

“Fiscal Policy: Accomplishments, Challenges and Opportunities”

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November 18, 2013

Remarks as Prepared

Thank you so much for having me here today. I was very happy to accept the invitation from your Chancellor Becky Blank. Becky and I worked closely together in the first four-and-a-half years of the Obama Administration and if she brings anything close to the brilliance, initiative and good judgment she brought to her various roles at the Commerce Department, including as Acting Secretary, to the University of Wisconsin at Madison then she is sure to be an outstanding Chancellor. I also want to thank Ananth, the Chairman of the economics department, for organizing this lecture.

My topic is “Fiscal Policy: Accomplishments, Challenges and Opportunities.” Fiscal policy plays a role in almost every major economic issue, from the way that the government collects revenue to the way the government spends money to how it handles the gap between those two. Fiscal policy affects short-run growth, our long-run potential, and everything from education to national defense and poverty alleviation to health care. It is also an issue I have been deeply involved in beginning with helping to craft the Recovery Act before the President was even sworn in to office up through the fiscal issues we are still dealing with today.

Fundamental Goals

But before jumping in to the specifics of fiscal policy, I want to step back and talk more fundamentally about the goals we have for economic policy broadly. We can think of these as falling in three general areas:

The first fundamental goal is to continue returning the economy to its full potential. The economy has made rapid progress in the last several years, expanding in sixteen out of the last seventeen quarters. The private sector has added 7.8 million jobs in 44 straight months of job growth. And the unemployment rate is falling at a rate of about 0.7 percentage point per year.

This progress has come in the face of the enormous challenge of recovering from the worst financial crisis since the Great Depression. One thing we have learned from economics is that rebounding to the economy’s full potential after financial crises is a lot more difficult than growing after your typical recession. In the 1980s, for example, we had a typical recession. The Federal Reserve raised interest rates, people started buying fewer houses, buying fewer cars and the economy went into a deep recession. Then the Federal Reserve cut interest rates, people started buying more houses, buying more cars, and the economy came quickly out of the recession. When you have a financial crisis, it does not work like that because families are over-leveraged, houses are overbuilt, the financial system and credit is overextended and it takes a

while to work that off and get back to the position where you can have those normal drivers of growth.

Measured by the standards of recoveries following deep financial crises, the current one has been impressive. One key yardstick is the length of time it takes GDP per working age population to return to its pre-crisis peak. We hit this benchmark just over four years after real per working age household GDP peaked in the fourth quarter of 2007. By comparison, it took a decade for output to recover following the Great Depression and about as long in nineteenth century financial crises as well. If you look at the ten other countries that Carmen Reinhart and Ken Rogoff recently identified as having recently gone through systemic financial crises in 2007 and 2008 only one other has seen its real GDP per working age population recover.

But grading on a curve, understandably, provides little comfort for Americans still struggling to find a job, worried about their family incomes, and having a hard time paying their mortgages. No one on the Obama economic team is unfurling a “Mission Accomplished” banner with the unemployment rate currently at 7.3 percent, the level of jobs still below its January 2008 peak, and an output gap that the Congressional Budget Office projected at nearly 6 percent of potential GDP for this past fiscal year. Getting the economy back to full employment and ensuring that we use our full potential remains the first order of business for economic policy.

The second fundamental goal is to expand the economy’s potential growth rate. To understand how important this goal is consider that in 2012 an American worker could produce nearly 5 times as much per hour as his or her counterpart in 1948. If you do a basic growth accounting that breaks this out, 9 percent of the increase is due to improvements in the composition of labor, mostly education. 37 percent is due to increases in the amounts of capital they have at their disposal. And 54 percent is due to increases in total factor productivity, or what the Bureau of Labor Statistics calls Multifactor Productivity and represents technology as well as the scale of markets and organization of production processes. This Total Factor Productivity is not only the most important historically, it is also the closest thing that economics has to a free lunch—which allows you to produce more output with a given amount of labor and capital input.

Unfortunately the growth rate of total factor productivity has been slowing. From 1948 to 1973 it grew at a 2.2 percent annual rate, fueled in part by public investments like the interstate highway system and the commercialization of innovations from World War II like the jet engine and synthetic rubber. But from 1973 to 2012 it has grown at only a 0.8 percent annual rate. This difference is profound. If total factor productivity had continued at its pre-1973 rate in the decades since then, our incomes would be 69 percent higher today—or roughly \$40,000 for a typical family.

And we have not been making up for this slower total factor productivity growth rate in other ways. The quality of labor inputs has grown at about the same rate in the pre-1973 period as the post-1973 period. The average educational attainment of new generations is still increasing but at nowhere near the rate it was in the 1950s and 1960s. And the growth of investment has not helped close the gap either, with the net stock of nonresidential fixed assets growing somewhat more slowly in the 1973-2012 period than from 1948-73.

The third fundamental goal is to address the rise in inequality. Since the late 1970s we have seen a large increase in inequality due to a combination of technological change, globalization, trends in education, changes in norms, and institutional changes like the erosion of the inflation adjusted minimum wage and the decline of union membership. The statistics in this regard are often repeated, but are none the less striking. The ratio of the household income from the 95th percentile to the median was roughly flat through the mid-1970s but has since grown from 270 percent of median income in 1975 to a record of 375 percent of median income in 2012.

The data is even more stark at the top of the income distribution. Recently updated numbers from Emanuel Saez at the University of California, Berkeley show that the top 1 percent of tax units received 19.3 percent of the total income, excluding income from capital gains, in 2012. This was the largest share since 1928. Since 1979 the income share going to the top 1 percent of the top 1 percent—that is the top 0.01 percent—has jumped nearly three-and-a-half percentage points, the equivalent of about \$300 billion transferred annually from the bottom 99.99 percent to the top 0.01 percent.

When you combine the double whammy of the long-standing trends of slower productivity growth and rising inequality with the recent financial crisis, you can see these challenges manifested in the fact that median family income has essentially been flat for over a decade—having stabilized after declining in the previous economic expansion—and the pre-tax and transfer poverty rate has been essentially unchanged for over four decades.

So while we have made substantial progress, we clearly have a lot more work to do—both in the short-run but more importantly in continuing to turn around these longer run trends.

Three Key Facts on Fiscal Policy—Plus One Judgment

I now want to pivot to talk about the role that fiscal policy has played in addressing these three fundamental goals and needs to continue to play. To do that, I will try to illuminate the accomplishments, challenges and opportunities for fiscal policy in the context of establishing three facts and then add one judgment I think would be widely accepted as well.

Fact #1: Fiscal policy made a significant contribution to getting the recovery on track, helping to prevent a second Great Depression

The first fiscal fact is about the past. This Administration's most important countercyclical fiscal effort was the Recovery Act. It represented a temporary but badly-needed boost to the economy that the Congressional Budget Office (CBO) originally scored at \$787 billion and its major elements included investments in infrastructure and innovation, relief for struggling States and localities, tax cuts for individuals and businesses, and expanded protections for the most vulnerable. While there has been a lot of Monday morning quarterbacking about the size of the Recovery Act, as someone who was there I can tell you that we were doing something that was much larger than most anyone was calling for, even larger as a share of the economy than the New Deal, and something that was ultimately passed with a zero vote margin.

It is also important to understand that the Recovery Act was not all we did. Numerous other jobs bills followed, further expanding investments in infrastructure, tax credits for homebuyers, business investment and hiring incentives, unemployment insurance, and a payroll tax cut for all working households. Moreover all of these fiscal measures were part of a broader response that included the financial rescue, the efforts on housing, as well as the independent actions taken by the Federal Reserve.

Altogether, Alan Blinder and Mark Zandi estimated that these actions prevented the unemployment rate from rising above 16 percent and prevented the loss of a further 8.5 million jobs. And as I said earlier, the United States has recovered more quickly from a systemic financial crisis than in most of its past experience and in most other countries around the world in large part because the response was so much more ambitious than what we have seen in the past and in many countries around the world.

Fact #2: The deficit has come down very rapidly—which is good for fiscal sustainability but has been a headwind on macroeconomic performance

The second fiscal fact is about the present. The budget deficit has fallen rapidly, from 9.8 percent of GDP in fiscal year 2009 to 4.1 percent of GDP in the fiscal year that just concluded. That is the fastest sustained pace of deficit reduction we have seen in this country other than the demobilization from World War II. And remarkably, nearly half of that total deficit reduction—2.7 percent of GDP—took place in just one year: fiscal year 2013.

Although deficit reduction is an important long-term policy goal, the rapid fiscal consolidation we have seen over the past year can also create challenges for growth and job creation. Fortunately, we have had a private sector that was leading the economic recovery and keeping our overall growth rate roughly steady, while declining federal spending subtracted from GDP growth in 10 of the last 12 quarters.

The good news is that the economy has already gone through the most severe fiscal headwinds at both the federal and State and local levels. Further immediate deficit reduction will likely be at a more gradual pace with nothing close to the 2.7 percent of GDP reduction we have seen this past fiscal year. And in the most recent two quarters the State and local sector actually made small positive contributions to growth.

Fact #3: We still have a medium and long-run deficit challenge, but it is modest compared to even recent estimates

The third fiscal fact is about the future. For years we have been warned about our long-run deficit problem. And for good reason—the familiar points about the baby boomers retiring, the increased dependency ratios that result from the decline in fertility, and the continued increase in the system-wide cost of both private and public healthcare.

But in the last few years something remarkable and not widely appreciated has happened: the projections for the medium- and long-run budget outlook have improved considerably.

Before describing the improvement I want to spend a moment on how economists generally think about fiscal policy. Our goal is to ensure that the debt is on a declining path as a share of the economy and eventually stabilizes. If we achieved this benchmark then the budget would generally be sustainable and our economy would be able to focus its resources on private sector growth and investment without being forced to undertake escalating borrowing from future generations or from abroad.

If you look at the latest CBO forecast the debt as a share of the economy is falling through 2018 and then starts a gradual rise. So we certainly have not solved the long-run deficit challenge. But it is important to understand the magnitude of that challenge. If you simply extrapolate out the deficit or debt for 75-years you will see eye-popping numbers, which is what always happens if you take an imbalance and extrapolate it over long periods of time. A more useful measure of the long-run debt that economists prefer is called the “fiscal gap.” It asks how much you need to raise taxes or cut spending as a share of GDP today in order to stabilize the debt-to-GDP ratio over the next 75 years. And CBO’s latest estimate of the fiscal gap is 1.7 percent of GDP, substantially below other estimates of the fiscal gap in recent years.

What changed? One big item is healthcare. CBO estimates that the Affordable Care Act (ACA) will reduce the deficit over the coming decade and by about 0.5 percent of GDP by the middle of the following decade. In addition, in light of ongoing developments in the health system, CBO is now projecting that Medicare and Medicaid spending in 2020 will be about 20 percent below, or a bit less than 0.6 percent of GDP, what was projected in August 2010 that already incorporated the ACA. These two changes are consistent with a reduction in the 75-year fiscal gap of substantially more than 1 percent of GDP. Also important are the spending reductions in the Budget Control Act, which, not even counting the sequester, are cutting discretionary spending to its lowest level as a share of the economy since the 1950s. A third major policy item has been returning to the income tax rates for high-income households that prevailed in the 1990s, which is consistent with a more than 0.4 percentage point reduction in the 75-year fiscal gap. Finally, revised forecasts, including a period of lower interest rates, have also made a difference.

I also want to stress that there is a huge amount of uncertainty in 75 or even 10 year budget forecasts. We have seen predictions go wildly wrong and reality turn out a lot better than we expected or a lot worse than we expected. The last few years the deficit has actually come in a lot better than we expected. One way to think about the uncertainty is a calculation by Larry Summers: he said that if the economy were to grow 0.2 percentage points faster per year we would erase the 75-year fiscal gap and thus stabilize the debt as a share of the economy. It is not clear, though, what role uncertainty should play in our fiscal policy. To some degree you do not want to overreact to a problem you are uncertain about by making major changes that are difficult to reverse. But on the other hand the uncertainty does call out the need for insurance against potential future economic needs, natural disasters or other events. Regardless, the outlook looks a lot better but our best guess is that we still face a manageable long-run fiscal challenge.

Judgment: Our bigger challenge for long-run growth is the composition of spending and revenue

Those are my three facts and I now want to talk about the judgment. The judgment, I think, is almost the most important for motivating what the Administration is trying to accomplish in fiscal policy. And the judgment is one that, I think, many, if not most, economists, business leaders and experts from across the political spectrum would share. And it is that our biggest fiscal challenges are about the composition of spending and the composition of revenue.

When it comes to the composition of spending, the biggest challenge is that we should be investing more in areas that are key to expanding the economy's growth potential, including infrastructure, research and education. And we should be continuing to build on our efforts to improve the efficiency of health care and reduce the rate of growth of health costs.

And when it comes to the composition of revenue, the biggest issues are a corporate tax code that could do more to encourage companies to create jobs in the United States and reduce the distortions that sometimes shape this investment, and an individual tax code that could be simpler, fairer and more efficient—all points I will return to shortly.

The Agenda Going Forward

These three fiscal facts and one fiscal judgment motivate the agenda going forward. And one way to summarize this agenda is to say that we have already locked in significant deficit reduction. While we need some more deficit reduction, the even more important emphasis is on ensuring that the deficit reduction is smarter. And smarter deficit reduction includes more to continue to return the economy to its potential, expand that potential and reduce inequality.

Timepath of Deficit Reduction

Some of the macroeconomic challenges that economies around the world face present insoluble dilemmas, the most classic being the impossible trinity of free capital flows, fixed exchange rates and sovereign monetary policies. Some countries around the world today are dealing with equally painful dilemmas about how to promote economic expansion in the face of capital flight and limited ability to borrow against large deficits and constraints on their monetary policy. In the United States what is so vexing is not the difficult or insoluble the dilemma we face but just the opposite—how simple and obvious the macroeconomics of the solution is.

Just about any economic textbook would tell you that the answer to our macroeconomic stance is less fiscal contraction upfront and more deficit reduction over the medium and long term. Nearly a year ago, the President put forward a framework that does just that. It provides relief for the sequester and upfront jobs measures like investments in infrastructure, teacher jobs and small business tax cuts.

If you compare that framework the sequester it is striking. It ensures that there will be more upfront assistance for job creation and less of an immediate fiscal headwind. And it includes significantly more medium- and long-run deficit reduction than the sequester: in 2021,

the President's framework has \$224 billion in non-interest deficit reduction as compared with \$109 billion from the sequester in that year, and by 2023 the deficit reduction under the President's plan grows to \$296 billion while the deficit reduction under the sequester falls to \$15 billion. As a result, the Congressional Budget Office estimated that the deficit falls to 2.1 percent of GDP in 2023 under the President's approach, consistent with falling debt as a share of GDP. Over the longer term, these measures close more than two-thirds of CBO's estimated 75-year fiscal gap and close the entire fiscal gap as estimated by the Office of Management and Budget (OMB). And the plan is balanced between spending and revenue.

The Composition of Government Spending

Perhaps even more importantly the President's proposal shifts the composition of spending towards investments in infrastructure, research and education that will help expand America's long-run potential while also expanding opportunities, increasing mobility and reducing inequality. I will not list all of the items here, but will say that one is a proposal to provide States the ability to provide a quality preschool education for all and another is a substantial, sustained investment in America's infrastructure.

It is important that it is not just how much you invest, it is how you invest it. Education depends not just on resources but also on how those resources are used, which was a key goal of Race to the Top and is integral to the President's focus on high-quality preschool. And in the area of infrastructure we need to recognize that the Federal government will never be able to invest as much as the country needs on its own, we also need to do more to leverage Federal resources, ensure that they are dedicated to higher-quality projects, and encourage private investment in the United States.

The Composition of Revenue

In July the President proposed that we focus on a Grand Bargain for Jobs. At the center of this Grand Bargain is a combination of business tax reform and some of the investments I have just described like infrastructure.

I want to go spend a moment on the economics of the business tax reform component of the Grand Bargain. While there is still substantial scope for simplification, improvement and additional high-income revenue on the individual income tax side, it's the business tax reform side where I think we have the lowest hanging fruit when it comes to the potential for increasing our economic growth.

At a deeper level, the guiding principal of the President's approach to business tax reform is to develop a tax system that is more neutral than the one we have today so that decisions are being made for business reasons and not for tax reasons. For example, that means being more neutral about the forms of investment so that we are not taxing investment in manufacturing structures at 32 percent and taxing investment in petroleum structures at 9 percent. It means being more neutral about the financing of this investment, so that were not taxing equity finance investment on rates that exceed 30 or 40 percent and taxing debt financed investment where there are rates that are actually negative. It means being more neutral about the form of

businesses so we're not saying that large pass-throughs can pay taxes on an integrated basis at a much lower rate than corporations. And finally it means greater neutrality about decisions about investing in the United States versus overseas, rather than a tax code that currently has an incentive often to invest and reinvest overseas.

The conventional mantra on business tax reform is lower the rate and broaden the base. And this is very much consistent with that economic perspective on having a tax code that's more neutral in all of those dimensions; broadening the base gets rid of the differential tax on different forms of investment, a lower tax rate obviates the painful tradeoffs you would face between debt and equity financing, between worldwide and territorial tax systems. And doing all of this with structural reforms can address the business foreign issue as well.

The President's Framework for Business Tax Reform proposes a 28 percent tax rate, reformed and expanded incentives for research, manufacturing and clean energy, a broader base, a reformed international system and tax cuts for small business—plus transitional revenue that could be reinvested in infrastructure while the plan does not add to the deficit over the medium- and long run.

In addition, there is scope on the individual side as well to further simplify, make the tax code more fair and more efficient. To this end, the President has proposed to cut back on some of the inefficient tax benefits that high-income households get—a step that also raises additional revenue as part of the balanced deficit plan I described earlier.

How the Budget Does—and Does Not—Matter for Inequality

I have mostly been focused on fiscal policy in the context of growth. But it also matters a lot for inequality, poverty and family incomes. As I said earlier, faster growth would help all of these. But fiscal policy has played an important role as well.

To put this in perspective, I want to talk about a really striking statistic that researchers at Columbia University recently produced. They took something called the Supplemental Poverty Measure, which was introduced under the leadership of Becky Blank when she was at the Department of Commerce. The Supplemental Poverty Measure is much more accurate in a lot of ways, including fully representing government policies. What these researchers did was to take that measure and extrapolated it all the way back to the 1960s. They then looked at what the poverty rate would be if we ignored all of our government policies and then they separately looked at what the poverty rate was with our government policies.

If you ignored our tax credits for working families, nutrition assistance, unemployment insurance, Social Security—all the elements of the social safety net—the poverty rate in 1967 was 32 percent and in 2011 it was 31 percent. It barely moved in 44 years. Now add in the EITC and other refundable tax credits—those were all invented after 1967 and have been expanded subsequently—add in food stamps and other programs and including all of these the poverty rate fell from 27 percent in 1967 to 16 percent in 2011. So we have actually cut poverty by 40 percent in 44 years, and we cut it entirely because of fiscal policies.

We have tried to build on this with expansions of refundable tax credits for working families in the Recovery Act that have been extended since then. As a result of these and other policies, including the long-standing safety net, we prevented a large increase in poverty in the wake of the Great Recession—while pre-tax and transfer poverty rose by 4.1 percentage points from 2007 to 2011, the post-tax and transfer poverty rate only rose 0.3 percentage point. In addition, we have also built on the legacy with the Affordable Care Act which helps families across the economy but has particularly large benefits for many moderate income families who previously did not have access to affordable health insurance. Finally, as part of the balanced approach to paying for these measures and bringing down the deficit, we have returned tax rates to high-income households to what they were in the 1990s. All of these measures are leaning against the wind of the trend of increasing inequality.

Going forward there is certainly more scope for fiscal policy to continue to help middle class families and those struggling to get into the middle class, which is why the President is pushing to make permanent expanded tax incentives for college and for moderate income families with children as well as to defend nutrition assistance against large proposed cuts and to extend emergency unemployment insurance.

But some of the biggest potential gains in reducing poverty and inequality and helping the middle class are not going to come from fiscal policy but will come from what economists would call rising pre-tax and transfer incomes. Fiscal policy plays a role, like preschool and education, but the most immediate policies we have in this regard are in other areas, like raising the minimum wage.

Commonsense Immigration Reform

The final fiscal policy area I want to mention briefly—in an effort to prove that an awful lot can fall under that heading—is comprehensive immigration reform. The primary purpose of comprehensive immigration reform is not to reduce the deficit—it is rooted in broader economic goals like higher growth as well as more fundamental questions like what America should be like as a society and how to further secure our borders. But we should not lose sight of the fact that immigration reform also helps to reduce the federal deficit by \$160 billion over the next decade and \$700 billion over the following decade, an important added bonus.

Conclusion

Which brings me to my conclusion. I have only had the chance to discuss part of the agenda. The President is very focused on a better bargain for the middle class that includes jobs, health care, retirement security, housing and ladders to the middle class. An important element of this better bargain for the middle class depends on fiscal policy, but it also depends on other areas like reforming our housing finance system and raising the minimum wage. Beyond that, much of the economy's potential growth comes from the slowdown of health costs, the expansion of energy production, and improvements in technology. Once again, these have dimensions that go beyond fiscal—including the effective implementation of the delivery system reforms in the ACA, the all-of-the-above energy strategy, reforms to our patent system and

mobile broadband spectrum as well as expansions in trade. I would be happy to talk about any of these in the questions and answer period.

But in terms of a broad conclusion, we have made a lot of progress. But there is a lot more to do—especially when you consider not just the immediate aftermath of the financial crisis but the decades long trends of slower productivity growth and increased inequality. The good news for public policy is that many of the policies that address these issues offer situations of win/win or even win/win/win. If you invest in infrastructure, it helps accelerate the economy's return to its potential, but also helps expand that potential and provides jobs for the middle class. Increasing the supply of skills through investment in education and training helps reduce inequality. It also expands growth, and I could go on. We do not need to spend money to make our business tax code more attractive for creating jobs in the United States. All of these are relatively simple and basic economic policies—the biggest challenge is making sure that Congress actually follows through on them.