Principles and Guidelines for Deficit Reduction

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In the next few weeks, the United States will be focused on deficit reduction. Analytically, the task of deficit reduction is simple: cutting expenditures and raising taxes. Politically, the task of deficit reduction is enormously difficult, for each cut in expenditure or increase in taxes hurts someone, and typically, some powerful group. Each, pursuing its own interests, has led the country into what is widely viewed as an untenable position. The hope is that a National Commission would devise an acceptable framework for shared sacrifice. It is more likely that that will be the case if there is an enunciated set of criteria against which we can judge proposals.

Different individuals may put more or less weight on different criteria, but behind them all is one core principle: at the head of the list of reforms are measures which increase both efficiency and equity; unacceptable are measures which decrease efficiency and equity.

A few statistics provide some guidance to these deliberations. Median income has declined by some 5% over the past decade—and was even in decline before the recession. Poverty has increased from 11.9% in 1999 to 14.3% in 2009.[1] Median income of males with only a high school education has decreased some 13.5% from 1999 to 2009, as measured in 2009 dollars.[2] The upper 1% of Americans accounted for an average of some 22% of the nation's taxed income during 2004-2008. 65% of the income growth during the Bush expansion was captured by the top 1% of families.[3]

Given the enormous increase in inequality that has occurred in the United States over the past three decades, any measure that harms those at the bottom should also be unacceptable, and measures that impose undue burdens on the middle class should receive careful scrutiny.

There is a further principle which should guide deliberations: what matters is not the deficit itself or the short-run national debt, but long-run levels of the national debt. The country should be looking at its national balance sheet. Debt reflects only the liability side. In assessing the economic strength of a firm, no one would look just at its liabilities; they would also look at its assets. The single-minded focus on deficits and short-run debt is thus fundamentally misguided. Spending on assets (investments in education, technology, and infrastructure) thus may improve the country's strength. By the same token, there is no magic number, like 21% of GDP, that represents the appropriate size of the federal government. If new public investment opportunities open up, the share of government might increase; if there has been a period of underspending on public investments, returns will be high, and so subsequent levels of government spending as a share of GDP may be high.

This conclusion is reinforced by the observation that what matters for debt sustainability is not the absolute value of the debt but the debt-GDP ratio. Spending that increases debt but simultaneously (over the long run) increases GDP can lower the debt-GDP ratio.

Elaborating the Principles: guidelines for deficit reduction

These general principles have some direct implications, providing some seven *guidelines*, which should guide proposals for deficit reduction as we strive for equity as well as efficiency and growth.

1. Public investments that increase tax revenues by more than enough to pay back the principle plus interest reduce long-run deficits.

2. It is better to tax bad things (like pollution) than good things (like work).

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3. Economic sustainability requires environmental sustainability. The polluter pay principle—making polluters pay for the costs they impose on others—is good both for efficiency and for equity.

4. Eliminating corporate welfare is good both for efficiency and for equity.

5. Given the increases in inequality and poverty and given the inequitable nature of the 2001 and 2003 tax cuts, the incidence of any tax increases should be progressive, and there should be no increases in the tax burden on the poorest Americans.

6. Eliminating give-aways of public-owned assets is an efficient and fair way of reducing deficits.[4]

7. Eliminating distortions in tax and expenditure policies —with appropriate compensatory policies for lower and middle income Americans—can be an efficient way of reducing the deficits. Even if overall such tax expenditures are regressive, given the dire straits that so many poor and middle class Americans are in, eliminating those tax expenditures without appropriate compensation (e.g. in the reduction in tax rates on lower and middle income Americans) would be wrong.

Getting our Metrics Right

The International Commission on the Measurement of Economic Performance and Social Progress noted the deficiencies in the current metrics of economic performance.[5] And the economic crisis made clear how current metrics may give the wrong impression about economic performance. In the years before the crisis, the performance of GDP appeared good (though not stellar). But beneath the surface, it was clear that all was not so rosy: as we have noted, most Americans were seeing their incomes stagnate; and the growth itself was not sustainable. It was based on a bubble, itself supported by unsustainable levels of debt. Moreover, 40% of all corporate profits were in the financial sector and 40% of all investment was in real estate—and both numbers were fictions, in one case based on flawed accounting, in the other on "bubble prices." In much of the discussion below, we will be paying attention to the impact of tax and expenditure policies on growth, but in doing so, we need to be sure that attention is focused on the appropriate metrics.

This means that a measure that corrects an environmental distortion *might* lower conventionally measured GDP; but even if it does so, that is not necessarily relevant. Because economic sustainability requires environmental and social sustainability, what matters is the impact on metrics that take into account impacts on resource depletion and environmental degradation (sometimes called "green GDP" metrics.)

Beyond Deficit Reduction: What this report is not about

The co-chairmen of the National Commission on Fiscal Responsibility and Reform, Alan Simpson and Erskine Bowles, have provided a set of suggestions for deficit reduction and addressing what they believe are other challenging issues for the country, some of which may have only a limited relationship to deficit reduction. This paper (and the work of the Fiscal Commission) should be focused on deficit reduction. It is only indirectly about the size of government: as we have noted, a larger government, but one focused on investments, could be associated with a smaller deficit.

As we have noted, deficit reduction entails either cutting expenditures or cutting taxes. This paper is about principles of efficiency and equity that should guide such cuts. It is not about political compromises not based on such principles; those, for instance, which arbitrarily say that half of the reductions should come from tax increases and half from expenditure cutbacks.

This paper outlines a set of proposals which, while we have not provided a costing, should reduce the deficit by more than the goal of $4 trillion. Even more, because some of the proposals contained here increase growth, the deficit/GDP ratio will be further reduced (as the denominator is increased), putting the country on a more sustainable path.

1. Growth Enhancing Deficit Reduction Measures

In the discussion below, we outline four categories of measures that simultaneously enhance growth and reduce the deficit—and do so in ways that at the same time increase equity. The first category, in particular (to repeat what was said earlier) is based on the premise that what is important is the long-run national debt, not the short-run deficit. Just like it may pay for a business to borrow ("run a deficit") in order to increase long-run profitability, so too for government.

A. Increased spending in high yield government investments

Public investments can yield high returns. If the returns are high enough, they can more than pay for themselves. Three factors make such investments particularly opportune today: (a) There has been underinvestment for years, so the returns on investment are high; (b) The interest rate at which government can borrow is at record low levels; and (c) Because the economy is operating significantly below capacity—and is likely to continue to do so for years to come—there are significant multiplier effects, with each dollar of such spending generating as much as 1.5 to 2 times the spending in increased output.[6] At current interest rates, a five-year project yielding as little as 7.5% can *reduce* long term deficits. Historically, public investments in education, technology, and infrastructure have yielded returns that are in excess—sometimes far in excess—of this. This is highlighted by New Orleans' levies: small investments in public infrastructure there would have saved tens of billions of dollars. It was known at the time that they were badly in need of repair. There are similar high-return investments all over the country.

B. Reduced spending (mainly through the tax system, in what are called taxed-expenditures) on corporate welfare

Corporate welfare consists of the billions—over a decade, tens and perhaps hundreds of billions—of dollars to enrich the coffers of corporations, sometimes to protect them from adverse situations (as in the massive bailout of the banking system, sometimes directly, as in the current crisis, sometimes indirectly, through the IMF), sometimes to "promote" particular industries. The net beneficiaries of such corporate welfare are, by and large, wealthy Americans—and increasingly wealthy foreigners (since foreigners are large owners of American corporations). But these expenditures distort our economy. There is a *deadweight loss*, that is, the value of the benefits of the recipients is less than the value of the losses to the Treasury. That is why the elimination of such corporate welfare should be at the top of the list of expenditure cuts.

Two categories of corporate welfare in particular deserve attention. *Subsidies to agriculture and agro-business* are bad for the environment, go disproportionately to those who are better off, hurt the poor in developing countries, and have been a major impediment in striking global trade agreements that might bring significant benefits to American businesses. As in other areas, such subsidies are often defended on the grounds that they help a particularly deserving group of poor Americans. When agricultural programs first began, farmers were, on average, poorer than other Americans, and hence targeting assistance at them might have made some sense. Even then, there is a question of why poor farmers are more deserving of assistance than other poor Americans. Today, though, most of the money goes to corporations and Americans who are better off than average, often much better off. Again, as in other areas, if there is a compelling case that poor farmers need more protection than other poor Americans (a case which has not been made), there are easy fixes, e.g. by limiting the benefits to, say, those whose income is below $100,000, and *limiting* payments to, say, at most $100,000 per farm.

A particularly egregious example of a subsidy to agro-business is that for ethanol. Originally justified on grounds of promoting renewable energy, it is now widely recognized by environmentalists and economists alike that the ethanol subsidy is an unjustifiable form of corporate welfare. The subsidy was originally justified too, a quarter century ago, as a "temporary" subsidy to help get a new ("infant") industry established. The ethanol industry is the classic example of an infant that has never grown up and is not likely to do so.

Subsidies to producers of fossil fuels also distort the economy and are bad for the environment. We should, in fact, be taxing the production (as we note further below). This is consistent with the general principle enunciated earlier: it is better to tax bad things than good things. Economists refer to the taxation of activities that exert negative externalities on others as corrective or Pigouvian taxes. Such taxes raise revenue at the same time as they increase economic efficiency, raising (correctly measured) national output.

C. Reducing excessive payments to the pharmaceutical companies

There is one specific category of distorted government spending that might rightly fall within the rubric of "corporate welfare" but is so massive in size that it needs to be singled out: the excessive payments to the pharmaceutical companies under the provisions of the Medicare bill, which restricted the government's ability to bargain with them on prices. The recent legislation embraced a compromise that left the implicit subsidy (almost 1 trillion dollars over ten years)[7] largely intact.

Like any subsidy, resources are distorted, as the subsidy pulls resources into the subsidized area and away from other areas. What is of particular concern here—besides the massive scale—is that among the resources that are pulled out are scarce scientific resources, so important for America's long run technology advantage.[8]

D. Better auctioning/management of government owned natural resources and other assets

The government owns large amounts of natural resources and is responsible for managing other natural resources (like fisheries) and assets (like the spectrum). Efficient auctioning of the rights to use these resources (assets) can lead to greater efficiency (ensuring that they are used by those generating the highest (social) returns and greatest revenues). As we have learned from the sale of the spectrum, the amounts at issue are significant. Yet the government continues to dispose of many of these assets in a less than optimal way. While cell phone companies pay for the use of spectrum, broadcasters are often not charged.

Rights to extract some natural resources are still given away in a manner similar to that used in the nineteenth century. Even when there is an auction, the auction is not well-designed, and the terms of the lease contract are far from optimal. Auctioning off fishing rights can not only raise revenues, but reduce the risk of over-fishing.

2. Towards a Fairer and More Efficient Tax System

Our tax system is neither fair nor efficient. Taxes affect economic behavior in a variety of ways. Many provisions of the current tax system were put there, justified by one rationale or another, but pushed by one special interest or another. Much corporate welfare takes the form of special treatment within the tax code. Behind each of the examples of corporate welfare, there is typically an "argument." But as the analysis of the examples given above illustrate, the arguments are typically bogus. Together, they erode the tax base and result in a tax system that distorts the economy.

The following categories of reforms would, together, make significant inroads in deficit reduction.

A. Progressive Increases in taxation

There is a general principle in economics that there is no such thing as a free lunch. To the extent that we can, however, improve the efficiency of tax and expenditure programs, there is a free lunch: we can achieve the objectives of the programs and reduce expenditures. But the reality is that such efficiency-enhancing measures are unlikely to suffice by themselves. That means that there will likely have to be increases in taxes. Someone has to pay. The question is, who?

Fortunately, the undesirable changes in the distribution of income in the United States provide a simple and easy answer. Most of the increase should come from those who have done so well by the US in the last quarter century; namely, the upper 1%, who, as we have noted, now garner for themselves some 20% or more of the total national pie.

A small increase in the tax rate on them—say 5% of their income—would generate revenues equal to between $1 and $1.5 trillion. Currently, most of these individuals pay effective tax rates that are far below the "official" rates because of their ability to take advantage of tax preferences and loopholes. Eliminating these tax preferences and loopholes would go a long way towards achieving this limited increase in the taxation (and might even suffice).

This would mean, for example, that someone earning $1 million would have to contribute an extra $50,000. Assuming that he is currently paying an effective tax rate of 20%[9], this person would still have $750,000 to get by.

B. "The Fair Tax"

One proposal that has been widely discussed is to tax all forms of income the same, i.e., eliminate the preferential treatment of dividends and capital gains, the benefits of which go disproportionately to upper income Americans.[10]

This is another example of a tax where the official rationale has little to do with the actual effects. The argument has been put that the United States should encourage savings. But the savings of most Americans (through their pension funds and 401k programs) already receive preferential treatment. When taxes on capital gains and dividends were lowered, the benefits were extended to investments made prior to the enactment; these tax benefits were simply windfall gains. Tax revenues were reduced without any concomitant increases in investment.

In the end, the special treatment did not have the benefits promised: instead of household savings increasing, the savings rate plummeted to new lows after the enactment of the Bush tax cuts.

There is, moreover, no justification for taxing those who work hard to earn a living at a higher rate than those who derive their income from speculation.

The complexity of our tax system (compared to what would be the case under the fair tax proposal, in which all sources of income are treated the same) leads individuals to expend enormous resources to convert income into forms that are tax-preferred. This distortion in our economy, like other distortions, reduces efficiency and growth.

Middle Class Expenditures

The Chairmen of the Commission have suggested the elimination of certain middle class tax subsidies, most significantly, tax deductibility of mortgage payments. In the long run, eliminating these tax distortions makes enormous sense. But there are two problems. The timing couldn't be worse: even the announcement of the future elimination of such subsidies would lead to further reductions in house prices, delaying further the recovery. On the other hand, one might decide that this is a good time to eliminate the subsidy: the market will be depressed for so long that another couple years will not matter much. The economy will have to find other bases for growth.

But even if the elimination goes forward, one can't simply ignore the distributional consequences. Middle class Americans have to be compensated, with at least an offsetting reduction in tax rates. In short, while it is desirable to have such tax reforms directed at the middle class—broadening the base to allow a lowering of the rates—the reforms should not be viewed as part of the solution to the nation's deficit problem. The only part that should be viewed as such entails curtailing these tax expenditures for upper income Americans—part of the agenda of increasing progressivity of the tax code.

Another major category of tax expenditures is that related to employer-provided health insurance, which encourages excessive spending but simultaneously provides important and hard-won protections for many Americans. The country has just been through an exhaustive debate on health care reform, and this may not be the appropriate time to reopen that discussion (beyond the elimination of the one major source of corporate welfare noted earlier). But if this tax benefit is reduced or eliminated, given its importance, some middle class compensatory tax adjustment should be made.

What are called tax expenditures depend, of course, on one's reference point: if one takes as one's "base" a fair tax in which all forms of income are treated the same, then the special treatment of savings, dividends and capital gains is clearly one of the most significant categories of tax expenditures, justified by the virtue of encouraging savings or investment. The evidence that these special provisions lead to higher levels of national savings is weak: even if the interest elasticity of savings were positive, the question is whether the increase in private savings is large enough to offset the reduced tax revenues, which lead to negative public savings.

IRA accounts and preferential treatment of pensions constitute an important source of middle class tax expenditures, but the incidence of other tax expenditures allegedly directed at encouraging savings is regressive and increasingly so as the inequality of wealth is even greater than the inequality in savings. The elimination of these tax preferences for upper income Americans could contribute significantly to national debt reduction, and probably to an increase in national savings.

C. A Growth-Oriented Corporate and Individual Income Tax

Corporations complain that the corporate income tax discourages investment, but with interest deductible and with accelerated depreciation (relative to what economists call "true economic depreciation"[11]) it may be that the tax system actually is biased the other way.[12] There is even some research that suggests that the preferential treatment of dividends may have had the effect of lowering investment.[13] Much of capital gains is in real estate, so that preferential treatment of capital gains may do as much to encourage real estate speculation (which contributed to the recent crisis) as it does to increase real investments that enhance real growth, increased employment, and productivity increases.

Rather than an across-the-board reduction in the corporate income tax, far better would be a tax reform that would encourage investments in jobs in the United States (the current system encourages firms not to repatriate money earned abroad, i.e., to invest abroad rather than at home), and that would encourage investment in research and development (and discourage real estate speculation.)[14]

D. The Generalized Henry George Principle

One of the general principles of taxation is that one should tax factors that are inelastic in supply, since there are no adverse supply side effects. Land does not disappear when it is taxed. Henry George, a great progressive of the late nineteenth century, argued, partly on this basis, for a land tax. It is ironic that rather than following this dictum, the United States has been doing just the opposite through its preferential treatment of capital gains.

But it is not just land that faces a low elasticity of supply. It is the case for other depletable natural resources. Subsidies might encourage the early discovery of some resource, but it does not increase the supply of the resource; that is largely a matter of nature. That is why it also makes sense, from an efficiency point of view, to tax natural resource rents[15] at as close to 100% as possible. The well-designed auctions described earlier enable government to capture most of the rents derived from government owned assets.

E. Generalized Polluter Pay Principle

The generalized Henry George principle identifies a class of taxes that does not impede economic efficiency. But there is a class of taxes that actually increases economic efficiency—taxes which discourage activities that generate negative externalities.[16] The most important category of such taxes are those on environmental externalities. Within this area, the most important are those associated with carbon emissions, with their impact on global warming and climate change.

It matters less whether those generating the pollution pay a carbon tax or buy emission permits that are auctioned; either can generate large amounts of money and simultaneously improve economic performance.

D. Financial Transactions Tax and Other Taxes on the Finance Sector

But environmental externalities are not the only examples of negative externalities in a modern economy. America's financial sector polluted the entire world with its toxic mortgages. The reckless and predatory lending and other behavior of key participants in the financial sector had adverse effects on the American and global economy. Even if the banks were to pay back every dime that they received, they would not have come anywhere close to compensating the country for the full costs (now in the trillions of dollars) that they have imposed on others.

Nor is this the first time that the banks have been rescued from their mistaken lending decisions; bailouts have become a regular feature of the global economy over the last three decades. The repeated bailouts have led to a distorted and inefficient economy. Taxes can be used both to undo these distortions and contribute to deficit reduction. The following are four examples of financial sector taxes that are receiving attention (and enactment) in many countries around the world.

It is reasonable that the financial sector play a significant role in deficit reduction because of the large role that it contributed, both directly and indirectly, to the current debt crisis around the world, both directly (in the costs of the bailouts) and even more indirectly (as a result of the recession for which it bears special culpability).

D.1. Bonus tax

Probably nothing did more to enhance the sense of injustice around the world than the receipt of huge bonuses by those responsible for the economic crisis, even as the banks were being bailed out by taxpayers who bore the brunt of the costs of the banks' misdeeds. Bonuses had been justified on the basis of outstanding performance, but this rationale was undermined when they were still paid as banks experienced massive losses. Huge payments by the banks to their officials also are one of the sources of growing inequality in our society. Moreover, the structure of the bonuses contributes to shortsighted behavior and excessive risk taking.

A well-designed bonus tax could thus encourage incentive structures that align behavior of those in the financial sector with the long term interests of society (thereby increasing overall efficiency); contribute to a broader sense of societal fairness; and simultaneously contribute to deficit reduction. Indeed, the United States is one of the few countries that had to rescue its banks that has not attempted to address these issues.

D. 2. Financial Transactions Tax

For a quarter century, it has been recognized that short term financial transactions may contribute to economic volatility without enhancing long term economic performance. They were at the center of the global financial crisis at the end of the last century. In recent years, partly because of that crisis and partly because of the current Great Recession, this notion has received widespread support within academia and within civil society; and with the acceptance of that perspective has come increasing support for a financial transaction tax. Such a tax, even at a very, very low rate, would raise considerable revenue, and there is little evidence that it would have any adverse effect on long-term productivity—on the contrary, it is likely to enhance it. [17] [18]

D.3. Bank Rescue Fund

As we have noted, banks have had to be rescued time and time again. It is unlikely that the Dodd-Frank bill will suffice to prevent the occurrence of another crisis, especially because nothing was done about too-big-to-fail banks.[19] Among economists, there is a broad agreement that the repeated bailouts have led to a problem of moral hazard, with excessive risk taking and an excessively large financial sector. Moreover, too-big-to-fail banks are able to get access to capital at lower interest rates and grow at the expense of competitors, not because they are more efficient, but because of the implicit public subsidy.

The Obama administration at one point talked about a tax based on leverage and size, designed to discourage excessive leverage and size. This is an example of "corrective" taxation—using the tax system to avoid behavior that could (and in the past has) imposed high costs on the rest of society.

D.4. EPS (Electronic Payment System) Fees

Modern technology has allowed the creation of an efficient electronic payments system. It should cost almost nothing to transfer money from an individual's bank account to the merchant's bank account when a purchase is made. Yet the credit card companies charge large fees, as much as .6% to 2.4%.[20] These fees act as a tax on every transaction, but a tax that goes not to public purpose but to enrich the coffers of the credit card companies, largely the banks. Other countries have curtailed the anti-competitive practices; but given the need for deficit reduction, an alternative is to redirect the revenues for public purpose, by, for example, setting the fees at 1.5%, with say 50 basis points going to the card companies, and the rest dedicated to deficit reduction. This is an example of an efficiency enhancing deficit reducing reform—consumers and merchants would be better off, transactions costs would be lowered, and so to would the deficit.

3. Careful Scrutiny of Non-Growth-Enhancing Expenditures

The discussion so far has focused on areas where revenues might be raised while promoting efficiency, growth, equity, and, in some cases, promoting other objectives like a better environment.[21] There are some areas of public expenditures where the objectives of the government programs could almost surely be achieved at lower costs. If the objective of agriculture programs is to help poor farmers, then limiting the benefits in the manner described earlier would save considerable amounts of money. If the objective of energy programs is to help the United States achieve long-run energy independence, then well designed conservation measures are far more cost effective than the "drain America first" subsidies that will in the long run make the US more dependent on foreign sources.

A. Military Expenditures

The single most important area of discretionary expenditures is military. America could obtain more security at lower cost. Even the Defense Department has recognized that there can be significant reductions in defense expenditures—of the order of magnitude of at least $100 billion a year.[22] The cold war ended in 1989. Yet non-terrorist related expenditures have continued to increase almost unabated. We spend billions on weapons systems that don't work against enemies that don't exist. With America's military spending approximately equal to that of the rest of the world combined, it is clear that there is a lack of balance.

Five observations should inform our thinking about the appropriate level and form of spending: (1) The cold war is over. (2) What matters most in the war on terrorism and similar conflicts that are likely to predominate in the twenty-first century is "soft power," America's moral authority, not its military power—a fact demonstrated so clearly by the ongoing conflicts in Afghanistan and Iraq. (3) In the long run, our willingness and ability to manage conflicts will depend on our economic strength; military expenditures do not contribute to our economic strength; indeed, unnecessarily large expenditures drain our strength. (4) Securing some small piece of global territory will be of only limited value in the global war on terrorism. Terrorists can always find other places from which to conduct their operations. "Victory"—securing a particular plot of land—just displaces the basis of operations. In this respect, the war on terrorism is totally different from traditional warfare. (5) Direct conflicts impose costs that extend decades into the future. With close to 50% of those returning from Iraq and Afghanistan suffering some form of disability and with health care and disability costs for each of these disabled soaring, America faces an immense unfunded liability—with the best estimates in excess of $900 billion.[23] The longer we are actively engaged in these conflicts, the larger not only is the short run deficit, but also the long-run national debt. In short, a speedy exit from both conflicts would save, over the long run, hundreds of billions of dollars.

To too large an extent, defense expenditures have become an inefficient and costly form of corporate welfare—generating benefits to what President Eisenhower referred to as the "military and industrial complex." Even a rich country like the United States today cannot afford such largesse, even when some of the benefits trickle down to workers. Resources wasted in this area are resources not available for *real* growth. America's defense industry has absorbed large fractions of our research personnel. Had the ingenuity devoted to the creation of smart bombs and other such innovations been devoted more broadly to advances in science and technology, America's competitiveness in these areas would be even stronger.

B. More Efficient Assistance to State and Local Governments.

Currently, states and local governments can issue tax exempt bonds, the effect of which is to lower the interest rate they have to pay. But the loss in tax revenue to the federal government far exceeds the benefits received by the state and local authorities. It is an example of how providing subsidies through the tax system—something the federal government has increasingly relied upon—is often an inefficient way of providing a subsidy. These provisions also contribute to the unfairness of our tax system, with the true beneficiary including some of the wealthiest Americans. Whether there should be subsidies may be a matter of debate; that whatever subsidies are given should be given in an efficient and fair manner should be beyond debate.

Summary

This paper has outlined a series of expenditure cutbacks, reforms *and* increases as well as tax reforms and increases which can more than meet the goal of $4 trillion dollars in deficit reduction (i.e. reduction in the level of national debt from what it otherwise would have been) in the next decade.[24] Indeed, the proposed actions would not only lead to a lower national debt, but also to a better environment, higher growth, and a fairer society.

Over the ensuing weeks, the nation will be debating how to achieve deficit reduction. Deficit reduction, it should be remembered, is not an end in itself, but a means to other objectives. If done the wrong way, our growth can be impaired, our society can become more divided, and the capacity of both our country and our government to deal with the challenges facing it can be impaired.

If the Chairmen's proposals are any guide to what might come out of the Commission, then it is clear that the Commission has identified some areas—like cutbacks on military expenditures—on which there can be broad agreement. But there are other areas that we have emphasized which are given short shrift, and still others —like some of the changes in taxation proposed by the Chairmen—which are totally misguided. The result would be a still less progressive tax system and a still more divided society.

The issue facing the country is, in the end, not economic, but political. From an economic perspective, we can easily meet the debt/deficit reduction goals, as the long list of proposals in this paper makes clear. The reason that we have, for instance, the myriad of the distortions and inequities that we have identified is because of the influence of special interest groups, who, so far at least, have been willing to sacrifice the national interest to their own. If they continue to do so, then the only way that we will be able to achieve these goals is at the expense of those who are less politically powerful. If we proceed to achieve the deficit reduction goals on their backs—for instance through the elimination of the earned income tax credit-- it will only contribute to the growing cynicism and skepticism about America's democratic political processes.

Economics is the science of trade-offs. Normally, one can, for instance, achieve greater equity only at the expense of a loss of efficiency. We can achieve deficit reduction only by cutting back on expenditures or raising taxes. America is, perhaps, lucky: because of its underinvestment in the public sector and the extraordinarily low interest rates and the vast underutilization of human and other resources, it can increase public investment, increase output and employment, and simultaneously reduce the long term national debt. Because of its distorted and unfair tax system, it can reduce some of these distortions and inequities with the result that growth and efficiency will be promoted at the same time that the inequities are reduced.

The country does face a critical choice: to continue on the current course, slightly modified, which might succeed in reducing the long term national debt, but at great cost to the long term economic and social fabric; or to embark on the alternative agenda that this paper proposes.

Endnotes

1. Source: The Annual Social and Economic Supplement (ASEC) to the Current Population Survey (CPS), Table 2. Poverty Status of People by Family Relationship, Race, and Hispanic Origin: 1959 to 2009, Census Bureau. November 2010. http://www.census.gov/hhes/www/poverty/data/historical/people.html (accessed November 23, 2010).

2. Household Income, Historical Data, Table P-16. Educational Attainment--People 25 Years Old and Over by Median Income and Sex: 1991 to 2009, Census Bureau, November 2010.

3. See "Income Inequality in the United States, 1913-1998" with Thomas Piketty, Quarterly Journal of Economics, 118(1), 2003, 1-39 (Longer updated version published in A.B. Atkinson and T. Piketty eds., Oxford University Press, 2007), with data updated through 2008, available at http://emlab.berkeley.edu/users/saez/ (accessed November 24, 2010).

4. By the same token, poorly designed privatizations and hypothecating future revenues are typically a poor way of going about deficit reduction; they may, in fact, result in a higher level of long term national debt.

5. Fitoussi, J.-P., A. Sen and J.E. Stiglitz, 2010, Mismeasuring Our Lives: Why GDP Doesn't Add Up: The Report by the Commission on the Measurement of Economic Performance and Social Progress, New York: The New Press.

6. See, for example, Ilzetzki, Ethan, Enrique G. Mendoza and Carlos A. Vegh, 2009 "How Big Are Fiscal Multipliers?", Policy Insight No. 39, Center for Economic Policy Research, October, available at http://www.cepr.org/pubs/PolicyInsights/PolicyInsight39.pdf (accessed November 29, 2010). The authors estimate that the multiplier for government investment in the U.S. is about 2.

7. Specifically, in one intermediate scenario, the implicit subsidy would amount to $928.3 billion during 2009-2018. See 2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, Table V.E.8, Operations of

the Part D Account in the SMI Trust Fund (Cash Basis), Page 212, May 2009.

8. What is perhaps most egregious is that, typically, underlying their products is research that is funded largely by the government, the returns to which they have manage to appropriate for themselves.

9. The effective tax rate was 23% and 21% for top 1% and 5% respectively in 2005 (Piketty and Saez, Op.cit.). Note that the effective tax rate is markedly lower than the "legislated" tax rate.

10. Eliminating preferential treatment of capital gains for upper income individuals is one way in which the effective tax rate on such individuals could be raised. Reforming the system of subsidizing states and localities through tax-exempt bonds is another. Not only are capital gains taxed at a lower rate, but much of capital gains totally escapes taxation as a result of the step of basis at death. This needs to be eliminated, and the estate tax reinstated.

11. True economic depreciation would allow firms only to deduct the reduced value of the asset that results from usage, obsolescence and aging.

12. That is, the cost of borrowing is reduced in the same proportion that returns are reduced.

13. Firms increased dividends to take advantage of this provision, reducing their liquidity and hence their ability to respond to new investment opportunities.

14. In this paper, we do not address the relative merits of alternative ways of encouraging investment, e.g. incremental investment tax credits versus accelerated depreciation. We should note that most of the benefits of accelerated depreciation go to those who would have otherwise made the investment, and hence is not well targeted (it has a low bang-for-the-buck). Moreover, it is of greater benefit for long-lived assets, and as a result arguably distorts patterns of investment.

15. Rents are the term that economists apply to payments to factors that are inelastically supplied.

16. These are the corrective or Pigouvian taxes referred to earlier.

17. There is by now a large literature in support of such a tax, and several European leaders have now endorsed one version or another of such a tax.

18. Not only do such short term transactions increase volatility, they lead firms to focus excessively on the short term. Such "short-termism" has become a marked feature of the American economy, contributing to the current crisis, and shifting attention away from the longer term investments that are essential for long term productivity and growth.

19. For an excellent discussion of the problems confronting the financial sector, see the recent speech of Mervyn King, governor of the Bank of England, "Banking: From Bagehot to Basel, and Back Again," The Second Bagehot Lecture, Buttonwood Gathering, New York City, October 25, 2010 http://www.bankofengland.co.uk/publications/speeches/2010/speech455.pdf (accessed November 23, 2010).

20. See Bradford and Hayashi, April 2008, "Interchange fees in the United States and abroad" Federal Reserve Bank of Kansas City. http://www.kansascityfed.org/Publicat/PSR/Briefings/PSR-BriefingApr08.pdf (accessed November 23, 2010).

21. Promoting a better environment should, in fact, be viewed as part of increasing overall economic efficiency, properly defined. Distorted prices (where environmental assets are underpriced) lead, as we have noted, to distorted metrics.

22. The co-chairs' proposal on deficit reduction released on November 10—which, incidentally, asks not to be cited—outlines $100 billion in "illustrative" cuts in defense spending (with respect to the 2015 budget). Of that, $28 billion is dedicated to "the overhead savings Secretary Gates has promised to deficit reduction (see page 19). See http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/CoChair_Draft.pdf (accessed November 23, 2010).

23. See "The True Cost of the War," Statement of Linda J. Bilmes before the House Committee on Veteran's Affairs, September 30, 2010, available at http://veterans.house.gov/hearings/Testimony_Print.aspx?newsid=632&Name=_Linda_J._Bilmes (accessed November 23, 2010).

24. The large items include, as a very rough estimate, $1 trillion in reduced benefits to pharmaceutical companies, $1 trillion in tax increases on the top 1% of Americans, $.5 trillion in financial transactions taxes, $2 trillion in defense expenditures, and $.5 trillion in corporate welfare, for a total of $5 trillion. Taxes correcting environmental externalities, especially those associated with global warming and climate change, by themselves would go a long way towards meeting the deficit reduction goals.