Project Syndicate

Fixing America's Fiscal Problem

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CAMBRIDGE – With America's elections less than six weeks away, it is time to think seriously about what will be done afterwards to deal with the nation's fiscal mess. Regardless of who wins, addressing the problem can no longer be postponed.

Americans are rightly focused on the "fiscal cliff" looming at the start of 2013, when, under current legislation, virtually all tax rates will rise, sucking more than 3% of GDP out of households and businesses. In addition, automatic cuts in government spending on defense and non-defense programs will subtract nearly another 1% of GDP in 2013 and similar amounts in future years. The Congressional Budget Office warns that falling off the fiscal cliff would push America's economy into a serious recession next year.

And the fiscal cliff is only part of the problem that must be solved. The bigger problem is that the United States has an enormous fiscal deficit – now about 7% of GDP and predicted to grow rapidly in future decades as an aging population and rising health-care costs increase government outlays for the "entitlement programs" that benefit middle-class seniors. Although politicians on both the left and the right recognize that these programs' growth must be slowed to avoid massive deficits or very large tax increases, their growth is unlikely to slow enough to prevent the national debt/GDP ratio from rising.

Fiscal consolidation therefore requires additional revenue as well as slower growth in entitlement spending. The challenge facing US politicians after the election will be to find a politically acceptable way to raise that revenue without undermining incentives and economic growth. The task is made more complex by the large number of legislators who insist that the deficit should be reduced by spending cuts alone.

Although no one can be sure how this complex problem will be solved, here is my best guess: Soon after the election, the US Congress will vote to postpone the fiscal cliff for about six months to allow time to work out an acceptable legislative solution. That solution will involve slowing the growth of Social Security pension benefits for future middle- and upper-income retirees. Mitt Romney, the Republican candidate, has explicitly proposed this, and President Barack Obama indicated support for such an approach back in 2009, before he turned his attention to health care.

The tougher problem will be how to raise revenue. The key will be to focus on the many special features of the tax code that are equivalent to government spending. If I buy a hybrid car, install a solar panel at my home, or upgrade to a more efficient water heater, I get a tax credit. And if I buy a bigger home or just increase the size of my mortgage, I receive a larger deduction that reduces my taxable income, lowering my tax bill. While the government is not giving me money, these special targeted tax breaks are no less "government spending" than they would be if the government sent me a check.

These features are rightly called "tax expenditures," because they describe the government spending that occurs through the tax code. Eliminating or reducing these tax expenditures should therefore be seen as cutting government spending. Although the effect is to raise revenue, that is just an accounting convention. The fundamental economic effect is to reduce government spending.

So the key to raising revenue is to reduce tax expenditures, use some of the resulting revenue to reduce tax rates, and devote the rest to reducing future deficits. Opponents of tax increases should see that, because such revenue-raising is really cutting government spending, it does not imply the adverse incentive effects of raising marginal tax rates.

But even if the intellectual objection to extra revenue can be overcome in this way, the practical political problem is that every large tax expenditure – the home mortgage interest deduction, the exclusion of employer payments for health insurance, etc. – has its fervent defenders.

So here is an idea that might work politically: Let taxpayers keep all of the current tax expenditures, but limit the total amount by which each taxpayer can reduce his or her tax liability in this way.

I have explored the idea of "capping" the benefit that individuals can get as a percentage of their total income (their "adjusted gross income," or AGI in US tax parlance). Applying a 2%-of-AGI cap to the total benefit that an individual can receive from tax expenditures would have a very powerful effect. It would not limit the amount of deductions and exclusions to 2% of AGI, but rather would limit the resulting tax reduction – that is, the tax benefit – that the individual gets by using all these special features. For someone with a 15% marginal tax rate, a 2%-of-AGI cap would limit total deductions and exclusions to about 13% of AGI.

Such a cap would have a significant impact on the fiscal outlook. Even if the cap were applied only to "itemized deductions" and the health-insurance exclusion, it would raise about $250 billion in the first year and about $3 trillion over the first decade.

There are many options in designing such a policy. The cap rate could be higher, or it could start higher and be gradually tightened, or it could vary with an individual's income level. But the economic and political attractiveness of a cap consists in its ability to raise substantial revenue without eliminating specific tax expenditures.

Fixing America's fiscal problem will be as difficult as it is important. But slowing the growth of Social Security benefits and capping total tax expenditures would be a good framework for the coming reform.

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