

THE TAX AND BUDGET REFORM DEBATE IN
THE UNITED STATES:
WHY HOPE SPRINGS ETERNAL

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THE TAX AND BUDGET REFORM DEBATE

- *Margin call: Marginal tax rate, tax revenue, and economic efficiency*
- *A capital idea: Saving and investment*
- *Mantra: Broaden the base, lower the rates*
- *Getting on base: Income versus consumption*
- *Playing by the rules: Budget reform*
- *Something old, something new: Financing social insurance*

MARGINAL TAX RATES

- *Renewed focus on incentives: “supply-side economics” to contemporary research*
- *Pushing the boundaries of “labor supply”*
 - Primary workers versus secondary workers
 - Taxable income
 - Entry into entrepreneurship
- *Summary: Potentially large efficiency gains are possible from*

SAVING AND INVESTMENT: MODELS, EXPERIMENTS

- *Household saving: life-cycle model*
 - Sensitivity to net return: targeted-saving-incentives debate
 - Precautionary saving and social insurance
 - Entrepreneurial link between saving and investment

- *Business investment: neoclassical model*
 - Theoretical nicety versus empirical realism
 - Contemporary empirical evidence based on tax reforms
 - Other “tax cuts” for investment: \downarrow inflation; financial reform

- *Summary: Tax policy has significant effects on saving and investment and, through them, on economic growth.*

BROADEN THE BASE, LOWER THE RATES

- *Problem of a narrow base: allocational distortions; inefficient subsidies to the poor; necessarily high marginal tax rates*
- *Lower rates on broad tax base raise revenue with less costly distortions (, , entrepreneurial selection, consumption versus leisure)*
- *U.S. success and failure*
 - *Success: Tax Reform Act of 1986*
 - *Failure: Narrowly targeted tax provisions (largest consequences for low-income and middle-income households); “political economy” problems*
- *Summary: Valuable mantra for public finance economists*

TAX BASE: INCOME VERSUS CONSUMPTION

- *“Tax base” debate in the United States*
 - Efficiency (capital income taxation)
 - Distribution (capital income taxation)
 - Simplicity (capital income taxation)
- *Difference is likely smaller than it seems*
 - Compare comprehensive integrated income tax (Treasury Department’s Comprehensive Business Income Tax) and comprehensive, business-cash-flow-plus-wage tax (so-called “Flat Tax”)
 - Differs centers on treatment of the safe rule of interest
- *Summary: The tax reform battle is one worth fighting. Economists’ interest in consumption tax reform should not eliminate discussion of income tax*

BUDGET RULES AND BUDGET REFORM

- *U.S. federal budget analysis: Shift in emphasis from optimal budget policy to political*
 - Models based on "self control"
 - Empirical work on institutions → fiscal performance (endogeneity problems)
 - Some success in U.S. at federal level: - -
Budget Enforcement Act (1990)
 - Is success due to institutions or to changing fiscal tastes?
- *Analysis of budget institutions in U.S. states*
 - Most states require submission of a balanced budget
 - Property tax limitations have been shown to limit local taxes and spending
 - Studies controlling for endogeneity of institutions still typically find real effects
 - Some limits on generationy to federal level: interjurisdictional mobility, credit access, money creation

- *International evidence*

- Cross-sectional studies (tighter budget rules/transparency associated with lower deficits (
- Coalition governments are less likely to pursue tight fiscal policies than single-party governments (emphasis on strong , as in the central banking literature)

- *Summary*

- Fiscal institutions matter.
- Which precise rules matter?
- Research suggests that reforms that centralize power in a small budget actors, increase the transparency of the budget process, and make it more difficult to issue long-term debt are likely to reduce the level of government spending.

FINANCING SOCIAL INSURANCE

- *Public old-age pensions - - “Social Security”*
 - *Economics?*: annuity-market imperfections; redistribution
 - *Financing?*: pay-as-you-go financing not necessarily implied
 - *Reform?*: Significant efficiency gains are possible from funding reform and from individual control
- *Public old-age health insurance - - “Medicare”*
 - *Economics?*: market failure in old-age insurance; redistribution
 - *Financing?*: pay-as-you-go financing not necessarily implied
 - *Reform?*: Significant efficiency gains are possible for funding reform and from individual control
- *Social insurance programs are the principal “budget deficit” issue facing the United States.*
- *Summary: Social insurance reform is likely the next big stage for tax reform.*

CONCLUSIONS

- *Tax reform debate continues: focus on marginal tax rates and*
- *Budget reform debate continues: focus on fiscal institutions*
- *Perhaps more important: public debate over social insurance reform as necessary*