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National Academy Fiscal Future Report

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The National Academy of Sciences has released the study *Choosing the Nation's Fiscal Future*.[1] The study looks at the federal government's finances and lays out different paths that the nation might take in the coming decades. The report was produced by a committee of 21 policy experts and a dedicated professional staff.

As a member of the NAS committee, I was honored to discuss and debate vital budget issues with such a high-caliber group. The following are my personal views on some of the more interesting aspects of the report.

Four Fiscal Paths

The NAS report does not provide a specific plan to cut federal deficits or reform fast-growing entitlement programs such as Medicare. Rather, it describes four possible fiscal paths that the government may take in coming years. The paths are defined by the share of gross domestic product that the government will consume.

For decades, federal spending has hovered around 20 percent of GDP. But official projections show that if no cuts are made to entitlements, spending could rise to 33 percent of GDP by 2040 and about 60 percent of GDP by 2080. That would create massive increases in federal debt, crushing tax burdens, or both.

The four NAS scenarios would limit federal public debt to 60 percent of GDP under various taxing and spending combinations.[2] Table 1 shows the federal spending share of GDP and required tax rates in 2040 to stabilize debt at that level. The low scenario would keep the government at about the same size as today. Under the other scenarios, payroll taxes would increase and all individual income tax rates would rise to generate added revenues. Under the high scenario, for example, all income tax rates would increase by 43 percent, the payroll tax would increase to 19 percent, and a new value-added tax—similar to a sales tax—would be added at 8 percent.

The NAS report focuses on controlling government debt and is neutral on the overall size of government. The report concludes that unless reforms are made, rising debt may raise interest rates, reduce domestic investment, push the dollar down, and create other economic damage.

Table 1. NAS Scenarios, Current Tax Structure, 2040

Government Size	Spending % GDP	Income Tax Rates	Payroll Tax Rate*	Corporate Tax Rate	VAT Rate
1. Low	21.5%	10% to 35%	15%	35%	0%
2. Middle 1	25.2%	12% to 41%	19%	35%	0%
3. Middle 2	25.5%	12% to 42%	19%	35%	0%
4. High	29.2%	14% to 50%	19%	35%	8%

* Options 3 and 4 would also include payroll tax increases for taxpayers above the Social Security wage cap.

Federal debt could also be stabilized at a smaller size of government than under the NAS scenarios. I have described reforms that would shrink the government to 15 percent of GDP by termination, privatization, and devolving activities to the states.[3] That would enhance growth and expand personal freedom in my view, but also improve the functioning of core federal activities.

A technical note is that the report's projections do not take into account the macroeconomic effects of tax changes.[4] If tax rates were to rise as under the larger-government options, GDP would likely shrink, and higher tax rates than shown in Table 1 would be needed to generate the revenues required to stabilize federal debt.

Tax Reform

The NAS report recognizes that for any given level of federal spending, the tax code could be reformed to make raising the needed revenue less damaging. As such, an alternative Simplified Tax was modeled for each of the four spending scenarios. The ST would scrap almost all deductions, exemptions, and credits under the individual income tax, and it would have rates of 10 and 25 percent instead of the current six rates.[5] The plan was loosely based on a dual-rate tax proposal of mine in 2005 and a similar proposal by Rep. Paul Ryan (R-WI).[6]

The lower rates and more neutral tax base of the ST would reduce the economic damage caused by taxation. To that end, the plan would also cut the federal corporate tax rate from 35 to 25 percent. A study by the Organization for Economic Cooperation and Development found that the corporate income tax is the most economically harmful tax.[7] The lower corporate rate under the ST would help America compete in the global economy.[8]

Table 2 shows the NAS spending scenarios and the tax rates under the ST needed to limit debt to 60 percent of GDP. Under three of the scenarios, the ST's individual tax rates would be lower in 2040 than the initial rates of 10 and 25 percent. One main reason is that the ST limits the health care exclusion to the current average cost of health care plans and grows that limit at a slower rate than projected health care inflation. The effect would be to broaden the tax base over time relative to current law.

Table 2. NAS Scenarios, Simplified Tax, 2040

Government Size	Spending % GDP	Income Tax Rates	Payroll Tax Rate*	Corporate Tax Rate	VAT Rate
1. Low	21.5%	8% to 21%	15%	25%	0%
2. Middle 1	25.2%	9% to 22%	19%	25%	0%
3. Middle 2	25.5%	9% to 23%	19%	25%	0%
4. High	29.2%	10% to 26%	19%	25%	0%

* Options 3 and 4 would also include payroll tax increases for taxpayers above the Social Security wage cap.

If Congress holds spending to the "low" level, the ST would allow families to enjoy a simpler tax system with lower rates. The ST would have the same "distribution" with respect to income groups as the current tax code when implemented in 2012, although the NAS report shows that the distribution would change modestly over time.

For those people who favor the higher spending scenarios, an ST-style tax reform would also be attractive. The higher economic growth generated by the ST would partly ease the rising burden of increased entitlement costs. And the ST's broader tax base would mean that a VAT would not be needed under any scenario.

Thinking about Larger Government

The NAS report leaves it an open question how a larger government may affect living standards. In thinking about that, note that government spending is of two basic types: production of goods and services and income transfers through subsidies and benefits. As a share of GDP, government production has been fairly stable over time but income transfers have skyrocketed.[9]

Income transfers reduce GDP because extracting taxes creates economic distortions and providing hand-outs generates unproductive behavior by the recipients. Social Security reduces savings and encourages early retirement; welfare reduces work incentives; farm subsidies induce inefficient farming practices; and so on. Some people support increased transfers for social reasons, but the effect on overall output is decidedly negative.

By contrast, government production activities could, in theory, generate positive returns. However, experience has shown that the performance of federal programs and investments is often abysmal.[10] Another problem is that governments in the United States already consume well over one-third of GDP, so it is very unlikely that added spending could earn a high enough return to overcome the economic losses caused by higher taxes. Besides, new investments with high returns, such as highways and airports, can be handed over to the private sector.

The future size of government will affect individual freedom as well as economic growth. Larger governments inevitably restrict the autonomy of individuals and their communities. The health bill before Congress, for example, would give new powers to the Internal Revenue Service, mandate the purchase of health insurance, and impose new regulations on businesses. Or consider how expanded federal education spending has gone hand-in-hand with greater federal control over local schools.

In sum, the NAS report provides a useful framework to help the public understand the options for solving the looming fiscal crisis. When considering those options, people should think about both the economic and civil liberties implications of alternative fiscal paths.

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1 Committee on the Fiscal Future of the United States, *Choosing the Nation's Fiscal Future* (Washington: National Academies Press, 2010), www.nas.edu.
2 The project's tax modeling was completed by the Urban-Brookings Tax Policy Center.
3 Chris Edwards, *Downsizing the Federal Government* (Washington: Cato Institute, 2005).
4 The estimates include microeconomic feedbacks from income tax rate changes, but not from payroll tax changes. And the estimates assume that changing tax rates do not affect GDP.
5 The ST would retain a refundable low-income tax credit and pro-savings features of the tax code, such as 401(k) plans.
6 See Chris Edwards, "Options for Tax Reform," Cato Institute, February 24, 2005. And see http://americanroadmap.org.
7 Asa Johansson et al., "Taxes and Growth," Economics Department, Organization for Economic Cooperation and Development," July 11, 2008.
8 For background, see Chris Edwards and Daniel J. Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).
9 www.cato-at-liberty.org/2009/12/10/government-and-gdp.
10 See www.downsizinggovernment.org.