EconoFact Chats: Government Budget Deficits - What's to Be Done, and When?

William G. Gale, The Brookings Institution

Published on 9th November, 2020

Michael Klein:

I'm Michael Klein, Executive Editor of Econofact, a non-partisan web-based publication of the Fletcher School at Tufts University. At Econofact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

In the fiscal year that ended on September 30th, 2020, the U.S. budget deficit was $3.1 trillion. About 16% of GDP. This represents the biggest dollar amount on record and is more than triple last year's deficit of $1 trillion. One reason for the ballooning of the deficit is the economic effects of the coronavirus. There were increased government expenditures. For example, through the CARES Act. This was coupled with decreased tax receipts because of the slowdown of the economy. The decrease in tax receipts predated the pandemic, the 2017 Tax Cut and Jobs Act reduce tax revenues. And even before this year, the government's budget deficit was growing. How concerned should we be with deficits of this magnitude? What is to be done? To answer these questions, I'm very happy to welcome to Econofact Chats, Bill Gale of the Brookings Institution. Bill is the co-director of the Tax Policy Center.

Michael Klein:

He's widely recognized as one of the country's top experts on public finances. He's the author of the book, Fiscal Therapy: Curing America's Debt Addiction and Investing In the Future. Bill, welcome to Econofact Chats.

Bill Gale:

Thanks very much. I'm happy to be here.

Michael Klein:

It's nice to have you on. Bill, how unusual is it that the budget deficit is about 16% of GDP?

Bill Gale:

It's extremely unusual. The last time it was this high was during the second World War, when it was even higher. But then like this time we're responding to a clear danger and responding appropriately with a strong federal presence. It's not nuts to run large deficits now to help the economy recover from the pandemic. But the deficits are definitely quite large right now. By comparison, in the great recession over a decade ago, we responded with a stimulus package, but deficits were not more than 10% of the size of the economy.

Michael Klein:

Was the deficit unsustainable before even COVID came because of the tax cuts and the slowing down of the economy that predated the COVID pandemic?

Bill Gale:

Most estimates, my own included, suggested that the debt was unsustainable. By which we mean the debt to GDP ratio was projected to rise inexorably over time, even with the economy doing well. Of course, COVID has set the economy back. And that set the budget deficit back too and increased the forecast of debt in the future.

Michael Klein:

What is an unsustainable debt to GDP ratio or an unsustainable deficit look like? Is it like wild animals will be running through the streets, and we have locus, and blood and all the other plagues? What would that actually look like to an average person?

Bill Gale:

There's two scenarios. One of which gets a lot of attention and the other, which I think is the more realistic one. The one that gets a lot of attention is if there's a crisis of some kind. That investors get spooked, they take their money out, they leave, they take the money out of the United States. They go invest it somewhere else. Our interest rates go way up, our exchange rate declines, the economy goes into depression. That type of thing happens in third world countries. I don't think it's going to happen in the U.S.

Michael Klein:

This is the 10 plagues, the boils locus, blood death of the first born outcome, right?

Bill Gale:

That's the outcome, yes. Again, I don't think it's likely. I think the gradual scenario is much more likely, which is more like deficits or like termites in the woodwork, in the words of one of my colleagues. And there the issue is just deficits soak up lending in the economy and make it harder for the economy to grow.

Michael Klein:

So in either case, unsustainable is bad. It might be bad in a very sort of acute way. It might be bad in a more chronic way. Deficit Hawks will say that our current situations mean that our children will be saddled with the debt and their children will be saddled with the debt arising from these deficits. Phil and I, we both have children. Bill, can we look our children in the eye without feeling guilty about the debt we've passed on to them?

Bill Gale:

I think there's a mixed bag here. I think there's definitely some debt burdens that we're passing on to future generations and they are significant. But we shouldn't let that let us freeze up and stop doing things. We're going to pass on a lot of things to the next generation, health and safety net programs, the environment, the infrastructure, et cetera. Those things cost money. So these are in my mind, isn't so much how much debt we're passing on, but how we're using the money. And if we use it in the right way and we pass on benefits in terms of infrastructure and the environment, and so on, then a higher debt is worth it and as is a good deal for future generations.

Michael Klein:

And right now, of course, some of the debt is being used to help battle the pandemic. One thing we hope to pass on to the next generation is that our children's grandchildren will have grandparents and will be around, because some of these resources have been used to fight the pandemic.

Bill Gale:

That's right. And that's a classic example of a good use of debt. When the economy needed the federal government to step up, it did. And frankly, in my view, it needs the federal government to step up again and create another stimulus package. And I say that in full recognition that it would increase future debt, but also with the view that the benefits would exceed the costs.

Michael Klein:

Right. Otherwise, who's going to spoil our grandchildren? This is an issue of the fairness across generations. But with tax policy and spending policy, there's also the issue of the fairness within a generation. And what I mean by that is whether the tax system favors the rich. What economists say, whether it's regressive. But more to the point, the 2017 Tax Cut and Jobs Act changed the tax structure. Your work with the colleagues at the Tax Policy Center showed that the tax cuts favored wealthier individuals and families. Is that right?

Bill Gale:

That's correct. The Tax Cuts and Jobs Act in 2017 was just the wrong thing at the wrong time. It boosted the economy at a time when the economy was already strong. It raised the deficit at a time when debt was already a concern. And it was a big tax cut for the rich compared to others at a time when the distribution of income had moved toward the rich over the last four decades. I think of it much more like the rich flexing their political muscles. That it was an attempt to redress existing social and economic issues.

Michael Klein:

There were promises that were made about the tax cut spurring investment, and helping growth and so on. Were these promises kept?

Bill Gale:

The promises that were kept were the negative aspects. It would increase the deficit. It clearly did that. It did not raise tax revenues. It clearly cut taxes for the rich, with some egregious provisions, small business or partnerships got truly unjustified subsidies, the estate tax was eviscerated and so on. Yet, the touted benefits in terms of growth or investment largely have not occurred.

Michael Klein:

The issue of the fairness of the tax system also turns on tax evasion, who avoids paying his or her fair share of taxes. You wrote an Econofact Memo, with Aaron Krupkin, and in that you present a statistic that really stunted me. That one in every $6 owed in federal taxes is not paid. What's going on with that?

Bill Gale:

Well, that's great question. And this is one of my favorite issues. I think it's extremely under appreciated in the U.S. As you mentioned, one out of $6 is not paid. It's much higher. It's not just a random one out of six. It's much higher in certain sectors like sole proprietorship income and farm income, where almost two-thirds of income is not reported. And it's not a secret why this is the case. If you think about people's wages, taxes are withheld by the firm and sent to the government. So that's called third-party withholding.

But you don't have that for sole proprietorship income or for farm income, so that it turns out to be enormous evasion in those sectors.

Bill Gale:

A related part of the problem, let me just add, is that IRS funding has been cut a lot over the past 25 years. Less resources, fewer staff members, fewer audits. And they have computer systems that frankly should be in museums, not operating in the 21st century. The IRS basically can't keep up right now because their resources have been cut.

Michael Klein:

Is this a situation where some money could actually bring back really large returns to the government, some investment in the IRS?

Bill Gale:

Absolutely. Everyone who has looked at this issue suggests that a dollar extra resources would generate direct revenue of multiples of that. I've seen estimates from four $4-$11 per dollar of investment. But that's only the direct effect of audits. There's also an indirect effect. If people know that the IRS is auditing more carefully or penalizing more heavily, they're also more likely to voluntarily report income. And that's not captured in those numbers. And it's hard to know how big that affect would be.

Michael Klein:

How naive do I sound if I ask, how come this isn't happening? The answer could be just very naive, but if you want to go in more detail.

Bill Gale:

I think that there has been an effort to demonize the IRS as part of a broader effort to cut taxes. The one way to reduce people's tax burdens is to reduce the power of the tax collector. And I think that's been an effort among Republicans, in particular the last 25 years. We'll never be able to collect all the money that's owed, just like we can't eliminate all crime in other circumstances. But everyone who's looked at this has concluded that there's a lot of gold in those hills and we should go after it.

Michael Klein:

All right. Maybe we can find some prospectors sometime in the future to do that. I want to raise another important point you make. Again, this is in Econofact Memo. This one you wrote with Zach Obstfeld. And that's that the question of the progressivity of the tax system. That is how much it favors the wealthier, doesn't favor the wealthy relative to the middle-class and the poor. That question sometimes, or somewhat misses the point that we need to take into account the overall stance of the government in redistribution and not just the tax system by itself. Can you talk a little bit about that in the memo that you wrote with Zach?

Bill Gale:

Sure. Whether the issue is deficits or tax policy, there's the other side of the coin, which is what does the government do with the money? And it's you can't judge the ultimate, the tax policy, without looking at how the resources are used. Most government redistribution occurs on the spending side, rather than through taxes. What people don't understand or don't think about, I'm sure they understand if they thought about it, is that if you have a tax that's proportional to income, and then you use it to spend money on a program that spends the same amount of money on each person, that is a very progressive shift of income. Because low-income households would get much more than the standard percent of their income. High income households would get much less. It's important to take into account both the spending and the tax rules.

Michael Klein:

Tax policy is obviously very politically charged and we've already discussed some points of that. And it has distributional implications. But beyond the broad distributional implications, it can also have more narrowly focused benefits for particular companies or individuals, right?

Bill Gale:

Yeah. The tax code is littered with special provisions, special rules that affect either particular companies or whole industries.

Michael Klein:

And so, this sort of brings me into the question of, as an economist, as one of the leading people in public finance, you come up with all these ideas about what the tax systems should be like, and to make it more efficient, to make it more fair, whatever that means. But in the face of such strong political headwinds, what is the role of economists in determining what the tax system should look like and how things are actually implemented?

Bill Gale:

That's a great question. I think economists are typically looking at big picture, societal-based measures of outcome when they look at tax policy. So they want to know, does this change improve competition, or efficiency in the economy? Does it make the overall distribution of income more or less equal? Does it help us pay for government spending and so on? Those are not the only questions one could ask, but they are neutral with respect to specific organizations or industries. A lobbyists, for example, might ask, does this policy help my firm, my company, my industry? That's a very different focus. Personally, I think policy would work out better if policy makers focused on the big picture questions. But lobbyists pay for campaigns and elected officials listen to lobbyists.

Michael Klein:

But there's an example of big tax change that actually was aligned with what economists would suggest. And by this, I'm referring to the 1986 Tax Reform. Can you give a little background to that and what that reform achieved?

Bill Gale:

Sure. What the 1986 Tax Reform did was broadened the base, which is a technical way of saying, eliminating a lot of the loopholes, and special exemptions, and provisions and stuff like that. It broadened the base and it used the revenue to lower rates. And the idea behind it was that taxing everything at the same rate was simpler, because you didn't have to distinguish between types of incomes. It was fairer, because different types of incomes were treated the same. And it was more efficient because people weren't making choices for tax purposes, they were making choices for economic purposes.

Bill Gale:

The way we got there though was long and torturous. Basically over the years, you have this kind of symbiosis, whereas tax rates go up, more people want special exclusions and carve-outs. And then the more special exclusions and carve-outs there are, the higher tax rates have to be on the rest of income in order to generate a certain revenue. You get a vicious cycle of more carve-outs, higher rates, more carve outs, higher rates. Eventually this got so bad in the '70s in particular that politicians on both the right and left united to try to reduce deductions and lower rates.

Michael Klein:

We had a situation where things were so bad, people were forced to act. Do you have any hope for something like that happening now, when the debt to GDP ratio is going to, as you mentioned, be over 100% of what it was at the end of World War II?

Bill Gale:

Partisanship, of courses, seems like is far worse now. Tribalism in the Congress, if you think of politicians as arrayed across a football field, there were some Democrats on the right side of the 50 yard line, and there were some Republicans on the left side of the 50 yard line. Now, as Tom Mann and Norm Ornstein have described, the two groups are huddled in their respective end zones. There's nobody-

Michael Klein:

... Or even in the stands.

Bill Gale:

There's nobody at midfield anymore. That obviously makes these things much harder to deal with.

Michael Klein:

As I mentioned at the beginning, you wrote this really wide ranging book, which I enjoyed quite a bit, Fiscal Therapy. And you discussed many of these issues. If people wanted to know, what are the main messages of your book, Fiscal Therapy? Which I guess reflects the main messages of your decades of studying these issues. What would you say are some of the main messages from your book? And more broadly, I guess, your background in public finance?

Bill Gale:

I think that the main message is we face a potentially daunting longterm problem with rising debt and a structural imbalance between taxes and spending. But that problem is solvable if we pay attention and work on it. The title, Fiscal Therapy, was meant to be a takeoff on physical therapy, where you kind of work at one thing and make it better. And then you work at the next thing and make it better. And the idea is this is going to be a continuing effort that we will have to address. It won't just be one thing where we just sort of snap our fingers and everything's better. It's going to require years or decades of attention to right the ship on the fiscal side.

Michael Klein:

I know that you got the title partly from your personal experience of going through physical therapy and that thank goodness was successful. Maybe we can hope for the same thing for fiscal therapy for the country as a whole.

Bill Gale:

Well, I hope the country actually does better than I'm doing physically. I got the title from my wife and it was a perfect fit for what I was trying to say about fiscal policy.

Michael Klein:

Bill, thank you very much for spending the time today. It was really, as always, real pleasure to speak with you. And I always learn something when I talk to you as well. Thanks a lot.

Bill Gale:

All right. Thank you. I enjoyed it.

Michael Klein:

This has been Econofact Chats. To learn more about Econofact and to see the work on our site, you can log in to www.econofact.org. Econofact is a publication of the Fletcher School at Tufts University. Thanks for listening.