Seliski (2019), after reviewing past research, conclude that a 1 percentage point increase in the debt-to-GDP ratio is associated with between a 2 and 3 basis point increase in the interest rate on 10-year Treasury bonds.

Social Security, more precisely Old Age Survivors and Disability Insurance (OASDI), is an important federal program that, like the overall fiscal balance, displays an imbalance between future outlays and future taxes. This program plays a critical role in the retirement security of many U.S. retirees. Social Security outlays are projected to increase in coming decades, in part reflecting the retirement of the Baby Boom cohort, which is taking place now and will continue for roughly another decade. OASDI is funded by payroll taxes, and the OASDI trust fund has accumulated an excess of taxes over outlays during past decades, when the ratio of workers to program beneficiaries was larger than it is today or is projected to be in the future. In 1980 and 2000, there were more than three workers for every retiree drawing benefits from Social Security. As a result of the decline in U.S. birth rates that began decades ago, that ratio fell to 2.7 in 2020 and is projected to decline further to 2.2 by 2040. The Social Security Administration (2021) currently forecasts that the OASDI trust fund will be exhausted in 2034. At that point, absent any other fiscal action, the payroll tax income accruing to the OASDI system will cover only 78 percent of program costs. In the highly unlikely

case that current policy remains unchanged and Congress does not take action to bring revenues and outlays into closer balance, the payments received by beneficiaries in 2035 would fall to 78 percent of their level in 2034, before trust fund exhaustion. Even though most analysts see the risk of across-the-board benefit cuts as very low, the uncertainty created by the prospect of such cuts, and the challenges of addressing the long-term Social Security deficit when there are large non-Social Security deficits, impose costs on current and potential beneficiaries.

Many Americans who have not yet retired doubt that they will receive Social Security benefits at current levels. Parker, Morin, and Horowitz (2019) report that 42 percent of those who are not retired expect their Social Security benefits to fall below current levels, and another 42 percent do not expect to receive any benefits at all. Among those over 50, 48 percent expect reduced benefits, and 28 percent expect to receive nothing. More than half of those between the ages of 30 and 49 do not expect to receive any benefits. These survey results suggest that a lack of understanding of Social Security's financing contributes to undue pessimism. Even when the Social Security trust fund hits zero, the system will still be able to pay benefits, although only at a fraction of the currently-promised levels.

The projected shortfall of future Social Security revenues is the result of political action, not the absence of policy options for addressing this issue. There are a number of actions that could restore balance to the Social Security program. As with the fiscal policy adjustments that would stabilize the debt-to GDP ratio, however, the size of the disruption for workers and beneficiaries rises as the window between policy change and trust fund exhaustion narrows. The set of potential policy actions includes raising the payroll tax rate on workers, which is currently 12.4 percent, equally divided between employers and employees; increasing the limit on individual earnings that are subject to the payroll tax, currently $142,800, either by selecting a higher cap or by allowing an exempt range and re-introducing the tax on earnings above another level; increasing the normal retirement age, currently on a trajectory to reach 67 in 2027; drawing on general federal revenues to fund any shortfall in the OASDI program; and reducing benefit payouts.

Benefit reductions, whether in the form of a higher retirement age or a cut in the monthly payouts to some beneficiaries, are politically challenging. Some proposals for benefit reduction limit the cutbacks to subsets of the beneficiary population, or phase

in the cutbacks gradually. For example, replacing the current full inflation indexation of benefits with partial indexation would disproportionately affect the oldest beneficiaries, for whom the cumulation of modest annual reductions in real benefits would be the greatest. Changing the benefit formula by making the payout structure more progressive would reduce the payouts of those with high lifetime earnings relative to those at lower levels. A combination of policy actions, for example higher payroll taxes and increased benefit progressivity, could spread the burden of restoring sustainability across many current or future beneficiaries.

For a significant subset of the elderly population, Social Security income represents a large share of total income. This underscores the importance of placing the OASDI program on a firm fiscal foundation. Dushi and Trenkamp (2021) use both survey and administrative data to study the share of household income, defined inclusive of withdrawals from defined contribution retirement accounts, that comes from Social Security. In 2015, for men over the age of 65, 37.3 percent received more than half, 18.6 percent received more than three quarters, and 12.1 percent received more than 90 percent of their income from Social Security. The analogous figures for women are 42.0, 23.3, and 15.1 percent. Across-the-board cutbacks in benefits, the default action if trust fund exhaustion is not addressed, would place heavy burdens on the subset of beneficiaries who are highly reliant on this program for retirement support.

There is growing evidence that the uncertainty surrounding the future financing of Social Security exacts a toll on current workers. In a survey of individuals aged 25 to 59, Luttmer and Samwick (2018) found that the average respondent was prepared to forego six percent of their expected benefits under current law if they could eliminate the uncertainty about the program's future. On average, respondents expected to receive only 59 percent of their current-law benefits. Shoven, Slavov, and Watson (2021) calculate how much a current 45-year-old worker would be prepared to pay to know, with fifteen years of lead time, that benefits were going to be cut, or the retirement age was going to be raised. Illustrating their findings by focusing on women who are currently in the labor force, they conclude that a low-income worker would be prepared to pay just over $5000, a middle-income worker about $12,000, and a high-income worker nearly $15,000 to resolve this uncertainty.

The case of Social Security, where taking action sooner rather than later will reduce uncertainty for beneficiaries and for workers and permit smaller adjustments to taxes

and to program parameters to achieve long-term sustainability, carries lessons for the broader U.S. fiscal picture. The higher the debt-to-GDP ratio when a program of fiscal adjustment begins, the larger the changes in taxes or spending must be to achieve a given long-term target. Even if real interest rates remain low for decades to come, and the debt capacity of the U.S. is substantially higher than in past eras, there will come a point at which the path of rising budget deficits like that associated with current forecasts is not sustainable. Recognizing that and taking steps to bring long-term spending and revenue streams into closer alignment sooner rather than later, potentially by considering reforms that could be enacted well before they take effect, will reduce the total cost of making such adjustments.

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James Poterba is the Mitsui Professor of Economics at MIT and the President and Chief Executive Officer of the National Bureau of Economic Research, a non-profit research organization with more than 1600 affiliated economists. He has served as President of the Eastern Economic Association and the National Tax Association, and as vice president of the American Economic Association. He is a member of the National Academy of Sciences and a Fellow of the American Academy of Arts and Sciences, the American Finance Association, the British Academy, and the Econometric Society.

Dr. Poterba's research focuses on how taxation affects the economic decisions of households and firms, particularly those involving saving and portfolio behavior. He is a trustee of the College Retirement Equity Fund (CREF) and the TIAA-CREF mutual funds. He holds an undergraduate degree from Harvard College and a D. Phil. in Economics from Oxford University, where he was a Marshall Scholar.

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Fix Social Security and Medicare to Protect Other Priorities:

By Brian Riedl,
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"Fixing the budget requires addressing the root cause of the long-term deficits: escalating Social Security and Medicare shortfalls."

The United States' government is in the early stages of the largest long-term government borrowing spree in modern history. And yet rather than responsibly rein in this debt surge, many lawmakers are trying to dig the hole even deeper. Now, the situation has changed and the relative importance of different components of the solution has changed as well.

Washington ran $6 trillion in deficits during the past two years of pandemic and recession, and is projected to run $12 trillion in baseline deficits over the next decade. Rather than pare back this borrowing, President Biden and Congressional Democrats are hoping to enact $6 trillion in additional debt. This latest round consists of the $1.9 trillion "stimulus" bill enacted in March, a $550 billion infrastructure bill that passed the Senate, the president's discretionary spending surge that would increase the baseline by $1 trillion over the decade, and a reconciliation bill that can borrow up to $1.75 trillion (plus likely $1 trillion more to extend new policies with fake expiration dates, such as the expanded child tax credit). All told, the national debt held by the public would rise from just under $17 trillion before the pandemic, to $42 trillion a decade from now.

Debt doves point out that the current federal debt burden of 100 percent of GDP has not severely damaged the economy or brought escalating interest rates. However, this does not prove that unlimited debt no longer matters, or that lawmakers need not set priorities and make trade-offs to keep its debt under control. Indeed, many of those who assert that Congress can afford to enact $6 trillion in new borrowing are failing to account for a historic debt surge that is already coming as part of the long-term budget baseline.

The numbers are staggering. Over the next three decades, the federal government is projected by the Congressional Budget Office (CBO) to run budget deficits of $112 trillion, pushing the national debt past 200 percent of GDP. By the end of this period, the annual budget deficits are projected to reach 13.3 percent of GDP (the current equivalent of $3 trillion). At that point, interest on the national debt would be the largest federal expenditure, consuming nearly half of all tax revenues. And rather than level off at this higher level, the debt is projected to continue accelerating rapidly in the years thereafter.

This is the CBO's *rosy* scenario that assumes the scheduled expiration of all recent stimulus spending, as well as much of the 2017 tax cuts. It assumes no additional spending expansions or tax relief, and no more major recessions, wars, or natural disasters. Perhaps most importantly, CBO projections assume that government-paid interest rates will forever remain below the levels that prevailed as recently as 2008, even as rising debt and baby boomer retirements would tend to increase interest rates. If interest rates exceed the CBO baseline assumptions by even one percentage point, it would add $30 trillion in interest costs over three decades. In that instance, the debt would rise to 243 percent of GDP, and interest costs would consume two-thirds of all tax revenues.

This debt path is unsustainable. The only other major economy to see its central government debt approach 200 percent of GDP is Japan. That nation has been able to finance its debt in part with stratospheric corporate savings rates (corporate retained earnings have reached 89 percent of GDP), as well as a central government that also holds a large number of financial assets. Yet Japan has still endured three decades of sluggish economic growth, and has moved to begin stabilizing its debt. By contrast, the U.S. has lower savings rates to finance its debt, and its large and escalating deficits are projected to eventually push its debt well past Japanese levels.

It is unclear who will finance Washington's mammoth projected deficits. Japan and China have collectively purchased just one percent of the $11.7 trillion borrowed by Washington over the past decade, and do not have the capacity or motivation to finance a significant portion of America's coming $112 trillion debt deluge. Nor has the Federal Reserve shown interest in financing such a massive amount of borrowing — in part because doing so would risk hyperinflation. That leaves domestic lenders such as retirement funds, mutual funds, other federal agencies, state and local governments, and savings bonds to finance the vast majority of this enormous debt. But as the debt continues escalating rapidly, financial markets may begin to question the federal government's long-term sustainability, and demand higher interest rates to compensate for this risk. This would in turn drive interest costs and the national debt further upward in a vicious cycle. The end result could be higher interest rates across the economy, spiraling federal budget interest costs, less fiscal space, and a potential economic crisis. CBO estimates that the next three decades of debt growth will shave $6,300 off of the growth of per-capita GNP by 2050.

Fiscal crises build up quietly over decades, and then occur suddenly. Because the resulting fiscal consolidations are so brutal — with the combination of steep tax increases, painful spending cuts, and steep inflation — the best solution to a fiscal crisis is to avoid one in the first place. That means phasing-in modestly-uncomfortable fiscal reforms now in order to avoid drastically-painful consolidations later.

Fixing the budget requires addressing the root cause of the long-term deficits: escalating Social Security and Medicare shortfalls. There is a popular myth that Social Security and Medicare are funded entirely by payroll taxes and senior Medicare premiums. In reality, those sources are insufficient to finance all annual benefits — and the Treasury must transfer general revenues into the Social Security and Medicare systems to plug the gap. As the 74 million baby boomers retire and health costs also soar, these general revenue transfer costs will grow rapidly. Over the next three decades, CBO data show that Social Security will require $21 trillion in general revenues, and Medicare will require $46 trillion. Much of these costs will be financed by government borrowing, which itself will be responsible for $45 trillion in projected interest costs. Altogether, these Social Security and Medicare shortfalls (and the resulting interest expenses) will cost the Treasury $112 trillion over three decades — which matches the entire projected 30-year federal budget deficit. In other words, if not for these Social Security and Medicare bailouts, the 30-year federal budget would be balanced.

In fact, by 2051, the Social Security and Medicare systems (and their interest costs) are projected to run an annual deficit of 15 percent of GDP. The rest of the federal budget will run a surplus of 1.6 percent of GDP, according to CBO data.

Thus, the bulk of federal taxes and borrowing will go towards subsidizing senior citizens. Social Security and Medicare were created in eras in which most senior citizens endured low incomes and few savings. By contrast, today's seniors are the wealthiest cohort in the wealthiest country in its wealthiest era. While some seniors still struggle, average household retiree income grew more than twice as fast as working age-salaries between 1979 and 2016 (the latest data available). And the wealthiest 10- to 20 percent of seniors are doing remarkably well. Four million retiree households hold more than $1 million in investable assets — of which 1.1 million households hold more than $3.5 million. Relatedly, CBO data show that 6.3 million elderly Americans live in households that currently earn annual market incomes of at least $87,200 for

someone living alone or $123,400 for a two-person household — including 2 million seniors in households earning more than $174,100 (one-person) or $246,200 (two-person) annually. To the extent that such high post-retirement incomes derive from annuities or 401(k)-style investments, they suggest investment portfolios that are well into the millions of dollars.

Even the middle-earning seniors retiring today will, on average, receive Medicare benefits three times as large as their lifetime contributions into the system, and come out ahead in Social Security (using net present values).

As Washington buries itself in a mountain of debt to subsidize (often wealthy) seniors, vulnerable populations will inevitably be squeezed. Those CBO 30-year projections cited above show unsustainable deficits even as total spending on non-senior federal programs declines as a share of the economy. That means fewer resources available for low-income health care, income support programs, education, and social services. These trade-offs have already emerged. During the 2011 debt limit showdown, Congress enacted $2.1 trillion in budget savings that disproportionately hit discretionary spending while shielding Social Security and the vast majority of Medicare benefits. In fact, the five major deficit-reduction laws enacted since 1985 have overwhelmingly focused their budget savings on discretionary and small entitlement programs, despite Social Security and Medicare costs continuing to drive the underlying deficit problem.

Vulnerable families will also be harmed by the economic drag caused by soaring debt, including slower economic growth as well as potentially-higher interest rates and inflation. If a fiscal crisis ever occurs, fragile families may suffer irreparable harm. Ultimately, a strong economy — with sustainable federal finances — is needed to raise incomes and reduce poverty.

Some progressives assert that taxing the rich can finance full Social Security and Medicare benefits, and generous benefits for vulnerable populations. In reality, even combining every progressive "tax-the-rich" proposal across income, corporate, payroll, estate, and wealth taxes would fail to close the long-term Social Security and Medicare gap, much less finance any new proposed social spending. The inescapable reality is that America must choose where to focus its government resources. It cannot eventually allocate 21 percent of GDP to benefits for senior citizens (the

CBO-projected figure for 2051 when including resulting interest costs), finance even a modest military, and still have significant budgetary resources remaining for social spending, education, and low-income families. To govern is to choose.

But there is a responsible path forward. If Congress begins gradually-phasing in budget reforms over the next few years, it can stabilize the debt closer to the current level of 100 percent of GDP, and preserve much more long-term fiscal space for other priorities. This path also requires forgoing major new federal initiatives today, because even those "paid for" with new taxes may use up the limited number of plausible tax increases that are otherwise needed to bring current federal programs into long-term sustainability. Washington should also aim to protect itself from possible rising interest rates in the future by locking in more of its federal debt with today's lower long-term interest rates.

From there, my long-term budget blueprint begins with lawmakers enacting health reforms that address inefficiencies, and thus save tax dollars without compromising care. This includes bringing a premium support system to Medicare that allows seniors the option of shopping around for a private plan using a generous federal subsidy that would cover the cost of the average plan (minus the standard enrollee premium). Next, lawmakers should begin trimming Social Security and Medicare benefits for wealthy seniors. The Social Security eligibility age could rise faster, and wealthy seniors could face higher Medicare premiums and slower growth of Social Security benefits. Lower-income seniors should be protected from these reforms. Some new taxes will also likely be necessary, such as modest upper-income tax rate increases, a slight increase in the payroll tax rate, and a gradual halving of the tax exclusion for employer-provided health care. These reforms could keep Social Security and Medicare from driving unsustainable deficits, and ultimately maintain fiscal space for other priorities.

Enacting these reforms will not be easy. The public seems unconcerned with rising deficits, and Social Security and Medicare reforms remain quite unpopular. Yet global warming politics has shown that young people understand the idea of modestly sacrificing now to avoid a terrible outcome later — even if we aren't yet feeling all the negative effects. Perhaps they can convince their parents that modest Social Security and Medicare reforms now can protect the long-term economy and so many other important priorities

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Riedl's writings have appeared in dozens of publications, including the *New York Times*, *Wall Street Journal*, *Washington Post*, *Los Angeles Times*, and *National Review*; and he has appeared as a guest on all major news networks. Riedl holds a bachelor's degree in economics and political science from the University of Wisconsin and a master's degree in public affairs from Princeton University.

Policy Makers Should Act Now to Address the Long-Term Fiscal Imbalance:

By Sita Slavov,
George Mason University

"Failing to address the fiscal imbalance imposes burdens on future generations that many would consider unfair."

In 2020, according to figures from the Congressional Budget Office (CBO), the federal debt skyrocketed to more than 100 percent of annual GDP for the first time since World War II, up from 79.2 percent in 2019. The debt buildup was driven by spending increases related to the COVID-19 pandemic — increases that were generally viewed as justified during an unprecedented emergency.

Even prior to the pandemic, however, the debt had been rising steadily. In 2019, at the peak of the business cycle, the federal deficit amounted to almost a trillion dollars. As the pandemic recedes, CBO projects that the debt-to-GDP ratio will level off temporarily but then continue its relentless growth, reaching more than 200 percent of annual GDP by 2051.

The projected growth in debt reflects a large and growing imbalance between future spending and taxes under current law, largely fueled by the aging of the population and the growth of healthcare costs. This fiscal imbalance has real costs. It reduces private investment and long-term economic growth, and it increases the risk of a financial crisis. Failing to address the fiscal imbalance imposes burdens on future generations that many would consider unfair.

The choices required to achieve a sustainable fiscal outlook will be difficult for people of all political stripes. In this essay, I argue that a sensible political compromise should include reducing Social Security and Medicare benefits for those with higher lifetime incomes, combined with tax increases designed to minimize harm to the economy. Those tax increases might include the adoption of a value added tax or a carbon tax, which are more growth-friendly, but less progressive, than income tax increases.

I. Why the Federal Fiscal Imbalance Is a Problem

As my American Enterprise Institute (AEI) colleague Alan Viard and I argued in a recent article in Tax Notes Federal, government borrowing involves a tradeoff: it benefits current generations at the expense of future ones. While there is no formula to determine the appropriate level of government debt, economists and other scholars across the political spectrum have expressed concern about the large and growing fiscal imbalance under current law.

Government borrowing competes with private sector borrowing, crowding out private investment and lowering economic growth. To be sure, foreign investors' willingness to hold U.S. government debt somewhat mitigates the consequences for the domestic economy. However, the projected ballooning of debt over the coming decades, combined with a lack of political will to address it, could undermine investors' confidence, precipitating a financial crisis.

Moreover, when policy makers delay difficult decisions about how to address the fiscal imbalance, they impose a real cost on young and middle-aged people who are trying to plan their futures. I recently co-authored two studies showing that policy makers' indecision on Social Security reform can impose a significant burden on young and middle-aged people trying to plan for retirement. As John B. Shoven, John G. Watson, and I argued in one of these studies, the direct cost of Social Security reform cannot be avoided; the only real decision is how to distribute that cost across groups and generations. However, the cost of government indecision can be avoided by committing to a plan for dealing with the program's financial shortfall. Yet policy makers from both parties have failed to do so.

Since 2011, real interest rates (interest rates net of inflation) on government bonds have been consistently below 1 percent. While these low interest rates make government debt less costly and may increase the sustainable level of debt, most economists agree that low interest rates do not allow policy makers to avoid hard choices. The Chicago Booth School's Initiative on Global Markets regularly surveys an ideologically diverse panel of economists on policy questions. In 2016, that panel was asked to indicate their degree of agreement with the following statement: "Long run fiscal sustainability in the US will require some combination of cuts in currently promised Medicare, Medicaid and Social Security benefits and/or tax increases that include higher taxes on households with incomes below $250,000." A clear majority either strongly agreed or agreed, while only 3 percent disagreed.

II. How to Cut Social Security and Medicare in a Progressive Way

Some polls suggest that there may be significant public support for reducing Social Security and Medicare benefits for those with higher incomes, a reform that is sometimes referred to as "means testing." Numerous proposals along these lines have been discussed. Making benefits more progressive would be a sensible way to reduce

cost growth while protecting those with lower incomes. However, measures to increase progressivity must be carefully designed to avoid unintended consequences.

Both Social Security and Medicare already include features that increase the progressivity of benefits. First, an individual's monthly Social Security benefits are based on the average of their top 35 years of earnings, indexed to economy-wide wage growth. This average can be thought of as a proxy for earnings over a person's lifetime. A progressive benefit formula is applied to this average. The formula results in monthly benefits that increase with lifetime earnings; however, lower-earning individuals receive larger monthly benefits as a fraction of their lifetime earnings than higher-earning individuals. Second, once an individual qualifies for Medicare, benefits are not tied to any measure of lifetime earnings, which means that benefits are a much larger share of earnings for lower-income individuals than for higher-income individuals. Third, beneficiaries with high annual incomes must pay income tax on a portion of their Social Security benefits. Finally, Medicare beneficiaries with higher annual incomes pay premium surcharges.

As Alan Viard and I argued in a series of two articles in Tax Notes Federal, additional progressivity in Social Security and Medicare should be based on lifetime earnings rather than annual income. Means testing that is based on beneficiaries' annual income punishes work at older ages and saving for retirement. It also incentivizes individuals to manipulate their income by altering the timing of retirement account withdrawals and Social Security claiming. Lifetime earnings measures are less sensitive to the timing of earnings and therefore less vulnerable to manipulation. Moreover, lifetime earnings are more indicative of a person's ability to pay and need for assistance because fluctuations in annual earnings are smoothed out.

Additional progressivity in Social Security could be accomplished by flattening the existing relationship between monthly benefits and the lifetime income measure on which they are based. In the Tax Notes Federal series, we advocated going even further and paying a flat monthly benefit. Other observers have made similar proposals, including my AEI colleague Andrew Biggs, and researchers at the Progressive Policy Institute. Such a policy could avoid disincentivizing long careers by tying the flat benefit to career length, as the Progressive Policy Institute's plan does.

III. How to Raise Taxes with Less Damage to the Economy

Any sensible compromise to address the fiscal gap must include revenue increases in addition to benefit cuts. However, revenue should be increased in a way that limits the distortion to economic incentives even if it reduces the progressivity of the tax system. Options along these lines include a value-added tax, which creates less distortion by taxing consumption rather than saving, or a carbon tax, which incentivizes people to consider the social cost of carbon emissions.

The U.S. tax system is highly progressive compared to the tax systems of other high-income countries, in the sense that the highest-income individuals bear a large share of the tax burden. However, our fiscal system does less redistribution than the fiscal systems of many other countries. This apparent paradox arises because the amount of redistribution induced by a tax system depends on its size as well as its progressivity. Scaling up a progressive tax system causes a direct reduction in inequality. Moreover, larger tax systems — whether they are progressive or regressive — indirectly reduce inequality by generating more revenue to fund transfer programs, which tend to be highly progressive. Because the U.S. tax system is relatively small, it induces less redistribution despite its greater progressivity.

To see this point more clearly, consider a nation that collects only $1 in tax revenue, imposing the entire burden on the highest-income individual, and redistributes the revenue to the lowest-income individual. Such a tax system is highly progressive, as the highest-income individual bears 100 percent of the tax burden. However, it barely reduces income inequality because only one dollar is transferred. Similarly, the U.S. tax system is highly progressive, but its small size limits the amount of redistribution it induces.

In another series of articles in Tax Notes Federal, Alan Viard and I provided a detailed discussion of these issues and argued that the small, progressive tax system in the U.S. is a result of political compromise between Democrats, who emphasize tax progressivity, and Republicans, who emphasize low taxes. The Democrats' focus on progressivity is driven by concerns about how much income the highest earners receive compared to the middle class, as well as whether high-income individuals are paying their "fair share" of taxes. The Republicans' focus on tax cuts comes from their concerns about the size of government.

However, this compromise is not conducive to addressing the long-run fiscal imbalance. As Viard and I argued, a larger and less progressive tax system may be a better compromise between the two parties. All else equal, highly progressive taxes do more to distort economic incentives, so using them to raise large amounts of revenue would do significant harm to the economy. In contrast, the value added tax systems found in other high-income countries do less economic damage; because they tax consumption, they do not distort the incentive to save and invest the way an income tax does. Similarly, a carbon tax corrects a market failure by incentivizing people to consider the impact of their choices on climate change. These taxes are less progressive, or even regressive. But a larger tax system could put transfer programs on a sustainable path (which supports Democrats' emphasis on distribution), while a less progressive tax system would do less to distort incentives (which supports Republicans' emphasis on economic growth). Under such a compromise, policy makers on both sides of the aisle would need to drop their commitment not to raise taxes on the middle class.

IV. Conclusion

In recent years, teenage environmental activist Greta Thunberg has drawn attention to the cost to future generations of delaying action on climate change, arguing, "The grown-ups have failed us." A similar logic applies to the failure to address the long-term fiscal imbalance, which also imposes costs and risks on future generations. Policy makers should act now to tackle this growing problem. A sensible compromise would include cutting social insurance benefits for higher-income individuals and increasing revenue in a growth friendly, but less progressive, way.

Policy makers should not shy away from such a compromise, thinking that the public would never get on board with it. In 2012, my Schar School colleague Siona Listokin, and her co-author Yair Listokin,administered a survey to a nationally representative population, asking respondents to select a set of policy options that reduce the deficit by a particular target. In contrast with most polls, this one forced its respondents to grapple with difficult economic tradeoffs. The results suggest that — when presented with these tradeoffs — people are generally supportive of reforms that broaden the tax base and make the tax system more growth friendly. For example, majorities supported introducing a national sales tax, introducing a carbon tax, and eliminating

the deductions for home mortgage interest and state and local income taxes.

In their presentation of the results, the authors note the importance of making tradeoffs explicit: "People may hate the idea of a carbon tax in the abstract, but when faced with the alternatives for raising revenue, more than half of them support it." Policy makers should similarly be honest about tradeoffs, offering leadership that steers the nation towards making these difficult choices sooner rather than later.

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Fiscal Space for Future Generations:

By Marc Sumerlin,
Evenflow Macro, LLC.

"The greatest gift today's leaders can give to future generations is the fiscal room to solve their own problems."

The foundation of the US economic and monetary system is trust. Over 60 percent of central bank foreign exchange reserves are held in dollars and nearly 90 percent of foreign exchange transactions involve the dollar. The high and enduring global demand for dollars allows the US Treasury to borrow at much lower costs, which masks the underlying fiscal imbalance.

There have been six global reserve currencies in the last six hundred years, with Great Britain's pound achieving the longest reign at 129 years. The dollar, having served as the reserve currency for 77 years, is getting long in the tooth. The challenge to the dollar is coming not from another country but from a new class of digital and crypto currencies. Digital currencies are a superior technology, allowing instant decentralized clearing and embedded digital contracts. According to the digital asset analysis firm Messari, the global transaction volume of stablecoins reached $1.7 trillion in the second quarter of 2021 compared with just $25 billion in the first quarter of 2019. Superior technologies always win out so the chance that the dollar is displaced as the reserve currency is high. The winner of the new game could be a regulated stablecoin or a central bank digital currency. The winner might be dollar based, preserving its reserve currency status. Or, if US policymakers fail to keep pace with the technological shift, the winner will be based on a foreign currency.

Crypto currencies have been around for a decade. Why are they surging now? The reason is that the aggressive fiscal and monetary action during the pandemic sparked a fear of inflation and currency devaluation. People who bought crypto currency based on the fear of inflation have been aptly awarded. Now that inflation is here, the case for alternatives to fiat currencies is getting stronger. Crypto exchanges are offering savings accounts with three to seven percent interest rates while dollar accounts offer zero percent. With five percent inflation, savings in a traditional US dollar checking account would lose half its value in 13 years. The threat to the old dollar is real.

Inflation has spiked in the US because fiscal and monetary policy were connected in a powerful way. During the great financial crisis, the Federal Reserve bought bonds with newly created reserves. These special reserves could only be held by banks and never circulated in the general population. This time around the central bank bought Treasury bonds and the Treasury sent checks to the general population. In other words, the new money is circulating in the economy. As a result, demand has spiked, and with the supply side of the economy constrained, prices have to rise to balance supply and demand.

Inflation may wane as demand cools and supply rebounds; or it may persist if continued fiscal expansion keeps demand inflated. The longer inflation lasts, the more likely it becomes embedded into contracts and expectations, allowing it to achieve self-reinforcing momentum. Sustained inflation would pull interest rates higher and expose the underlying rot in the US fiscal situation. If net interest payments as a share of GDP were to rise at the same time the Federal Reserve was fighting inflation, the US would have no choice but to sharply contract fiscal spending.

The main point is that equilibriums change. Low interest rates today do not tell us where interest rates will be in ten years. Charles Goodhart of the London School of Economics argues in a recent book that we are on the cusp of a great demographic reversal that will revive inflation and raise interest rates. To Goodhart, ageing societies, waning inequality, and increasing inflation mean that the world will look very different in a decade's time. It is completely irresponsible to run US economic policy today on the assumption that the global interest rate balance will never change.

The pandemic has shown that America has many needs, adding more stress to our fiscal situation as policymakers worked to protect the most vulnerable populations who lost work and income. The explosion in fiscal spending was necessary during the pandemic but cannot become permanently rooted into the budget. We have to return to a thoughtful budget process rather than continuing with a blank-check mentality.

A robust binding budget process ensures that programs compete so that only those with the highest chance of success are funded. A fiscal environment where any program is funded at any level is sure to extract resources from the private sector via higher taxes and result in less private sector job opportunities. US economic policy should strive for a robust private economy and a vigorous public sector. In both spheres, ideas must compete for scarce resources. Discipline is automatic in the private sector, as poor performing companies fail, but is a choice in the public sector.

One of the best uses of resources is crisis prevention and preparedness. I estimate that over $10 trillion of our $29 trillion in national debt is attributable to two events: the global financial crisis and the COVID pandemic. Rigorous monitoring of the subprime housing market or a ready-made plan to confront a disease that spreads by aerosols rather than droplets would have saved the country trillions in economic damage. Preparedness programs are miniscule in size compared to spending on the massive

entitlement programs or the military.

The world is also facing a huge challenge in moving to a decarbonized global economy with the hope of changing the temperature of the planet. Europe has showed that you can move too fast as well as too slow. By eliminating coal and nuclear power, Europe has greatly increased their dependence on Vladimir Putin. In fact, global energy reserves are concentrated in just two countries today: Saudi Arabia and Russia. Neither wind nor solar is a reliable source of energy. The wind stopped blowing in the North Sea this year causing the UK to bid for natural gas. At the one point, the UK was paying the equivalent of $230 per barrel of oil for its gas. A cold winter this year will cause great suffering and remind us that reliable energy is also a policy choice. he world cannot move off carbon without embracing nuclear power. Nuclear power needs to supply at least 20 percent of each electricity grid for it to have the ability to run carbon free without power outages. The good news is that the next generation of nuclear power is here. Sodium fast reactors that use natural or depleted uranium (instead of enriched uranium) dramatically reduce safety and proliferation concerns. This technology was developed with a combination of public and private resources. The world can move off carbon but only with a thoughtful strategy that avoids concentrating power in the hands of autocratic countries. The solution to climate change need not be expensive if high-value solutions are used rather than a scatter shot "all of the above" approach that guarantees wasteful spending.

Despite our long list of challenges, the world is getting better. The last thirty years has brought the greatest reduction in global poverty in history. Technology is offering up the solution to our biggest problems. Governments need to invest more in basic science, technology, and preparedness. A rigorous budget process is essential to making government programs compete so that the best solutions are funded while the private sector is allowed to flourish as well.

We also have an obligation to leave future generations the fiscal space to deal with problems that we cannot envision today. It is the height of arrogance to assert that we know with certainty the greatest problem fifty years in the future. No one would think that the leaders of 1970 should have set all of our fiscal priorities today. Adaptability is the key to survival and the greatest gift today's leaders can give to future generations is the fiscal room to solve their own problems.

About the Author:

Marc Sumerlin is Managing Partner at Evenflow Macro, a global macroeconomic consulting firm he founded in 2013. He is a member of US Treasury's Financial Research Advisory Committee, which is tasked with identifying significant financial risks. From 2003 to 2012, he served as Managing Director and co-founder of the Lindsey Group, during which time he testified before the Congressional Oversight Panel on the origins of the financial crisis; he also traveled extensively to Japan, China, and Europe.

From 2001 to 2002, he served as Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council. In that capacity, he helped President George W. Bush develop and implement his economic agenda. He also worked as an economic policy advisor for the George W. Bush for President campaign, after starting his career at the U.S. Senate Budget Committee.

Sumerlin holds a master's degree in applied economics from Johns Hopkins University and a master's degree in public policy from Duke University, where he was a Senator Jacob Javits Fellow. He graduated magna cum laude from Georgetown University. He serves on the Board of Governors at the Johns Hopkins Wilmer Eye Institute.

Through the Looking Glass: The Reverse World of the Pandemic Economy:

By Diane Swonk,
Grant Thornton

"The Fed is not in the business of monetizing our government's debt but is skating close to the edge, which has upped the risk of a misstep."

Encountering the pandemic made me feel like Alice with her trip through the looking glass. Many of the previously held notions about the economy suddenly worked in reverse. Inflation surged even with factories idled; labor shortages erupted despite millions of jobless. Long-term interest rates plummeted even though federal deficits and debt ballooned. Those shifts were most pronounced in the U.S., which is still protected by the dollar's status as the world's primary reserve currency. Even so, you literally could have knocked me over with a feather if you had told me that the 10-year Treasury bond would flirt with a level of 52 basis points at the same time that deficits soared into the trillions in 2020.

Why did interest rates fall so low, and remain so low? The bond market has been on a four-decade long roll. Inflation and growth have slowed and with that, global bond yields have plummeted. The drop in bond yields below the overall pace of growth has enabled us to service rising deficits and debts, without making tough decisions about spending and taxation. It ushered in a period of a sort of tax and spending bliss, where old rules of thumb disappeared; we were able to finance what we needed with little to no consequences.

There were two major exceptions to the four-decade long bond rally. The first was in February 1994 when Former Federal Reserve Chairman Alan Greenspan raised rates to preempt what turned out to be a nonexistent inflation threat. Inflation was already decelerating on a global scale when he made that decision. The result was the worst bond market rout since the years when Paul Volcker was chairman of the Fed and yields on long-term debt soared from a little above 5% to more than 8% in a year. Hubris in the Fed's ability to forecast inflation prompted the once gradualist, Greenspan, to overshoot.

The second was in May 2013 after former Fed Chairman Ben Bernanke warned that the Fed was close to tapering its purchases of Treasuries and mortgage-backed securities, which began during the 2008-09 financial crisis. Threatening to pull the plug on that support triggered what has become known as the "taper tantrum" and threw emerging markets into turmoil. Brazil, India, Indonesia, Turkey and South Africa were the hardest hit. Back then, Bernanke was adamant that the Fed is not responsible for what happens outside of the United States; we don't hear that from the current Fed. There is no Las Vegas in the global economy; what happens abroad quickly washes up on our shores. (The law of unintended consequences.)

Other missteps occurred but did not have such dire consequences. The Fed realized that efforts to preempt inflation in 2018 went too far and backed off to allow the unemployment rate to dip farther than in the past and, perhaps more importantly, level the playing field for the most marginalized workers. The gap between the unemployment rate for white and Black workers finally narrowed as employers were forced to cast their nets wider and remove their biases when hiring in the later stages of the last expansion.

I bring up those examples because they underscore just how outsize the Fed's role has become in determining what were once considered market rates. The Fed is now the largest single buyer of U.S. Treasury bonds; the Fed balance sheet has ballooned to $8.5 trillion, nearly two-thirds of which is in Treasuries. Just for comparison, the current federal debt outstanding is $28.5 trillion. The Fed is not in the business of monetizing our government's debt but is skating close to the edge, which has upped the risk of a misstep.

The bond market has started to get nervous but most financial market participants remain complacent, believing that 1) the Fed will not repeat the mistakes of the past or make new ones, and 2) that the Fed will be there to bail them out if and when something does go wrong. They could be wrong on both counts.

Inflation has already surged faster and for longer than most within the Fed anticipated. Fed Chairman Jay Powell has pledged that inflation will be transitory, one way or another. Either it will abate on its own, as bottlenecks in the supply chain are resolved, or the Fed will raise rates to curb unwanted inflation. Sounds good in theory. Reality is another story.

Shelter costs are accelerating and likely to continue to do so, even as some bottlenecks are resolved. This, coupled with recent wage gains, suggests that it could take well into 2023 instead of 2022 to get inflation back down to pre-crisis levels. It has been decades since the Fed actually had to chase inflation; it is unclear how financial markets will react to such a shift in strategy.

Add a tapering of the Fed's massive monthly purchases of Treasury bonds and the era of cost-free deficit financing may come to an abrupt end. Most are hoping that event will be manageable, comparing it to other bond market blips, but there is no real

benchmark for the pandemic-induced inflation we are experiencing or how it will play out.

That is not the only problem. Debt across developing markets has ballooned at the same time it has surged across the developed world. Much of that debt is now held on the balance sheets of banks in those developing economies. If a country is forced to default, those losses will quickly morph from a sovereign debt crisis into a full-blown financial crisis. Credit could seize up from internal and external sources, which would compound losses.

The Fed may be running out of ways to contain the damage; its balance sheet is already bloated and its ability to cut rates limited, unless it were to go negative on short-term rates. That would raise a whole new set of challenges. (Understatement.)

Alarm bells rang at the Kansas City Federal Reserve's Jackson Hole Symposium. The fear was that we could be on the precipice of another financial crisis. That would amplify the downside risks to the economy associated with more aggressive 2022 rate hikes.

Does that mean we should abandon efforts to upgrade our infrastructure and back off efforts to deal with the existential threat of climate change? No. We have already kicked the can down the road for too long and done what is easy instead of what is necessary. The losses triggered by extreme weather events are already mounting.

Ultra-low rates now have provided us with a rare window of opportunity to address infrastructure investments. I would issue longer term debt — something much longer term than 10-year Treasury bonds — to finance those investments while the window is still open. That includes investments in addressing climate change, including work to repair the damage already done.

Infrastructure investment has larger, known payoffs in terms of productivity growth over time than spending programs do. Dilapidated roads and bridges are compounding bottlenecks and delivery delays, while extreme weather events are further disrupting supply chains. The Treasury and the Fed are getting increasingly concerned about how climate change could destabilize the financial system and the broader economy.

I would use "pay-fors" — tax hikes and spending cuts — to fund the increases the administration is seeking via budget reconciliation. The White House's wish list includes a broad spectrum of programs that span child tax credits, child care and universal pre-K, parental leave, enhanced Pell grants for college, expansions to Medicare, subsidies to encourage the adoption of cleaner technologies and immigration reform. The $3.5 trillion package intended to narrow inequalities is a virtual kitchen sink.

Why finance infrastructure and pay for the rest via tax hikes or spending cuts elsewhere? Because much of the increase in the administration's budget would expand existing government programs. Those programs are inefficient at the best of times. Add the need to issue direct transfers to individuals to implement many of the proposals and we could unwittingly stoke inflation when it is already running hot.

Separately, the Fed has weighed its options should Congress fail to lift the debt limit, which applies to debt we already owe. Transcripts from an October 2013 call revealed a potential game plan should Congress fail to lift the debt ceiling and default on U.S. debt obligations. Among the options discussed was a move to buy any debt that Congress defaults on, while selling Treasuries from the Fed's bloated balance sheet.

Then Governor Jay Powell argued such measures would be "loathsome" and "repugnant" but would not rule them out. Fed Vice Chair Janet Yellen reluctantly agreed: "I wouldn't say never." The economic Armageddon such a default on our debt would trigger would be even worse.

That is no guarantee about how Fed Chairman Powell and Treasury Secretary Yellen would work together to handle such a crisis today but provides us with a clue. Of course, it would be better for all of us if Congress stopped treating the debt limit as a political piñata, given the enormous risks associated with not raising it, but I am not holding my breath. Imposing a ceiling does nothing to rein in deficits.

Even interventions by the Fed may not be enough to stem more permanent damage to the U.S. economy. The reserve currency status of the U.S. dollar would be most directly affected, which could dramatically raise our borrowing costs.

It is worth noting that the Fed was forced to intervene during the 2011 standoff

over the debt ceiling, which brought us within days of defaulting. The rating agency Standard & Poors downgraded the investment status of Treasury debt, which could have forced banks to hoard cash. Instead, the Fed issued a statement saying that all Treasury debt still qualified as the highest grade for bank capital purposes to prevent a hoarding of cash.

The pandemic pushed us through the looking glass. We discovered that investors were more than willing to absorb the debt needed to deal with the crisis. They were willing to accept negative inflation adjusted returns on that debt rather than risk the larger and more permanent losses associated with contagion. They were responding to a once-in-a century phenomenon. It would be a mistake to assume that investors will be as eager to finance our debts indefinitely, especially if inflation persists. Deficits and debts don't matter until they do; then, it can get ugly.

About the Author:

Diane Swonk is one of the most respected macroeconomists, who maintains a unique perspective on the inner workings of Main Street as well as Wall Street. She is an expert on the economics of the labor market, monetary policy and structural changes that are distinct from economic cycles. Her global network includes economists, industry leaders and geopolitical experts, which amplifies the breadth and reach of her analysis. She advises policy makers at all levels of government, including central bankers. Diane's uniquely accessible approach to macroeconomic shifts has made her a highly sought-after expert quoted by local, national and international newspapers and broadcasters. For her outstanding contributions in the field of economics, Diane has been named a Fellow of the National Association for Business Economics (NABE). She is a member of the Council on Foreign Relations, serves on the Sitting Committee to the Booth School of Business at the University of Chicago and advises the economics department at the University of Michigan. She has testified before Congress to improve the quality of economic data and on the causes and consequences of income inequalities. Diane has won many awards for excellence in forecasting and leadership in economics and the business community. She is deeply involved in nonprofit organizations focused on expanding access to education and increasing the quality and diversity of our country's leadership. She earned her B.A. and M.A. degrees in economics with top honors from the University of Michigan. She received an MBA in finance from the University of Chicago's Booth School of Business, also with top honors.

The Peter G. Peterson Foundation is a non-profit, non-partisan organization that is dedicated to increasing public awareness of the nature and urgency of key fiscal challenges threatening America's future, and to accelerating action on them. To address these challenges successfully, we work to bring Americans together to find and implement sensible, long-term solutions that transcend age, party lines and ideological divides in order to achieve real results.