

# FISCAL POLICY IN A REBALANCING WORLD

GRADUATE SCHOOL OF PUBLIC POLICY

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BASED ON A CO-AUTHORED PAPER WITH ROSANNE  
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# Global Economic Recovery

- Marked by very slow growth in all of the advanced economies
  - Weak recovery from financial crisis
  - Deleveraging and rebuilding of balance sheets
- Full recovery and strong growth in emerging markets
  - No financial crisis
  - Impacted only through trade channel
- Contrasts particularly marked for advanced economies and emerging Asia.

# World Economic Outlook

(annual percentage growth)

	2008	2009	2010 <sup>p</sup>	1011 <sup>p</sup>
<b>Advanced Economies</b>	<b>0.2</b>	<b>-3.2</b>	<b>2.7</b>	<b>2.2</b>
United States	0.0	-2.6	2.6	2.3
Japan	-1.2	-5.2	2.8	1.5
Euro Area	0.5	-4.1	1.7	1.5
<b>Emerging Economies</b>	<b>6.0</b>	<b>2.5</b>	<b>7.1</b>	<b>6.4</b>
Developing Asia	7.7	6.9	9.4	8.4
China	9.6	9.1	10.5	9.6
India	6.4	5.7	9.7	8.4

# United States Economy

- Two economic policy objectives
  - Economic recovery, and
  - Rebalancing of economic structure away from excessive reliance on domestic consumption toward external trade
- Monetary and Fiscal Policy Strains
  - Monetary policy largely exhausted
    - Interest rates at lower bound
    - Effects of quantitative easing are highly uncertain
  - Fiscal policy under severe strains
    - Collapse of policy coordination within G-20
    - Political opposition to further stimulus

# Similarities Between United States and Japan

- Both have very limited macroeconomic policy options
- Threat of economic stagnation and continued high unemployment
- U.S. current economic performance resembles Japan's lost decade(s)
- United States has a large external deficit, while Japan has a small surplus
- Declines in domestic saving and investment

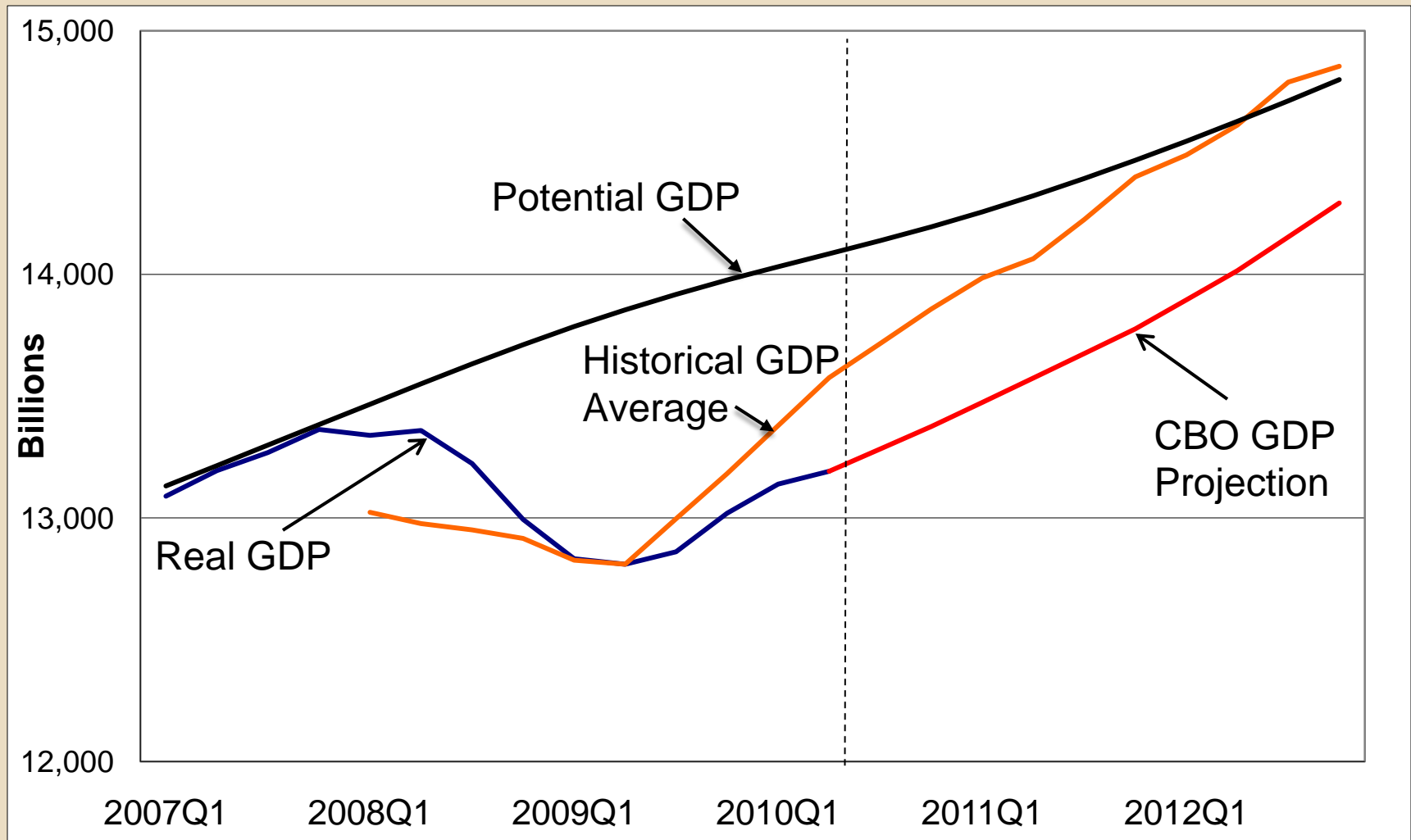
# United States Net Saving and Investment by Sector, 1980-2009 (% of Net Income)

Item	1980-89	1990-99	2000-07	2008	2009	2010:H1
<b>Saving</b>	6.5	5.4	3.6	-0.5	-2.7	-1.6
<b>Corporate</b>	2.9	3.2	3.0	1.2	2.3	3.6
<b>Household</b>	7.2	4.7	2.3	3.5	5.4	5.1
<b>Government</b>	-3.6	-2.4	-1.7	-5.3	-10.4	-10.4
<b>Investment</b>	9.4	7.9	8.4	5.9	1.9	3.4
<b>Corporate</b>	5.0	3.8	3.3	2.6	-0.6	1.2
<b>Household</b>	2.8	2.9	3.8	1.9	1.0	0.9
<b>Government</b>	1.6	1.2	1.3	1.5	1.5	1.3
<b>Current account</b>	-1.8	-1.7	-5.4	-5.3	-3.1	-3.7
<b>Statistical discrepancy</b>	1.1	0.8	-0.6	1.1	1.5	1.4

# Japan Net Saving and Investment by Sector, 1980-2008 (% of Net Income)

Item	1980-89	1990-99	2000-07	2008
<b>Saving</b>	16.6	13.2	6.1	2.6
<b>Corporate</b>	3.6	2.7	9.1	6.9
<b>Household</b>	10.9	8.9	2.7	0.9
<b>Government</b>	2.1	1.6	-5.6	-5.1
<b>Investment</b>	14.1	10.8	2.9	0.9
<b>Corporate</b>	8.3	6.0	2.7	3.1
<b>Household</b>	2.4	1.1	-0.6	-1.4
<b>Government</b>	3.4	3.7	0.9	-0.8
<b>Current account</b>	2.5	2.8	4.1	4.0
<b>Statistical discrepancy</b>	0.0	0.6	1.0	2.4

# Alternative Paths to Recovery 2007-2012





# Illustrative Rebalancing

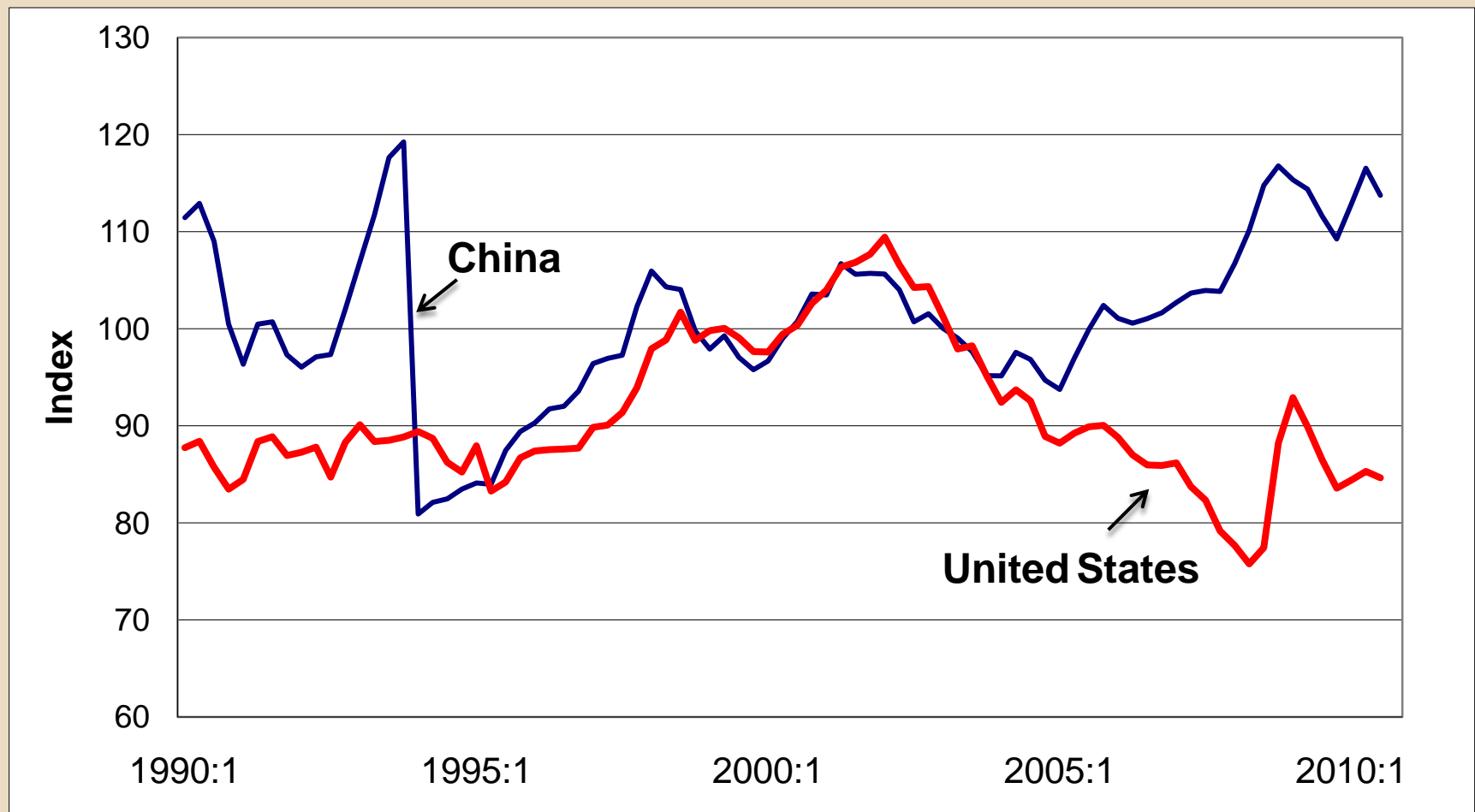
Percent of Potential GDP

Demand Component	Mid 2010 Shortfall From Potential	Alternative Recovery Paths	
		Pre-Crisis Economy	Economic Rebalance
Consumption	-4.0	4.0	1.0
Investment	-4.0	4.0	2.0
Net Exports	2.0	-2.0	3.0
Government	0.0	0.0	0.0
Total GDP	-6.0	6.0	6.0

# Current Account as a Share of World GDP, Selected Regions and Years

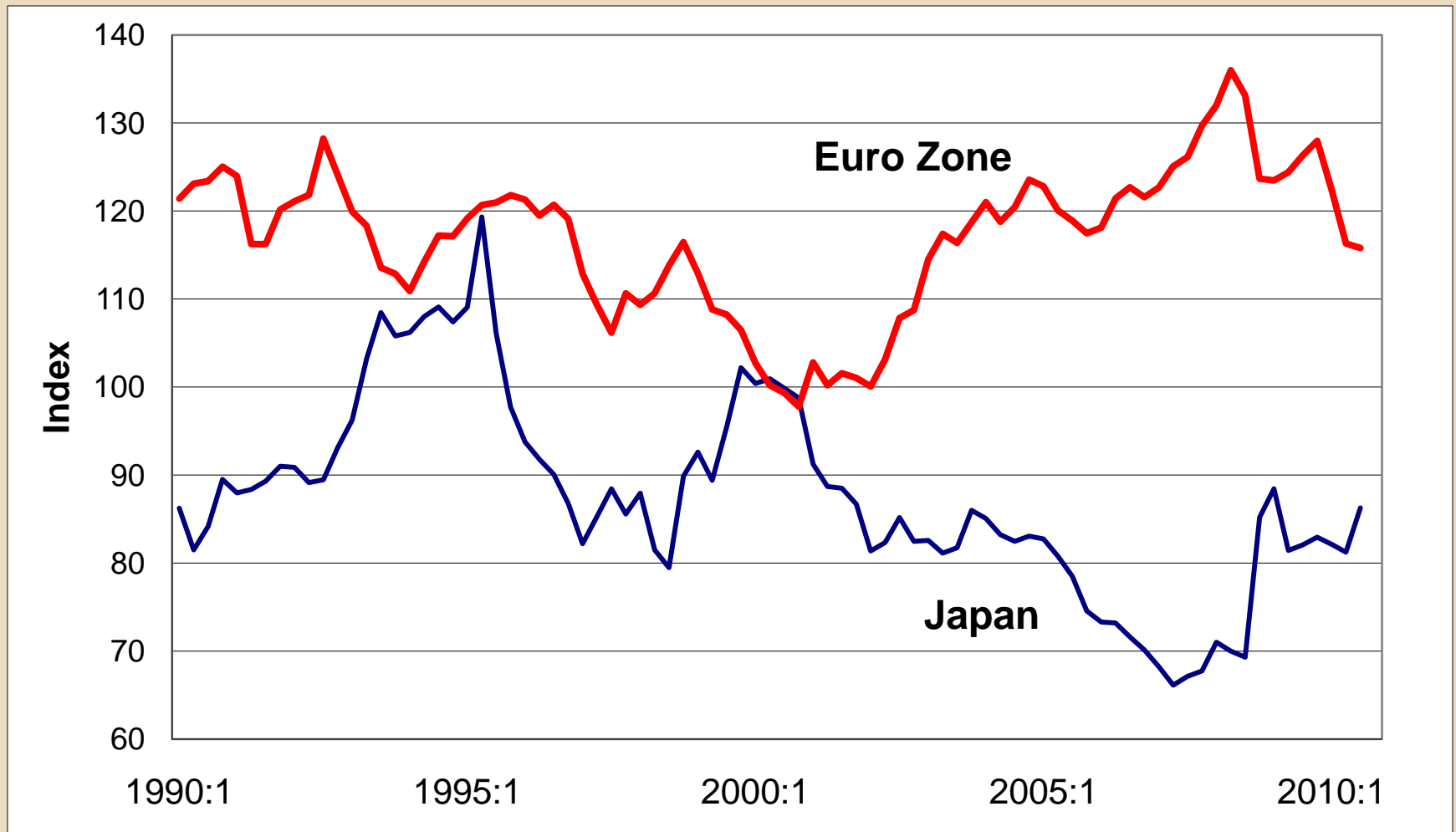
Region	1980-89	1990-99	2000-05	2006-08	2009	2010
U.S.	-0.50	-0.43	-1.41	-1.37	-0.72	-0.79
Japan	0.26	0.36	0.35	0.33	0.24	0.24
Europe	-0.01	0.08	0.23	0.16	0.11	0.18
Emerging Asia	-0.01	0.06	0.38	0.87	0.81	0.78
Emerging Latin America	-0.11	-0.14	-0.02	0.04	-0.02	-0.06
Middle East	0.13	-0.04	0.21	0.49	0.10	0.23
Other countries	-0.31	-0.21	0.00	-0.11	-0.21	-0.18
Discrepancy	0.54	0.30	0.27	-0.41	-0.32	-0.41

# Trade-weighted Exchange Rates, 1990-2010



Source: JPMorgan

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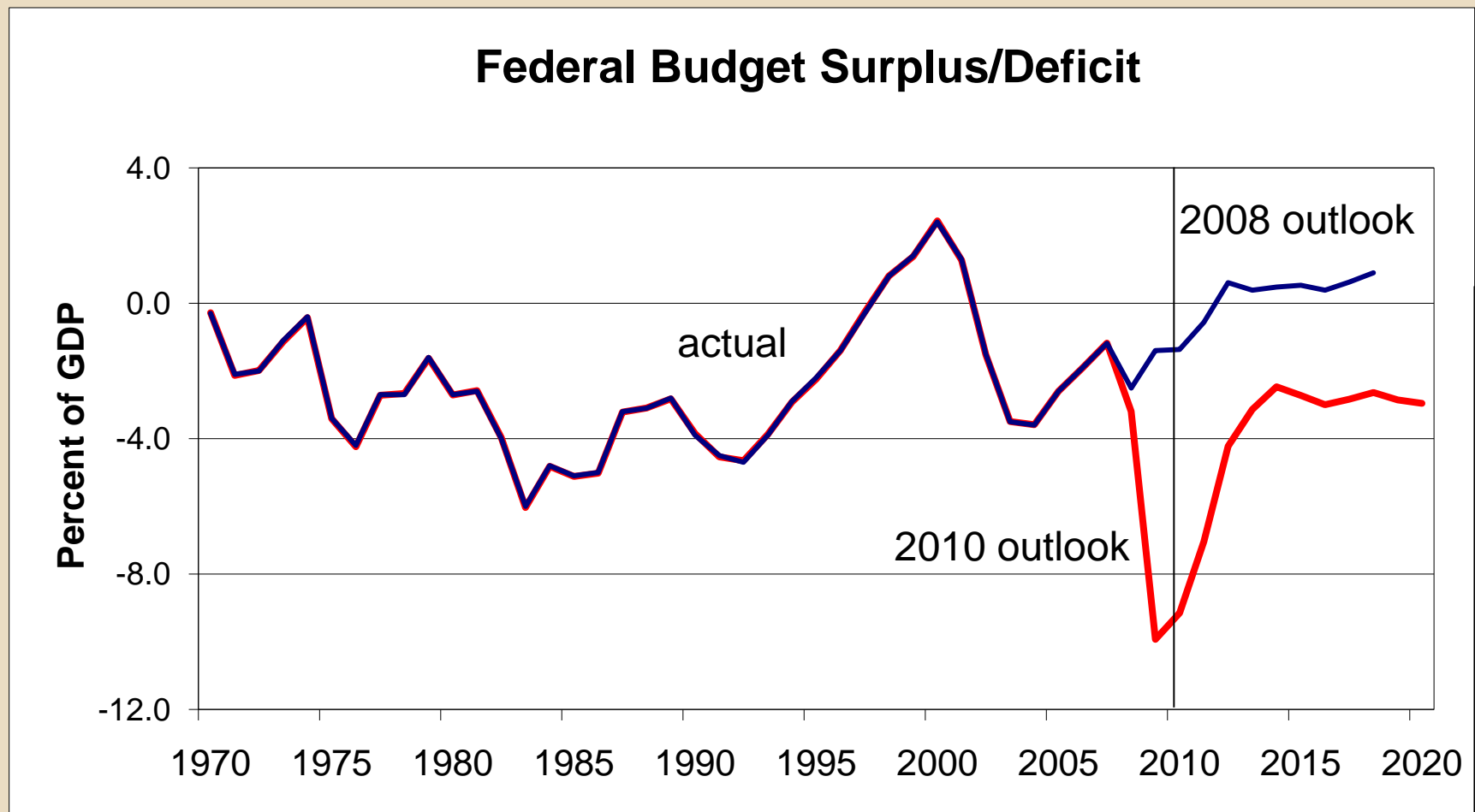


Source: JPMorgan

# United States Fiscal Policy Options

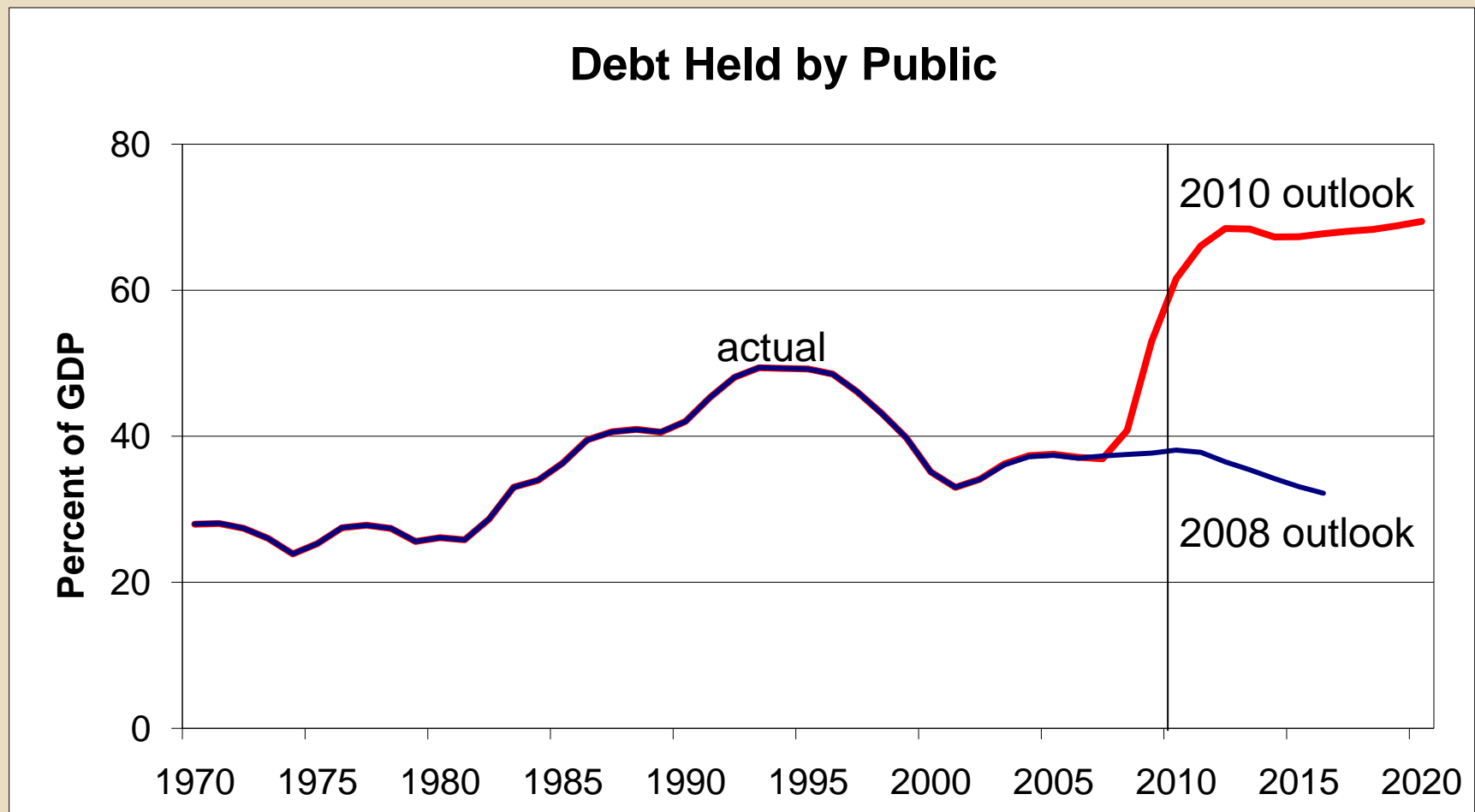
- Entered financial crisis with a federal budget deficit of about 3% of GDP
- Financial bailout
  - Authorized \$700 billion of asset purchases
  - Only expected losses or subsidy is included in budget
  - Net cost of about \$100 billion
- Fiscal stimulus program
  - \$800 billion over 3 years
- Total deficit ballooned to \$1.5 trillion (10% of GDP) by 2009 and 2010

# The Federal Budget Balance and the Public Debt, 1970-2020



Source: Congressional Budget Office, Budget and Economic Update, August, 2010 and August 2008

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Source: Congressional Budget Office, Budget and Economic Update, August, 2010 and August 2008

# Short-run Challenge

## □ Current-law baseline

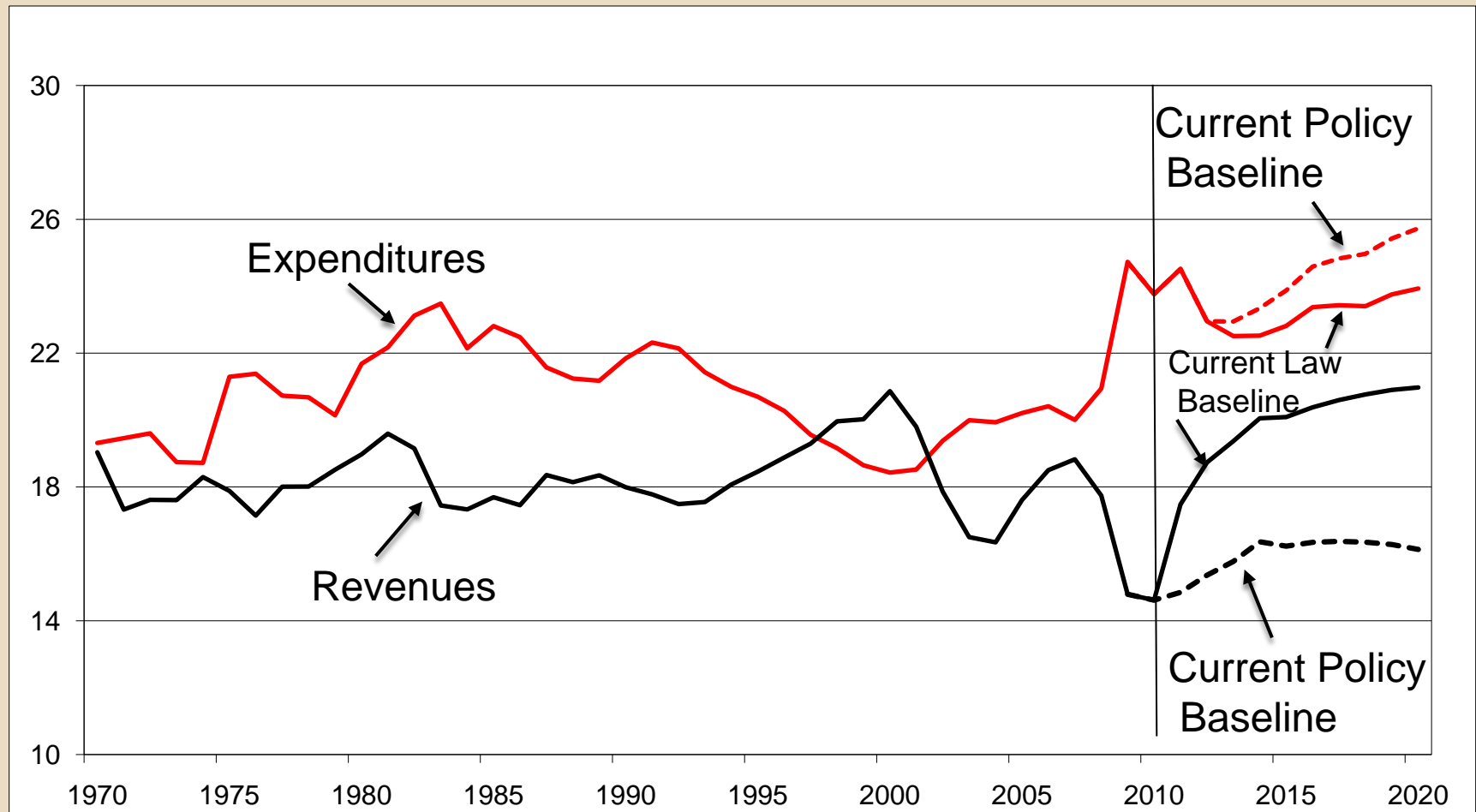
- Bush tax cuts expire
- No inflation adjustments for AMT
- Increases in discretionary spending limited to adjustments for price inflation

## □ Current-policy baseline

- Bush tax cuts *extended*
- *Inflation adjustments* for AMT
- Increases in discretionary spending *in line with growth of GDP*



# Federal Revenue and Expenditures, 1970-2020 (% of GDP)



Source: Congressional Budget Office. 2010c.

# Expenditures

- United States differs from other countries in:
  - Smaller social welfare programs
  - Larger defense
  - Most health care is private
  - Public pension – Social Security
  - Medicare – National health insurance for elderly (65+)
- State and local government budgets are separate from federal government

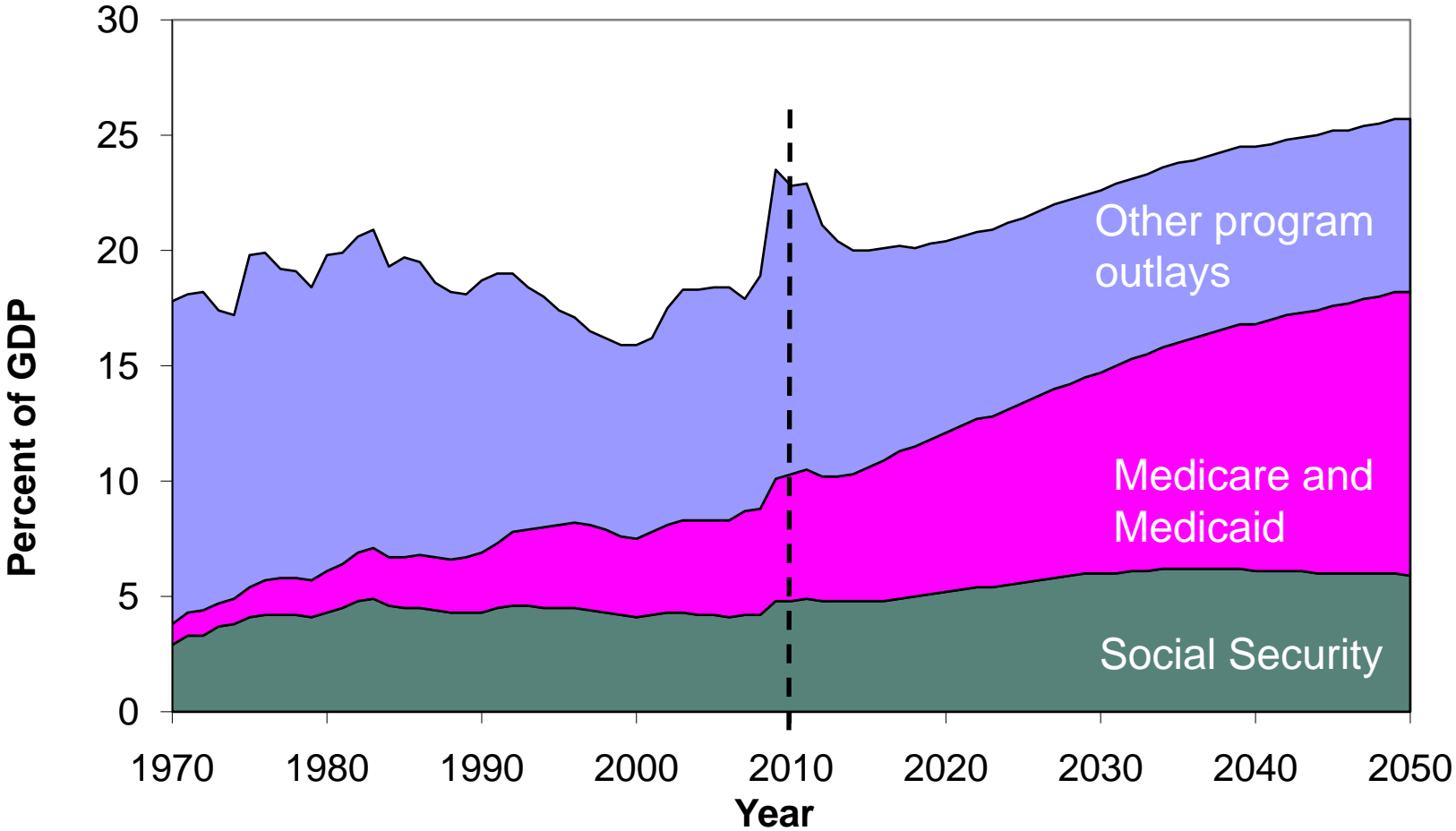
# General Government Outlays by Function, 2007

% of GDP	EU-15	USA	Japan
General public services	6.3	5.1	4.7
Defense	1.5	4.3	0.9
Public order and safety	1.7	2.2	1.4
Economic affairs	3.7	3.7	3.8
Environmental protection	0.7	0.0	1.2
Housing and community amenities	1.0	0.7	0.6
Health	6.7	7.7	7.2
Recreation; culture and religion	1.1	0.3	0.1
Education	5.1	6.3	3.9
Social protection	18.0	7.1	12.4
<b>Total general government</b>	<b>45.9</b>	<b>37.4</b>	<b>36.3</b>
<b>Total less social protection</b>	<b>27.8</b>	<b>30.3</b>	<b>23.9</b>
Gross Fixed Capital Formation	2.5	2.5	3.1

# Long-term Budget Outlook

- Less than 40% of federal outlays subject to annual appropriations and control
  - Will fall to a projected 30% by 2020
- Rising health care costs and Social Security will dominate long-run budget outlook
  - Almost all increase in outlays accounted for by rise in spending on medical care

# Projected Federal Expenditures, 1970-2050



# Budget Expenditures By Major Category, 1980-2020

	<b>Discretionary Spending</b>	<b>Mandatory Spending</b>	<b>Net Interest</b>	<b>Total Outlays</b>
1980	10.1	9.6	1.9	21.7
1990	8.7	9.9	3.2	21.8
2000	6.3	9.8	2.3	18.4
2008	8.0	11.2	1.7	20.9
2010	9.3	13.1	1.4	23.8
2015	7.7	12.4	2.6	22.8
2020	7.0	13.6	3.4	23.9

Source: CBO 2010c, Current Law Baseline

Note: 2015 and 2020 reflect CBO assumption that economy has returned to full employment and short-term interest rates will rise back to 5%.

# Budget Expenditures and Revenues By Major Category, 1980-2020

	Discretionary Spending				
	Defense			Non-Defense	Subtotal
	Total	Afg-Iraq	Other		
1980	4.9	0.0	4.9	5.2	10.1
1990	5.2	0.0	5.2	3.5	8.7
2000	3.0	0.0	3.0	3.3	6.3
2008	4.3	1.3	3.0	3.7	8.0
2010	4.7	1.2	3.6	4.5	9.3
2015	4.2	0.9	3.2	3.6	7.7
2020	3.8	0.8	3.0	3.2	7.0

Source: CBO 2010c, Current Law Baseline

# Budget Expenditures and Revenues By Major Category, 1980-2020

	Mandatory Spending				
	Social Security	Health Care	Other Mandatory	Offsetting Receipts	Subtotal
1980	4.3	1.8	4.6	-1.1	9.6
1990	4.3	2.6	4.0	-1.0	9.9
2000	4.2	3.4	3.0	-0.8	9.8
2008	4.3	4.8	3.5	-1.3	11.2
2010	4.8	5.5	4.1	-1.2	13.1
2015	4.7	6.0	3.0	-1.3	12.4
2020	5.1	7.0	2.7	-1.3	13.6

Source: CBO 2010c, Current Law Baseline



# Options for Expenditure Reductions

- Population aging and health care costs are driving forces behind budget challenge
- Social Security (public pension)
  - Not a contributor to medium-term fiscal problems...
    - but faces long-run financing deficit equal to nearly 2% of taxable payroll.
  - Choices are simple (increase contributions, reduce benefits, or combination)...
    - but intensely political and technically complex.

# Options for Expenditure Reductions

- Medical care programs
  - Same demographic problems as Social Security...
    - but additional pressure from historic trend of increases in costs per enrollee in excess of average growth in per capita incomes.
  - Dominant source of rise in budget outlays (will double as share of GDP between 2000 and 2020)
  - Key to achieving budget saving is slowing rate of excess cost growth...
    - but slowing growth is not straightforward and enacting cost containment measures has been highly unpopular.
    - Measures to introduce various forms of rationing to control costs have been strongly opposed in U.S.

# Revenue Outlook

- Under current law baseline
  - Revenues increase rapidly to historic high of 21% of GDP in 2020
  - Almost doubling in proceeds from individual tax
  - Budget deficit of 3% of GDP
- What if Bush tax cuts do not expire?
  - Historical low revenue share, 16% of GDP
  - Budget deficit more than doubles by 2015

# Increase in Deficit under Current Policy Baseline

## Percent of GDP

	2011	2015	2020
<b>Current law baseline deficit</b>	<b>-7.0</b>	<b>-2.7</b>	<b>-3.0</b>
Extend Bush tax cuts	-0.8	-1.7	-2.1
Index the AMT	-0.5	-0.3	-0.6
Extend other expiring tax provisions	-1.3	-1.4	-1.6
Total Changes*	-2.6	-3.9	-4.8
<b>Current policy baseline</b>	<b>-9.7</b>	<b>-6.6</b>	<b>-7.8</b>

Source: CBO (2010c), Table 1-7.

\*Note: Figures do not add due to interactions effects between extending the tax cuts and indexing the AMT.

# Options for Revenue Increases

- Increase individual income tax rates
  - Challenge to reverse Bush tax cuts
- Increase revenues from corporate tax
  - Already above global average
- Tax expenditure reform
  - Base broadening measures
  - Politically difficult
- Adopt the VAT
- Environmental taxes

# Adopt the VAT

- U.S. only OECD country without VAT
  - virtually only country in world without VAT!
- VAT could help address medium and long-term shortfalls
- Benefits
  - Efficient tax
  - Can adopt best practices from around the world
  - Substitute for portion of income tax

# Adopt the VAT

## □ Concerns

### □ Distributional effects

- Regressive when measured as percent of current income
- Regressivity could be relieved through refundable credits run through individual income tax

### □ Revenue impact

- Both base and rate matter for revenues
- Five percent VAT on broad base could raise 2.3 percent of GDP
  - Adding refundable credit would decrease this revenue gain to about 1.4 percent of GDP

# Environmental taxes

- Potentially significant revenue source
- Addresses important environmental externality
- Congress and President have put forward cap-and-trade proposals
  - But have either given away revenue or used it for purposes other than deficit reduction
- Raising tax on gasoline may be more feasible
  - Would also correct an environmental externality
  - With state and local taxes, current average tax rate is about 40 cents per gallon for gasoline.
  - An increase of 50 cent per gallon would generate about 0.4 percent of GDP



# Conclusions

- Economic rebalancing will be critical to U.S. recovery
- Current weakness of economy makes it difficult to decide when to begin to address budget deficit
- Continuation of current policy will lead to rapid growth of public debt as share of GDP
- Balancing budget will require large structural changes in expenditures and revenues
- U.S. will need to consider broader range of new revenue sources including VAT and environmental taxes