The Ghost of Tax Day Future
By R. Glenn Hubbard
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Tax Day – the day our last-minute tax returns leave our hands for the warm embrace of the IRS – invariably follows late nights. For most of us, the late nights call to mind the numbing complexity of the tax code. The late nights add up to the tax compliance costs of $150 billion, and drive about 60 percent of taxpayers to rely on professionals to do their returns. For economists, the late nights add the lamentations over "deadweight loss" – the added drain on economic activity that significantly exceeds the direct amount raised to fund government spending because of the tax code's inefficiency. And no academic curiosity that: Recent studies suggest that fundamental tax reform – changing to a broad-based income or consumption levy that taxes income only once – could yield annual household income gains of 9 percent.

But what should keep us all up at night is the image of a Dickensian Ghost of Christmas Future (er, Tax Day Future) showing us the shadows of what might be, but need not be. Imagine our Tax Day Dream if our tax burden were 50 percent higher – a dream (nightmare?) not so farfetched as it sounds.

Economists' thoughts about 'taxes' quickly turn to thoughts about 'government spending.' The important first question we decide through our elected officials is the *size of government* – the level of spending on defense and homeland security, on physical infrastructure on highways and airports and ideas infrastructure in education and research, on job training and unemployment benefits, on entitlement spending on Social Security and Medicare, and so forth. These decisions then raise the question of how we pay for that spending – *taxes today* or *taxes tomorrow* (deficits today). Then we get to the question of how we structure those taxes: What should be taxed? At what rates? How important is economic growth? Fairness?

The Congressional Budget Office regularly quantifies these shadows of the Ghost of Tax Day Future. Their forecasts are not sanguine. Absent any changes, increases in Social Security and Medicare spending alone are projected to consume 10 percentage points more of our nation's GDP after a generation than they do today. (This growth could be greater still if the pace of health care cost increases is not mitigated.)

It is difficult to believe that the present size of the federal government of about 20 percent of U.S. GDP would be maintained in the presence of this entitlement spending surge. What other component of spending would give? After all, we spend only 4 percent of GDP on national defense. And we spend at the federal level only 3.1 percent of GDP on *all* current programs outside national defense, Social Security and Medicare, other health programs, income security, and net interest. Accommodating an entitlement surge will be painful. Would America play the same role in the world with a shrunken commitment to national defense? Will we be able to make the investments in education and basic research that are essential competitiveness? Could it be that it is this grim budget arithmetic and not simply a different "choice" that is withering the global standing and domestic health of continental European democracies?

There is another possibility. If we set aside these possibilities of having a government simply devoted to entitlement programs, imagine the Ghost of Tax Day Future's second shadow of a rise in federal government spending of 10 percentage points of GDP from its present level of 20 percent. With this chore highlighted for us, current votes for a "deficit reduction" are describing a path of required “tax increases.” (Remember that from an economic perspective – as well as from the perspective of the decisions that our elected leaders actually make – the relevant variables are always “spending” and “taxes”, not the “deficit” per se.)

To frame the path of required future tax increases, it is useful to highlight the popular “Tax Freedom Day” concept of the Tax Foundation. For Tax Freedom Day in 2006 – the day this year that taxpayers on average stop working to pay their tax obligations and begin earning for their own spending and saving plans – is April 26. And the Foundation cheerily notes that this date is earlier than the May 3rd date for the year 2000, when higher tax rates and real bracket creep were at work. But the variation between April 26 and May 3 loses our interest if we start to contemplate a Tax Freedom Day in, say, mid June.

Why? Closing the spending gap shown us by the Ghost of Tax Day Future with tax increases would eventually require *all* taxes on average to increase by more than 50 percent, as the current federal tax share on GDP is about 17 percent. Such a tax increase is not simply a larger check made out to “United States Treasury.” Economic research suggests that larger governments are associated, all else equal, with slower economic growth because of the tax and regulatory burdens associated with a larger state. Using the estimate of Eric Engen of the Federal Reserve Board and Jonathan Skinner of Dartmouth College, meeting our entitlement spending wave through tax increases would ultimately depress our annual rate of economic growth by about a full percentage point. That such tax increases would build up over many years does not dull the observation that tax increases of this magnitude would carry serious consequences for our future living standards. Their sheer size would restrain incentives for innovation and flexibility, and entrepreneurship and productivity growth that have characterized the absolutely and relatively strong U.S. economic performance. Indeed, the “tax increase” shadow could ultimately crowd out about as much of the rate of growth as the productivity growth boom of the past decade has contributed.

The Ghost’s alternative shadow – again, dictated by arithmetic – is to reduce the size of future spending on entitlement programs. Reducing the rate of growth of benefits can be gradual, and the burden of adjustment can be focused on middle- and upper-income households. This adjustment could incorporate stronger traditional benefits for lower-income workers, slower benefit growth for higher-income workers, and saving incentives to help younger workers prepare for their needs as they age. That is, a more progressive plan to limit the growth on entitlement spending would also include reforms to beef up defined-benefit pensions and build up private savings for all workers. A similar approach could be applied to Medicare, but with an added twist. The growth of benefits needs to be reduced for higher-income workers, as with Social Security, but rising health care costs can also be addressed by encouraging younger workers to accumulate funds in Health Savings Accounts, giving them to incentives to consume health care services more efficiently, while saving for the purchase of true health insurance on old age.

Now to the Ghost’s final shadow – how to raise the taxes for the size of government we demand – that is, discussion of *tax reform*. The nation faces many challenges and needs in the coming decades. We should make sure that tax code maximizes possibilities for economic growth, especially given the many requirements of an aging society. And if our elected leaders decide to increase revenue modestly as a compromise matching greater limits on the future size of federal spending, that revenue should be raised n the most efficient way possible, with the lowest “deadweight loss” in foregone economic activity. Not all tax reforms or simplifications are equal. Tax reform to promote growth should keep marginal tax rates low and remove (or at least sharply reduce) tax bases against saving, investment, and risk-taking. One direction for reform builds on recent tax changes and a recommendation of the President’s Advisory Panel on Federal Tax Reform: Remove investor-level taxes on returns to saving. All income would be taxed once with a broad base – wages at the household level and business income at the business level.

All of these issues are significant and hard. But the visit of the Ghost of Tax Day Future is an opportunity as well as a challenge (Remember that seeing the apparition's warning led Ebenezer Scrooge to change his behavior for a happy ending.)

As we wake up from a Tax Day dream, a few questions are clear: How large do we want our government to be? What constraints on our services and living standards are we willing to accept as entitlement spending grows? Can we agree to face reality soon and focus adjustments on middle- and upper-income workers (whether on the spending or tax side), while urging tax reform to give us the best possible choices?

Sweet dreams.

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