Fiscal Challenge 2016

Team #120
• Challenges to economic growth
• Rising instability of pension and Social Security financing
• Fiscal imbalances
Without intervention, the debt-to-GDP ratio of the U.S. would skyrocket to above 100% until 2040.

To maintain a stable debt-to-GDP ratio of around 76%, additional annual revenues or cost savings at 1.1% of GDP are necessary.

Our proposals collect more than 1.5% of GDP annually and thereby reduce the debt-to-GDP ratio to below 71%.
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Summary of Proposals

Income Inequality in the US

Additional Consideration #1

Source: Census Bureau
Fiscal Challenge 2016
Summary of Proposals
Global Competitiveness

Additional Consideration #2

Corporate Tax Rate

Source: taxfoundation.org
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Proposals: Taxation (Demand)

Value Added Tax (VAT)

- VAT charged on sales: 5%
- VAT paid on purchases: 5%

VAT due
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Proposals: Taxation (Demand)

Value Added Tax (VAT)

VAT due

Transfer Payments

$450 per adult
$200 per child

+ Transforming state sales taxes to VAT

Taxation (D)
Soc. Security
Medicare

VAT
Revenue/GDP (%)

1%
Taxation of Gasoline

- **Pigouvian Tax**
- Positive effects on health, the environment and future generations
- Brings fuel prices in line with OECD
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Proposals: Taxation (Demand)

Taxation of Gasoline

OECD fuel prices, Jun 2014

(Australian cents per litre)

Source: Australian Bureau of Resources and Energy Economics.
Mortgage Interest Deduction

• **Proposal:** Convert the current deduction for mortgage interest (slowly phased out by 2018) to a 15% non-refundable tax credit on mortgages up to $500,000

• **Justification:**
  • Increase tax incentive for, especially for the less well-off homeownership (key aspect of social mobility)
  • Directs economic investment away from expensive homes (artificially advantaged under current tax system)

• **Net effect:** Additional revenues amounting to 0.05% of GDP cumulating to $270 billion until 2040
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Proposals: Taxation (Supply)

Corporate Tax Reduction

- Phase-in period
- Reestablishing competitiveness
Proposal: Bring the United States in line with the territorial tax system used by most countries by exempting 95% of dividends received by domestic corporations from foreign subsidiaries from taxable income

Justification:
- Incentivizing US corporations to return earnings back to domestic shareholders rather than accumulating funds overseas
- Levels the playing field with other industrialized countries
- Capital ownership neutrality: does not discriminate against companies on basis of residence

Net effect: Reduction of revenues amounting to -0.13% of GDP cumulating to $727 billion until 2040
Proposals: Taxation (Supply)

Deemed Repatriation

**Proposal:** Reclassify accumulated foreign earnings held abroad as cash (after 1986 and prior to 2015) as repatriated under Subpart F and levy a one-time tax of 8.75%, spreadable over 8 years.

**Justification:**
- Penalty for companies holding excess amounts of cash abroad

**Net effect:** Additional revenues amounting to 0.10% of GDP cumulating to $539 billion until 2040
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Proposals: Expenditures (Social Security)

Cost-of-Living Adjustment

CPI-W

Chained CPI-U

Taxation (D)
Taxation (S)
Soc. Security
Medicare

Revenue/GDP (%)

1%
Proposals: Expenditures (Social Security)

Taxable Maximum Income

- **Proposal:** Increase the taxable maximum by 13% per year to reach $319,900 by 2025, then switch to annual growth in wages; include additional earnings in benefit calculations

- **Justification:**
  - Extend OASDI trust fund's exhaustion date to 2039
  - 47% smaller reduction in benefits needed to make outlays equal revenues in 2040
  - Tax increase offset by increase in paid benefits

- **Net effect:** Additional revenues amounting to 0.51% of GDP cumulating to $2.5 trillion until 2040
Medicare Part D Rebate

• **Proposal:** Require manufacturers to provide a minimum rebate for all prescription drugs used by low-income households (similar to Medicaid dual coverage prior to 2006)

• **Justification:**
  • Politically more acceptable due to recent public outrage directed at Gilead Sciences and Turing Pharmaceuticals
  • Minimal impact on research/development expenditures (especially "breakthrough" drugs that can wield monopoly power)
  • Insignificant price distortion for beneficiaries on private insurance (due to increased market penetration of generics) outweighed by cost savings due to lower drug prices
  • Successfully used by Medicaid

• **Net effect:** Saving costs amounting to 0.08% of GDP cumulating to $417 billion until 2040
## Fiscal Challenge 2016

### Summary of Proposals

<table>
<thead>
<tr>
<th>Taxation (Demand)</th>
<th>Proposal</th>
<th>Tax revenue effect (in % of GDP)</th>
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<tbody>
<tr>
<td></td>
<td>Introducing federal Value Added Tax (VAT)</td>
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<td></td>
<td>Raising gasoline tax by 35ct</td>
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<td></td>
<td>Converting mortgage interest rate deduction into tax credit</td>
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<tr>
<td>Taxation (Supply)</td>
<td>Reducing corporate taxes</td>
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<td>Territorial taxation of corporate earnings</td>
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<td>Social Security</td>
<td>Cost-of-living adjustment: chained CPI-U</td>
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<tr>
<td></td>
<td>Raising taxable maximum income</td>
<td>+0.51</td>
</tr>
<tr>
<td>Medicare</td>
<td>Medicare Part D rebate</td>
<td>+0.08</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td><strong>1.51</strong></td>
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</table>
Thank you very much for your attention!
Value Added Tax (VAT)

- **Proposal**: 5% flat-rate tax on all products except for education, Medicaid, Medicare, spending on charitable organizations, and spending of state and local governments; accompanied by implement transfer payments ($450 per adult, $200 per child) to low-income households.

- **Recommendation**: states can switch from sales tax to VAT.

- **Justification**:
  - Raises revenue with minimal distortion on savings and investment choices.
  - Eliminates distortions of state sales taxes.
  - Reduces administrative costs by linking state and federal VAT databases.
  - Transfers decrease regressive nature of tax.

- **Net effect**: Additional revenues amounting to 1% of GDP cumulating to $5.4 trillion until 2040.
Value Added Tax (VAT)

Current rule

- No Value Added Tax (VAT) existent
  - Only OECD country not having such a tax
- Most states levy sales taxes on consumption goods
  - 45 states plus D.C. do have a sales tax
    - Exceptions: Alaska, New Hampshire, Delaware, Montana, Oregon
    - Highest sales tax: 7.5% (California)
    - Some regional sales taxes may increase the total taxation to over 11%
  - 40% of sales tax revenues are generated from businesses, which should be exempt from this rule
  - Administratively burdensome as tax rate must be determined dependent on the nature of the buyer
Reason for transfer payments instead of reduced VAT rates (as common practice in Europe and other countries)

• Gets complicated quickly
  • E.g., should carnival costumes be declared as toys (full VAT), or as clothes (reduced VAT)?

• Requires subjective judgment of which goods qualify

• Exceptions for reduced VAT rates create incentive to falsely declare products

• Might be misused for protectionism
  • E.g., Germany introduced lower VAT rates for Hotels to boost tourism

• Transfer payment system is more regressive than VAT exemption system as it distinguishes between low-income and high-income households
Proposals: Taxation (Demand)

Taxation of Gasoline

- **Proposal**: Raise taxes on gasoline and diesel by $0.35 and index for inflation (base year 2015)

- **Justification**:  
  - Pigouvian tax  
  - Existing collection network  
  - Decreased pollution and less green-house gas emissions

- **Net effect**: Additional revenues amounting to 0.27% of GDP cumulating to $1.4 trillion until 2040
Current rule
• 18.4ct per gallon of gasoline and 24.4ct per gallon of diesel
• Federal gasoline taxes credited to Highway Trust Fund to pay for highway construction/maintenance and investment in mass transit
• Together with local/state taxes amounting to tax burden of around 50ct per gallon of gasoline and 55ct per gallon of diesel
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Proposals: Taxation (Demand)

Taxation of Gasoline

Our proposal

• Increasing gasoline tax by 35ct

• Leading to 53.4ct per gallon of gasoline and 59.4ct per gallon of diesel

• Adjustment based on CPI from 2017 on
Taxation of Gasoline

**Positive effects**
- Substantial revenues generated
- Pigouvian tax: pricing a negative externality
  - Many economists suggest much higher taxes (e.g., $1 per gallon; or equivalents of $30 per ton of CO2)

**Negative effects**
- Businesses’ costs increase and therefore lower income and payroll tax base
- Rather regressive effects
Corporate Tax Reduction

**Proposal:** Reduce the rate on corporate income from 35% to a flat rate of 25% through phase-in

**Justification:**
- Critical to increase US economic competitiveness (US currently has one of the highest corporate tax rate globally)
- Increases the corporate tax base potentially off-setting short-term reductions in revenues following the rate cut
- Corporations incentivized to decrease their tax liabilities through "self-help" (shifting operations overseas, exploitation of legal loopholes)

**Net effect:** Reduction of revenues amounting to 0.51% of GDP cumulating to $2.8 trillion until 2040
Corporate Tax Rate

U.S. Effective Corporate Tax Rate
1947-2011

Source: Federal Reserve
Corporate Tax Rate

U.S. Kept a High Corporate Tax Rate, Revenue Remained Low

Source: OECD
Success in Other Countries:
- Ireland corporate tax rate is 15% but it has experienced benefits in the form of massive job growth and upward trends in income
Mortgage Interest Deduction

Current situation:

• Most developed countries do not allow a deduction for interest on personal loans
• Glaeser argues it encourages people to leave urban areas and irresponsibly borrow to invest in housing
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Proposals: Expenditures (Social Security)

Cost-of-Living Adjustment

- **Proposal:** Change the Cost-of-Living Adjustment for Social security payments from CPI-W to chained CPI-U

- **Justification:**
  - Avoids small-sample and substitution bias
  - Captures a far-more representative sample of consumer behavior

- **Net effect:** Additional revenues amounting to 0.14% of GDP cumulating to $831 billion until 2040
How would you respond to criticisms that, unlike the CPI-W, the CPI-U is too broad in that it no longer is an accurate reflection of the lower and middle class working population?

- The CPI certainly impacts the lower and middle class working population, but increasingly so, the additional demographics that CPI-U includes as well. As a result, an index like the CPI-U that covers as many of those impacted as possible, and not only the lower and middle class working population, is needed.

What additional costs do you anticipate to be associated with this transition?

- Currently, the majority of funds are already being utilized to calculate CPI-U, and the calculation for CPI-W is not an entirely separate study but rather a derivation utilizing the CPI-U and some other information. That is, the funds for calculating CPI-U are already present, so it is mainly a matter of eliminating the CPI-W calculations, which does not require significant additional costs.

How did you calculate the 831 billion USD generated in revenue until 2040?

- CBO stated that this policy would generate revenue amounting to .2 percent of GDP each year. .2 percent of GDP * (2040 - 2016) = 4.9 percent of GDP = 831 billion USD
Why is annual growth rate in wages a better determinant of increase in benefits than is the inflation rate?

• Annual growth rate in wages is a better and more individualized reflection of the increase in benefits people should have access to; whereas inflation is too general and incorporates more irrelevant factors.

How did you calculate the 2.5 trillion USD generated in revenue until 2040?

• Calculated additional revenue from increasing taxable maximum income (obtained from CBO)/GDP ratio

• This ratio is quite stable and steadily increasing, so projected out by the decade along this trajectory, assuming it grows with GDP, to obtain .51% of GDP by 2040, which equals 2.5 trillion USD
Current System

- US-sourced and foreign-sourced income by US multinational corporations taxable
- Foreign-sourced income by US MNCs subject to tax upon repatriation as a dividend to the US parent, otherwise deferred
- Limited foreign tax credits allowed from deferral
Figure 1. Foreign Taxable Earnings and Taxes Paid by U.S. Companies, 1992-2010

Note: Includes only repatriated income and income subject to current taxation. Does not include income currently held abroad.
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Dividend Exemption System

Problems

- Favors flow-through enterprises over taxable corporations
- Incentivizes financing investments with debt rather than equity
- Encourages withholding of dividend repayments to US shareholders
- Allows many MNCs to shift reported income to tax havens
Advantages of Reform

• More aligned with other developed economies (UK, Japan, Canada, France, etc.)
• Increase US MNC competitiveness by lowering effective tax rate on income
• Potential long-run increases in revenue as a result of fewer profit relocations (tax inversions and moving income to tax havens)
• One-time tax on foreign subsidiaries offsets cost of new dividend exemption system

Challenges of Reform

• The level of increase in repatriations may be small and transitory
• Direct benefits to the US through benefits to MNC competitiveness unclear
• Federal bargaining power for Medicare Part D is limited
  • Required to cover all drugs in six protected classes
    • Includes four of the largest categories of dual-eligible drug spending (anti-psychotics, anti-depressants, anti-retrovirals, and anti-convulsants) (Bagchi, Esposito, and Verdier 2007)
    • Cannot implement cost-sharing provisions (different drugs in tiered system)
• Reliance on direct negotiations between private insurers and drug manufacturers
• Dual-eligible beneficiaries precedent prior to 2006 implementation of Medicare Part D
  • Currently used by Medicaid and Tricare
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Proposals: Medicare

Exhibit 2

Medicare Drug Benefit Low-Income Subsidy Eligibility and Participation, 2009

- Eligible but not receiving subsidy: 2.3 million (19%)
- Eligible but estimated to have other drug coverage: 0.5 million (4%)
- Applied for and receiving subsidy: 1.5 million (12%)
- MSP and SSI recipients automatically receiving subsidy: 1.8 million (15%)
- Full dual eligibles automatically receiving subsidy: 6.3 million (50%)

Beneficiaries Eligible for Low-Income Subsidies = 12.5 million

SOURCE: Centers for Medicare & Medicaid Services, 2009 Enrollment Information (as of February 1, 2009). NOTE: *Includes Veterans Affairs, Indian Health Service, and Retiree Drug Subsidy (RDS) coverage. **MSP is Medicare Savings Program; SSI is Supplemental Security Income.
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Proposals: Medicare

- Expand minimum rebate (23.1% of average manufacturer price) to low-income (LIS) Medicare beneficiaries
  - Only required to cover difference with existing rebates
  - Additional rebate for price increases net of inflation

- Medicare Savings Act of 2015 sponsored by Bill Nelson (Senate) and Kathy Castor (House)

(Billions of dollars)  
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Notes: This option would take effect in January 2017. Estimates are relative to CBO's August 2014 baseline projections.

* = between zero and $500 million.
Average Cost of Drugs for 53 Therapeutic Classes in Medicare Part D and Medicaid FFS in 2010

- Medicare Part D: $50
- Medicaid FFS: $37

Dollars per 30-Day Supply

Note: Over time CBO expects this cost difference between Part D and Medicaid FFS to lessen somewhat as manufacturers respond to the change in Medicaid’s basic rebate under the Affordable Care Act. Other changes in the drug market over time, such as the relative usage of brand-name and generic drugs, will also affect this cost difference in the future.
• Decreased drug manufacturer R&D spending
  • Frank (2012) shows no impact on antipsychotic drugs
  • Breakthrough drugs can still be launched at a higher price (CBO 2013)

• Fewer rebates for private payers and higher “launch” prices
  • Morton (1997) shows only 4% price increase for Medicaid rebates
  • Increased market penetration of genetics decrease pricing impacts
  • Employers will bargain for better rebates
  • Reduce impact of price increases (half of Medicaid cost savings from inflation provisions)

• Higher premiums and drug costs for non-LIS Part D beneficiaries
  • Inconsistent with profit-maximizing behavior for drug manufacturers
  • Private plans can’t restrict plan offerings to either group of beneficiaries
Primary Sources
OECD Data
IMF Data
CBO Data
Gale, Krupkin: Major Tax Issues in 2016. 2015
Secondary Sources
https://fas.org/sgp crs/misc/R42624.pdf
http://www.slideshare.net/cbo/44366-academy-healthpresentationcook
https://kaiserfamilyfoundation.files.wordpress.com/2013/01/8307.pdf
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