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The U.S. Fiscal Balance and the True Tax



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Avoiding the cliff

The United States has narrowly managed to avoid falling off the so-called fiscal cliff, a 600 billion dollar budget tightening in the form of immediate tax increases and spending cuts that might have precipitated the U.S. economy into recession. Thanks to a last minute muddled compromise, accepted by the Senate on December 31 and by the House of Representatives on January 1, the immediate danger has receded. Nonetheless, nothing enduring has been accomplished, except that this sorry spectacle has further undermined public confidence.

Next political confrontation?

The agreement makes the Bush tax cut permanent for 99% of the taxpayers. The rollback of the tax cut for the high income earners will have little impact on the deficit and it is mostly symbolic. It gave President Obama what he needed to fulfil an election pledge, but it comes at a cost since further income tax increases may be off the table, at least for the time being. Thus, nothing much has been achieved on the income side. On the expenditure side, the two-month delay of the automatic spending cuts simply defers resolution of the problem. Uncertainty will endure, hiring and investment decisions will be further postponed. A new bitter political confrontation is pre-programmed, all the more so, since the debt ceiling must urgently be lifted by the end of February at the latest if a shutdown of non-essential government services is to be avoided. While they handed the Democrats a short-term victory, the Republicans might actually now be in a good tactical position, since they should be able to obtain significant expenditure reductions in exchange for agreeing to lift the debt ceiling. All this will happen at a time when the successor of Tim Geithner, the U.S. Secretary of the Treasury who announced his intention to leave the Administration by the end of January, will still need to be nominated and confirmed.

The U.S. economy might yet fall of the cliff in March if President Obama is serious about not wanting to negotiate the debt ceiling adjustment. In any case, the next agreement, if there is one, is likely to be flawed as well, with an array of short-term, makeshift measures that will do little to convince anxious markets. What the United States badly needs is a comprehensive long-term plan that brings spending and entitlement programs under control, which reforms the tax code, which gradually reduces the deficit and which stabilizes the debt. There are no indications that there is political will or a commitment to work towards such a plan at this stage. With U.S. monetary policy arguably out of control, U.S. fiscal policy seems to be equally rudderless.

Federal dept more than doubled

Yet the U.S. fiscal position needs urgently to be brought onto a sustainable path. The Federal debt has more than doubled during the past ten years. At over 16 trillion dollars, it now exceeds annual GDP. The debt continues to grow rapidly with the 2012 budget shortfall at about 1.3 trillion dollars. This amounts to nearly 9% of annual GDP. While 9% is a very high figure indeed, the enormity of the gap becomes even more obvious if one expresses the deficit as a fraction of expenditures rather than of GDP: thus, the deficit represents about one third of U.S. Federal expenditures. In other words, tax revenues would need to increase by about half to cover the current level of spending!

The true tax

In principle, governments have three ways to finance their current expenditures: taxes, money creation (the use of the "printing press") and borrowing. Money creation acts like a tax too, though excessive money creation leads to inflation, which reduces real balances and wealth as surely as a tax would. It is often called the inflation tax for that reason. As for borrowing, it is simply a deferred tax; the debt needs to be serviced and eventually paid back. This will require extra taxes at some time in the future. In present value terms, the future tax bill is exactly equal to the amount that is borrowed! This result, known in the economic literature as Ricardo's Equivalence Principle, is also captured by the popular saying that today's borrowings are tomorrow's taxes. One should also stress that large government deficits and correspondingly large borrowings do not necessarily stimulate economic activity as many people believe. They could just as well raise anxiety among taxpayers about their future liabilities and thus lead them to cut down on their own spending. Government expenditures then simply crowd out private consumption. The Japanese experience is a case in point; its economy has stagnated for the past two decades in spite of huge government deficits. The more the government overspends, the more households save.

The bottom line is that no matter how current government expenditures are financed, taxes will be due, now or later. Thus, the **true tax** is not the money that we pay more or less grudgingly to the government, but the government expenditures themselves! The extra tax becomes inescapable as soon as the government spending takes place. This is obvious if we think of government purchases; clearly the resources that the government absorbs are no longer available to the private sector. Disposable income shrinks immediately. It is less apparent, but even more pernicious if one thinks of government transfers since, by taking from some and giving to others – by hijacking resources, so to speak – they reduce incentives to work at both ends of the so-called solidarity chain.

The sovereign risk

If everyone understood that government borrowings are just a deferred tax and acted accordingly, there would be nothing much to worry about growing public debts. Unfortunately, there are some caveats. For one thing, some households might be unwilling or unable to prepare themselves for the future tax liabilities and thus, when the taxes eventually become due, they will be thrown into a precarious financial situation themselves. Furthermore, the longer the tax is deferred, the higher it will eventually have to be. Most taxes lead to distortions that increase with the square of the amount of the tax and thus, the bigger the tax, the more harmful it becomes to economic activity and welfare. Thirdly, and most importantly, if the debt becomes too large, investors will start doubting about the state's willingness or capacity to honour its liabilities. The debt might then be downgraded, which will tend to increase the government's interest burden and worsen the budgetary situation even more, risking to precipitate the country into a downward spiral leading to an eventual sovereign default. Greece is a recent example of precisely this process.

The United States is far from defaulting on its debt, but it must nevertheless act without delay. The inability to tackle the problem and a further downgrading of the U.S. debt might eventually damage the standing of the U.S. dollar as the reserve currency of choice... if it were not for the euro's own difficulties.

The need to act

While it has managed not to fall off the cliff for the time being, the United States must now urgently put together a credible long-term plan that will eventually restore fiscal balance and bring the debt down to a more manageable level. It needs a comprehensive tax reform and it must aim at eventually generating a primary budget surplus. Temporary, half-hearted measures will not do. All this has been said and repeated over and over again by many observers, including by the International Monetary Fund. The time to act is now. History teaches us that debt reduction takes a very long time, and too much of it has been wasted already. Moreover, the current circumstances are favourable: monetary policy is extremely supportive and real interest rates are even negative at this juncture. Who knows what the situation will be like in a few years time?

Increasing the tax base

Given the size of the gap (nearly ten trillion dollars needed over ten years...), the task is formidable. According to some calculations, reinstating the 35% and 39.6% top tax brackets (in lieu of today's 33% and 35% rates for those earning less than 400'000 dollars annually) would "only" bring in 442 billion dollars of extra revenue over 10 years. Taxing dividends and capital gains as ordinary income would merely raise 242 billion. On the other hand, repealing or setting a limit or a cap on itemized deductions might bring in up to 2'200 billion dollars. This shows that increasing the tax base might be more effective than raising tax rates. But clearly, lawmakers will have to work on the other side of the equation as well, the expenditure side, i.e. on the true tax! There is an urgent need to reduce spending and, in particular, to cut back entitlement programs, starting with Medicare and social security.

Short-term focus on cost cutting

The question remains, though, whether Congress can achieve this year what it has been incapable or unwilling to undertake in previous years. What our analysis suggests is that, while income tax increases may be off the table for now, the bulk of the adjustment will have to come from expenditures. This is just as well since expenditures are the true tax! As long as the Democrats refuse to accept this evidence, any makeshift adjustment will fall short of what is needed and hence will not be credible. However, Republicans should understand that as far as past expenditures are concerned, the true tax is already well overdue. The ballooning debt is there to prove it. Some measures on the income side are needed as well. It is hard to be optimistic in these circumstances and to believe that sanity will prevail. The saga is likely to go on for some time yet and market participants are in for more turbulence.



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Ulrich Kohli holds a licence ès sciences économiques from the University of Lausanne (1971), an M.A. in Economics from Queen's University in Kingston (1972), and a Ph.D. in Economics from the University of British Columbia (1976). He has been an economist at the Bank of Canada in Ottawa (1975 – 1977), and an economic adviser at the Swiss National Bank in Zurich (1983 – 1985). In 2001 Ulrich Kohli was appointed Chief Economist and Alternate Member of the Governing Board of the Swiss National Bank (Switzerland's central bank) by the Swiss federal government, a position he kept until the end of 2009. In January 2010 he returned to the University of Geneva as a visiting professor. Ulrich Kohli has published over seventy articles in refereed journals in the areas of international trade, aggregate production theory, economic growth, monetary economics, and macroeconomics.

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