NAVIGATING NEAR-TERM FISCAL ISSUES

Economic Policy Institute

Josh Bivens, Chief Economist, Economic Policy Institute

Introduction

After two decades of low and falling interest rates and below-target inflation, the post-pandemic recovery in the U.S. economy has shown signs that this period of “secular stagnation” has been (at least temporarily) ended. In the big picture, this is very good news. The two decades of low interest rates and low inflation signaled clearly that aggregate demand was too low relative to the economy’s potential output. This chronic demand shortfall caused great economic damage in those decades, mostly through years of excess unemployment and weak growth of both productivity and real wages.

But while ending this chronic demand shortfall is clearly desirable, it does require more attention be paid to the nation’s fiscal balance. Currently, fiscal deficits are large relative to previous periods that saw similarly low unemployment, inflation remains a bit above the target set by the Federal Reserve, and policy interest rates are well in excess of estimates of their long-run neutral level. All of this would argue that the economy would see benefits from stopping the upward trajectory of debt relative to GDP.

Further, the next decade is one where a robust build-out of renewable energy capacity is needed—and is receiving considerable fiscal policy support. Like all capital expenditures, renewable energy investment is affected by the level of interest rates. Given this, anything that relieves upward pressure on these rates will be quite useful to the goal of transitioning to an economy that emits fewer greenhouse gases. This might be the single strongest argument for near-term moves to rein in the upward trajectory of the debt-to-GDP ratio.

But *how* one achieves deficit reduction is as important as *whether* one achieves it if the goal is to lift the living standards of the vast majority—and especially if one takes on the goal of avoiding harm for the most vulnerable. In short, deficit reduction can aid goals of progressive governance if done at the right time and in the right manner.

Consistent with these commitments—avoiding harm for the most vulnerable and maintaining broad-based prosperity and security—our plan relies on tax increases much more heavily than spending reductions to bring revenue and outlays into closer balance. We seek realistic efficiencies in spending when they are available, but we take seriously the fact that the United States is a near-outlier among rich nations in how little it raises in revenue and how little it spends on social protection and seek to move closer to advanced country norms in this regard. A growing research literature highlights that robust social protection is good not just for keeping inequality in check but also constitutes a valuable investment in the nation's future. By keeping inequality in check and investing in the nation's future, our plan would reliably boost economic mobility and opportunity and would break cycles of intergenerational poverty.

What's the Political Opportunity for this Budget?

Our plan is admittedly not constructed to get a majority in the current House and Senate. It is an aspirational budget for a progressive governing majority. For anything like this plan to pass in the future will require persuasion about the broad benefits it would provide—but we are confident that the facts and evidence are on our side in this persuasive effort.

Broad bipartisan support *in Congress* is hard to come by for any policy these days. In our plan—and more generally in budget debates—we think measures that aim to rein in the rising cost of public health programs without sacrificing the protectiveness they provide beneficiaries might have broad support even within Congress. This can be seen in the relatively broad popularity, for example, of the prescription drug bargaining provisions included in the Inflation Reduction Act. We also think that higher taxes on high-income and high-wealth households and corporations likely have broad bipartisan support *among the general public*—but this has so far not translated in any way to broad bipartisan support in Congress. How to solve the wedge between popular opinion and Congressional plausibility is beyond the scope of this project—it's not about technocratic tweaks to specific fiscal policies.

Below we provide an overview of the guiding philosophies behind the broad brush of our proposals on taxing and spending, as well as a bit of detail on specific policies. A key goal of our budget is to convert costs throughout the economy into direct public spending when that will help them more efficiently meet their goals. Too often in the U.S. economy social policy goals are addressed through a combination of preferential tax policy (the "tax expenditures" we radically reform in our section below) and employer benefits. These social policy goals can often be met more efficiently and more progressively by converting preferential tax treatment or employer benefits into direct, universal public benefits.

Additionally, these "tax expenditures" are a large drain on the nation's fiscal capacity, but they do not show up as an identifiable line-item in either the tax or spending side of most presentations of the nation's fiscal balance. What this means is that while on its face our budget sees large increases in spending and taxes as shares of GDP, a good portion of these increases are not actually a net new fiscal commitment; instead they are pulling large fiscal costs that are today hidden from view into a more transparent accounting system. This would lead to much more honest and useful policy debates.

Finally, we think there are larger efficiency gains to be had from approaching the issue of progressivity and "targeting" of fiscal benefits from a system-wide perspective. That is, instead of trying to construct each individual tax break or spending program with phase-outs and means-tests to keep it progressive, we move to universality of benefits on the spending side combined with an overall tax system that is strongly progressive. Again, we think this leads to more-transparent policy debates and could remove key sources of administrative burden from many programs.

Spending

As noted above, we try to meet many of the social goals that are currently targeted through the tax code with direct spending instead. Given that the "tax expenditures" we are seeking to replace are large in fiscal terms, this means that our spending plans look quite large. But many of these high spending costs are not really net new demands on fiscal capacity; they are just making these fiscal demands more transparent.

But we also are affirmatively targeting a more protective and robust welfare state with our spending programs. The United States remains an outlier in how stingy its spending on social protection is relative to other advanced economies. While U.S. spending is currently quite well-targeted in the sense of directing most benefits at lower-income families, increasing the scale of social insurance and income support would lead to a large gain in social welfare.

Medicare, Medicaid, and Other Federal Health Programs

Our 2019 budget called for global budgeting of all major health programs (including our single-payer plan described below), and we argued that this global budgeting could lead to a reduction in Medicare cost-growth without sacrificing protectiveness. Since 2019, the Congressional Budget Office (CBO) has significantly marked-down its estimates of Medicare cost growth even as no scaling back of Medicare's guarantees of coverage have occurred—we take this as evidence that we were correct about the possibilities for win-win cost containment. But it does mean that our estimates for reduced growth in Medicare relative to the CBO baseline is substantially smaller this time. Besides the global budget, we also call for expanding on the introduction of pharmaceutical bargaining in Medicare and think this can provide modest but important savings over the longer-run.

For Medicaid, our main policy change is to enact the proposals related to the home and community-based services (HCBS) made by the Biden administration in their "Build Back Better" proposal from 2021. This change substantially increases funding for the HCBS to provide better access for patients and higher pay for front-line providers of this care.

Social Security

We adopted the Social Security expenditure provisions of a 2019 bill proposed by Senator Sanders; it essentially provides an across-the-board increase in benefits, but one that is tilted towards lower-income beneficiaries. This bill would move the United States a step closer to norms (but still on the notably low side) among advanced economies in terms of the generosity of public pension systems. We also provide an across-the-board boost of 25 percent in Supplemental Security Income (SSI) benefits.

Defense

For defense spending, we target spending at 2.6 percent of GDP, slightly lower than the CBO baseline.

Nondefense Discretionary

For nondefense discretionary spending, we target a level of 3 percent of GDP. This nondefense target is higher than the CBO baseline. Given that this portion of the budget is where so much public investment is housed, and given how important well-functioning federal agencies are to quality of life, we think reversing the recent downward pressure on this part of the budget makes good sense.

Other Mandatory

By far our biggest change to spending is bringing the nearly 5 percent of GDP that is currently private households' and employers' contributions to providing health insurance for non-elderly Americans onto the federal government's spending ledger. We also take up state and local governments' share of Medicaid payments onto the federal government and cut private out-of-pocket costs to near zero. This push to universalize access to basic health insurance protections has been taken up recently by some of the world's leading health economists. It both expands access but also provides a better structure for cost containment over the longer run. Evidence of this cost containment can be seen by comparing per enrollee growth in health spending between the large public programs (Medicare, Medicaid and the Veterans' health programs) with growth in privately-provided insurance costs. Yes, this proposal adds some further stress to fiscal balances, but there are substantial fiscal benefits as well. The tax exclusion for employer-provided health insurance premiums—by far the single largest tax expenditure—will no longer be needed. Further, subsidies for coverage in Affordable Care Act exchanges will also no longer be needed. Finally, pulling health costs onto the public spending ledger acknowledges the reality that solving a *fiscal* problem by keeping costs off of public programs and on private households just leaves an underlying *economic* problem unaddressed.

Our plan calls for an ambitious investment in early childcare and education, allocating enough money to provide for universal, high-quality pre-Kindergarten for 3- and 4-year olds and providing substantial subsidies to cap childcare costs at manageable levels for working families. We also provide for a substantial increase in federal grants for state and local K-12 public education. In short, our budget significantly increases the federal investment in children—a task that is overwhelmingly left to state and local governments in our current system of fiscal federalism.

Finally, our plan calls for a substantial increase in the generosity and protectiveness of unemployment insurance (UI). We provide enough spending in our budget to make UI benefit durations and generosity respond more automatically to conditions-based triggers and to make baseline levels of eligibility much broader. The pandemic recession highlighted just how transformative a generous UI system could be for workers navigating spells of job loss, and we try to make this a more-permanent part of the U.S. social insurance system.

Many of these plans are ambitious enough in scope that they likely would take a number of years to rollout. However, we essentially assumed that they were up and running in 2025 to not game the scoring system by having revenues come online substantially before spending and giving a number of "free" years where we got credit for implementing progressive programs without really paying for them.

Revenues

As we noted in the spending section, we think tax policy is significantly overused to target specific social policy goals. This almost always means preferential tax rates or bases (so-called "tax expenditures") are offered to incentivize actions that have been deemed desirable, leading to substantial revenue losses versus a world where rates and bases were applied more consistently.

Individual Income Taxes

We raise income tax rates and reform brackets and the standard deduction to move closer to 2000 levels of income taxation. Had the rates and brackets of that year stayed the same over the next 20 years, the U.S. debt-to-GDP ratio would be *far* lower today. For example, the 2010 long-term budget outlook by the CBO included a "extended baseline" projection for revenue that assumed (as was the current law at the time) a full rollback of the tax cuts passed between 2000 and 2010. In that 2010 extended-baseline projection, revenue averaged almost 5 full percentage points of GDP higher between 2024 and 2052 than it averages under the most-recent long-term budget outlook projections. This is more than double what would be needed to eliminate today's fiscal gap. We also raise taxes on capital gains and dividends.

Corporate Income Taxes

We raise corporate income tax rates back to pre-TJCA levels and enact reforms to stop profit-shifting to tax havens. We abolish the corporate tax expenditure on interest payments but allow for full expensing of new investments.

Tax Expenditures

Our view is that the tax system should not try to micro-target specific social policy goals and should instead be tasked with raising sufficient revenue in a progressive fashion. Direct spending should allocate that revenue to meet desired social policy goals. Since the vast majority of tax expenditures fail to contribute to this vision of the proper role of a tax system—they instead reduce revenue and implicitly provide benefits in a regressive fashion—we abolish nearly every tax expenditure in the tax code, save for the Earned Income Tax Credit and the preferential tax rates and deductions associated with Social Security benefits.

Some might be surprised that we abolish the Child Tax Credit. But instead of running this benefit through the tax code and trying to enforce some measure of targeted progressivity strictly within the parameters of this benefit alone, we instead provide a Universal Child Allowance that provides flat benefits to all families with children. We are confident that the sum of taxes and benefits across the population leads to a strongly progressive fiscal system, so we do not feel the need to make sure every individual provision has (often complicated and different) rules and phase-outs to make it targeted.

Corrective taxes

We call for a carbon tax of $80 per ton of CO2 equivalents of greenhouse gases, and gradually raise it to a level of $120 per ton—a measure closer in-line to estimates of the social cost of carbon emissions. To ensure that putting a price on carbon does not impose hardship on households, our plan calls for recycling *more than* the full amount of revenue collected by the carbon tax in a per-capita lump-sum allocation across U.S. households (we rebate 125 percent of all revenue collected). In a sense, it can be seen as a carbon tax-funded universal basic income to provide a bridge over the transition costs associated with moving to a greener economy.

Payroll taxes

To help pay for the large new fiscal obligation of the single-payer health insurance coverage provided to non-elderly Americans, we institute a 5 percent payroll tax (levied on employers). This is meant to largely mirror an important way that healthcare is paid for today for these families—through employer payments for premiums. This payroll tax levy is substantially flatter and more broad-based than many of our other revenue raisers. But we think it makes sense that after substantial revenue is raised from high-income and high-wealth households that further ambitious expansions of the social insurance state should be paid for largely by the households who will benefit from them.

We also substantially broaden the base for Social Security taxes. We essentially combine FICA and FUTA taxes into one base—the base currently used for Medicare taxes. This means payroll costs over the current taxable maximum for Social Security and net investment income is included in our overall tax base. We also adopt rules clarifying what income can and cannot escape self-employment or net investment income taxes. We apply a 15 percent rate to the entire base. This leads to a large revenue increase for those above the current taxable maximum for Social Security or those with large net investment income, but a tax decrease for those below the taxable maximum.

Other taxes

We also include a wealth tax that starts at $15 million in net worth. There are many good reasons to tax capital, but if people seriously believe that a coming wave of artificial intelligence (AI) technology is going to make capital much more valuable than labor in coming years and displace jobs, taxing capital will be necessary to ensure that any such economic transition gives the federal government resources it needs to provide baseline levels of economic security to all.

The main practical challenge to implementation of the tax provisions in our plan is IRS capacity to estimate wealth valuations and keep tax evasion in check. This should not in theory be insurmountable. For example, the

IRS in our plan would need to have the ability to put a price on many assets. But they currently do this in estate tax enforcement—they would just need to scale up that existing capacity significantly.

An issue in modeling these plans is that large changes in both spending and taxes can lead to very large changes in projected deficits or surpluses. In our plan we overshot on how much revenue we targeted to raise. In a world where resources for analysis were unlimited and we could toggle plan parameters, we might have come up with a different structure of taxes. As is, we think the main issue regarding revenue—having it be sufficient and progressively raised—is satisfied, but we would probably change things if we had another run or two at estimating tax changes.

Conclusion

Our plan increases spending considerably but increases tax revenue more. This allows for stabilization of debt-to-GDP ratios and manageable budget deficits, without leading to harmful cuts to economic security for the vast majority.

We think this constellation of tax increases and spending increases moves us closer to advanced economy norms in the level of social protection afforded by the public sector, and it also recognizes a reality of economic life that the demand and relative cost of public services tends to rise over time as incomes rise. While of course smart management and spending efficiencies should be a constant goal of fiscal policymakers, this rise in the share of overall output devoted to public services is not in and of itself a problem to be solved—it is a reality to be reconciled by our fiscal system. Trying to buck this reality by clamping down on the overall fiscal footprint (on both the spending and taxing side) arbitrarily will lead to costs shed off of public ledgers, showing up and stressing household budgets.

In short, even from perspective that only targets stability in the debt-to-GDP ratio, what matters is not the size of the public sector in an economy, instead it is how adequately this public sector is financed.

Percentage of GDP	2024	2034	2054
Revenues	17.5	31.3	33.8
Spending	23.1	34.2	35.4
Deficit (-) or Surplus	-5.6	-2.8	-1.6
Debt Held by the Public	99.0	92.1	78.7