Fiscal Challenge Proposal

Team #103

April 2017
Executive Summary

Current Outlook

- Current Debt to GDP Ratio: 77%
- Projected increase in ratio to 144% by 2047
- Growing unsustainability of social security
- Fiscal imbalances caused by excessive debt and spending
- Risk of decline in global competitiveness
- Must cut costs or increase revenues by 1.9% of GDP to stabilize Debt-to-GDP ratio

Proposals

- Itemized Deductions Elimination
- Mandatory Spending Adjustments
  - Link Social Security to a Pure Price Index
  - Increase Payroll Tax for Medicare by 1%
- Environmental Taxes
  - Enact Greenhouse Tax
  - Increase Motor Fuels Taxes
- Corporate Tax Restructuring
  - Tax Foreign Subsidiary Income
  - Repeal Deduction for Domestic Production Activities
  - Reduce Corporate Tax Rate

These proposals exceed the 1.9% GDP needed to stabilize the debt ratio and achieve a 2.28% increase in GDP, thereby lowering Debt-to-GDP to 72%
Current Budget Outlook

The current Debt-to-GDP ratio is at 77%, and is projected to rise rapidly and unsustainably in the near future due to sharp increases in mandatory spending from an aging population.
Current Budget Outlook

The level of US national debt held by the public is rising at unsustainable levels relative to GDP.

**U.S. Debt-to-GDP Ratio**

- U.S. national debt over $19 trillion
- ~$161,000 per taxpayer \(\rightarrow\) 3x the median household income
- Rising unsustainable debt levels crossing 100% by 2038
Importance of Stabilizing the Debt to GDP Ratio

The rising debt burden has tangible negative effects on the US economy.

Impact of Debt-to-GDP Ratio

- Slowed economic growth from heavy debt burden
- High interest payments affecting exchange rates and borrowing rates
- Declining international competitiveness
- Increases in mandatory spending such as social security and healthcare take away from discretionary spending opportunities
- Strain on future generations
Measuring Budget Impact

The following meter tracks the impact of each proposal on % of GDP.

CBO Recommendation
- Annual 1.90% cost savings or revenue gains to stabilize Debt-to-GDP at 77%

Proposals Effect
- Annual 2.28% cost savings or revenue gains to stabilize Debt-to-GDP at 72%
Increase Tax Revenue

Increasing government revenues from taxes and simplifying the tax code has many benefits on the debt ratio. Doing so in a progressive tax code method minimizes effects on income inequality.
Eliminate Itemized Tax Deductions

Completely eliminating itemized deductions would **increase revenues by $10.6 trillion, or .94% of GDP.**

**Proposal**

- All taxpayers claim a standard flat rate deduction rather than itemize and deduct expenses such as state and local taxes, mortgage interest, charitable contributions, and some medical expenses

**Justification**

- Creates more progressive tax code
  - Highest 20% of income population files 80% of all deductions
- Simplifies tax code
- Improves allocative efficiency of tax filing resources
- Reduces distortions caused by government intervention, realigns market incentives (ex. Installing solar panels)

**Implementation**

- Possible to exempt charitable contributions to continue positive effects of donations
Adjust Mandatory Healthcare Spending

As one of the fastest growing pieces of the long term budget, making healthcare spending more self-sustainable is crucial to reducing debt burden.
Link Social Security to a Pure Price Index

Linking Social Security to a Pure Price Index would increase savings by $1.75 trillion, or .15% of GDP.

Proposal
- Link the growth of initial Social Security benefits to the growth of prices as opposed to growth in average wages
- Introduce new peg to new cohorts, maintain old index for current recipients

Justification
- Social Security is currently unsustainable
- Extends projected lifespan of Social Security
- Still allows for benefits to be distributed to those who are promised when entering the system
- Does not change formula of tax collection

Implementation
- Only minor effects for those currently entering retirement
- Largest effect will be on those in the far off future, who have the most time to prepare
- More politically feasible because it doesn’t affect current recipient population
### Increase Payroll Tax for Medicare by 1%

Increasing the Hospital Insurance Payroll Tax for Medicare by 1% would increase revenues $3.7 trillion or .33% of GDP.

#### Proposal

- Increase the basic rate of both employers and employees by 0.5%, to 1.95%, resulting in a combined rate of 3.9%
- HI tax on earnings that pass the surtax threshold would also increase by 1% to 4.8%

#### Justification

- Payroll tax is already failing to generate sustainable amount of revenue
- HI tax increase delays exhaustion of the HI trust fund by more than a decade
  - Reduces long-term gap between projected income and projected costs by almost 33%
- Relatively small increase per person and small effect for employers

#### Implementation

- Most simple and effective means to increase the funds for Medicare because of relatively minor changes to current tax system needed
- Possible to implement progressive collection system with higher increases on wealthier income cohorts
Enact Environmental Taxes

Taxes related to energy production and transportation accumulate significant revenues and have the additional externality of reducing pollution.
Enact Greenhouse Tax

Implementing a $25 per metric ton tax would increase revenues by $4.1 trillion, or .36% of GDP.

Proposal

- $25 per metric ton tax on energy-related emissions of greenhouse gases in the United States, specifically electricity generation, manufacturing, and transportation

Justification

- Provides tax revenues that would not have been realized through cap-and-trade system or command-and-control regulation
- Produces second largest revenue stream amongst proposals due to size of industry
- Generates positive effects on the environment, technological innovation
- Generates co-benefits of limiting other pollutants not necessarily capped by tax specifically

Implementation

- Uses existing administrative tax functions for implementation
- Politically feasible because revenues can be redirected towards tax cuts in other areas

![Global Warming Chart]

- Total Warming
- U.S. Contribution

<table>
<thead>
<tr>
<th>Temperature Change (°C)</th>
<th>BAU</th>
<th>$15/ton CO₂</th>
<th>$25/ton CO₂</th>
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<tbody>
<tr>
<td>0.19</td>
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<td>0.08</td>
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</table>
Increase Motor Fuels Taxes

Adding 35 cents per gallon to existing motor fuel excise taxes would increase revenues by $3.7 trillion, or .33% of GDP.

Proposal

- Increase federal excise taxes on gasoline and diesel fuel from 18.4 and 24.4 cents per gallon to 53.4 and 59.4 cents per gallon respectively
- Continue to allocate revenues for highway and mass transit investment

Justification

- Provides additional highway fund revenues for currently insufficient infrastructure spending
- Higher price internalizes marginal social costs of motor fuel consumption; e.g. foreign oil dependence, pollution

Implementation

- Low implementation cost because tax is already in effect
- Consider positive effect on rural lower-middle class with no access to public transport
Restructure Corporate Taxes

Through a combination of new taxes and overall tax rate reductions, these policies both increase tax revenues as well as stimulate GDP growth via increased domestic investment.
Tax Foreign Subsidiary Income

Taxing income of US subsidiaries abroad would **increase revenues by $1.7 trillion, or .15% of GDP.**

**Proposal**

- Enact tax US corporations and foreign subsidiaries at a combined U.S. and foreign tax rate of 19% as income is earned

**Justification**

- Taxing foreign income as it is earned prevents tax revenues from being withheld due to deferral
- Ending deferral makes revenue streams more predictable
- Reduces after tax-return on foreign investment, increasing relative appeal of domestic investment

**Implementation**

- Couple with overall decrease in corporate taxes to offset reduction in investment
- Must create completely new part of tax code
- Consider effect on US business competitiveness
Repeal Deduction for Domestic Production Activities

Repealing the deduction for domestic production activities would increase tax revenues by $598.6 billion, or 0.06% of GDP.

Proposal

- Repeal tax deductions for domestic activities such as production of utilities, construction of real property, and transactions of tangible personal and intellectual property

Justification

- Reduces economic distortions that inadvertently promote only some but not all domestic production activity
- Increases resource allocation efficiency for businesses by shifting away from the need for large tax-planning procedures
- Offset by reduction in corporate income tax (see next)

Implementation

- Simplifies tax code by eliminating the need for businesses to account for qualifying expenses
- Invigorates market efficiency in domestic production, once combined with a corporate tax rate reduction and minimum level of taxation on foreign income
Reduce Corporate Tax Rate

Reducing the corporate tax rate would **decrease savings by $370 billion, or 0.03% of GDP, but promotes corporate investment spending.**

### Proposal

- Reduce the corporate income tax rate from 35 percent to 20 percent to incentivize domestic corporate investment spending
- Considers policy effects dynamically, including both macroeconomic gains and losses

### Justification

- United States has highest corporate tax rate of all the OECD countries, decreasing global competitiveness
- Projected to add $3 trillion to capital stock (10% increase), and raise wages by equivalent of 650,000 full time jobs
- Tax rate reductions facilitate investment in new innovation and perhaps more hires

### Implementation

- Easy implementation resulting from adjustment in corporate tax revenue percentage
- Designed to bring domestic production back within the States, combined with a minimum level of taxation for income earned abroad
- Strong current political climate for such changes
In addition to the above proposals, the US should consider allocating resources for investment in human capital for the long term. Increasing current spending on education, for example, could be a creative solution with short term losses but massive long term benefits.
Implement Universal Pre-K Education

Universal preschool education would **contribute $60 billion, or 0.006% of GDP in the next 30 years, with substantially more gains occurring after 2047.**

Proposal

- Allocate an additional $30 billion annually towards Pre-K education, including a voucher system by which parents can enroll their children in the pre-K institution of their choice
- Resulting in a *minimum* x4 return in the long run (30+ years)

Justification

- Early education investments yield the highest gains per dollar spent as opposed to other educational investments - driving GDP growth and decreasing debt-to-GDP ratio
- Pre-K focuses on social skills, which are crucial to the attainment of high-paying jobs and can lead to expansion of the service sector

Implementation

- Voucher system to avoid crowding of successful private pre-schools.
- Voucher amounts can vary based on family income and geographic region
- Utilize best practices from Obama administration findings
Summary of Proposals

The proposals in this presentation achieve a 2.28% change in GDP, which ultimately bring the Debt-to-GDP ratio well below the current level to 72%.

<table>
<thead>
<tr>
<th>Category</th>
<th>Proposal</th>
<th>Tax revenue effect (in % of GDP)</th>
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</thead>
<tbody>
<tr>
<td>Increase Tax Revenue</td>
<td>Eliminate Itemized Tax Deductions</td>
<td>+0.94</td>
</tr>
<tr>
<td>Adjust Mandatory Healthcare Spending</td>
<td>Link Social Security to Pure Price Index</td>
<td>+0.15</td>
</tr>
<tr>
<td></td>
<td>Increase Payroll Tax for Medicare by 1%</td>
<td>+0.33</td>
</tr>
<tr>
<td>Enact Environmental Taxes</td>
<td>Enact Greenhouse Tax</td>
<td>+0.36</td>
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<td>Increase Motor Fuels Tax by 35 cents</td>
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<tr>
<td>Restructure Corporate Taxes</td>
<td>Tax Foreign Subsidiary Income</td>
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<tr>
<td></td>
<td>Repeal Deductions for Domestic Production</td>
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<tr>
<td></td>
<td>Reduce Corporate Tax Rate to 20%</td>
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<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>+2.28</strong></td>
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</tbody>
</table>
Appendix
Eliminate Itemized Tax Deductions

Current Law

- Itemized deductions typically include certain expenses, such as state and local taxes, mortgage interest, charitable contributions, and some medical expenses.

- Alternatively, standard deduction amounts are as follows:

<table>
<thead>
<tr>
<th>Taxpayer Status</th>
<th>Amount</th>
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<tbody>
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<td>Single</td>
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<tr>
<td>Head of Household</td>
<td>$9,100</td>
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<tr>
<td>Married Filing Jointly</td>
<td>$12,400</td>
</tr>
<tr>
<td>Married Filing Separately</td>
<td>$6,200</td>
</tr>
</tbody>
</table>

IRS Data for 2013 Tax Year

- Who itemizes?
  - 30.1% of households itemize deductions
  - 68.5% of households chose the standard deduction

- Taxpayers with higher incomes are more likely to itemize
  - 93.5% of tax returns from >$200,000 in income
  - 6.0% of tax returns from <$25,000 in income
Link Social Security to Pure Price Indexing

Current Status

- As of right now, COLAs (cost-of-living adjustments) keep benefits in pace with inflation.
  - Current COLA = 0.3%
  - Based on increases in Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W)
- In 2015, twenty-four percent of the budget ($888 billion) was spent on Social Security.
  - Monthly retirement benefits of an average of $1,342 were paid out to 40 million retired workers.

Future Implications

- Social Security trust fund projected depletion years by fund components:
  - OASI (Old-Age and Survivors Insurance): 2035
  - DI (Disability Insurance): 2023
- By 2046, scheduled Social Security outlays would be 16% less than what they are today.
Increase the Payroll Tax for Medicare by 1%

Medicare Parts A - D

- **Part A** (Original Medicare) - **hospital insurance** (HI): inpatient hospital care, inpatient stays in most skilled nursing facilities, hospice and home health services
- **Part B** (also Original Medicare) - **medical insurance**: doctor and clinical lab services, outpatient and preventive care, screenings, surgical fees and supplies, physical and occupational therapy
- **Part C** (Medicare Advantage): combines Parts A and B in one plan; can also combine with Part D prescription drug coverage creating a Medicare Advantage Prescription Drug (MA-PD) Plan
- **Part D** Prescription Drug Plan (PDP): can be stand-alone or combined

Current Law

- Basic HI tax = 2.9% of earnings (1.45% from employers, 1.45% from employees’ paychecks)
  - Tax levied on total earnings - not just up to an annual maximum like Social Security
  - Surtax of 0.9% applies for only household income above certain threshold
    - $200,000 for unmarried taxpayers
    - $250,000 for married couples
- Since 2008, expenditures for HI have surpassed program’s total income → declining trust fund balances
  - CBO projects that HI trust fund balances will continue to fall until being depleted in 2026.
Enact Greenhouse Tax

Current Law

- No greenhouse tax currently in effect
- Under the Obama administration, the EPA was instructed to regulate greenhouse gas emissions from existing power plants
- Tax is logically—not just ecologically—compelling
- Results in 2\textsuperscript{nd} largest revenue source, along with positive environmental effects
Increase Motor Fuels Taxes

Current Law

- Motor fuels taxes are currently set at 18.4 cents per gallon of gasoline and 24.4 cents per gallon of diesel fuel produced.
- Decline in recent fuel prices allows for this wedge of taxation.

Future Implications

- Motor fuel usage projected to continue to be consumed in significant quantities, on the magnitude of millions of barrels per day.
Tax Foreign Subsidiary Income

Current Law

- Foreign tax credit provided to offset potential double taxation by foreign taxes on foreign income.
- Income earned by foreign subsidiaries of U.S. companies not subjected to taxation until income is repatriated.
- Current system of deferral provides an incentive to hold profits overseas.
  — Deferral reduces the cost of foreign investment relative to the cost of domestic investment. By ending deferral, this option would reduce the after-tax return on foreign investment, which could increase domestic investment.
Repeal Deduction for Domestic Production Activities

Current Law

- Originally created by the American Jobs Creation Act of 2004
- Businesses may deduct up to 9 percent from their taxable income for qualified domestic production activities.
- This includes:
  - Transactions related to property in the U.S.
  - Production of films
  - Production of electricity, potable water, natural gas
  - Construction or renovation of real property
  - Performance of engineering or architectural services
- The Emergency Economic Stabilization Act of 2008 limited oil-related activities to a 6 percent deduction
Reduce Corporate Tax Rate

Current Law

- Corporate tax rate currently at 38.90 percent for 2016, the highest corporate tax rate among OECD countries.
  - Globally, among 188 countries, U.S. corporate tax rates exceeded only by the United Arab Emirates and Puerto Rico.

- Average global corporate tax rate = 22.5%

- Europe’s average corporate tax rate = 18.88%

Future Implications

- Reduction to 20% corporate tax rates benefits the US economy via the following mechanisms:
  - Boost long term-GDP by 3.4 percent OR $588 billion
  - Lift wages by 2.9% over long-term
  - Create more than 650,000 jobs
  - Increase domestic investment levels

- Larger GDP $ \rightarrow$ higher after-tax incomes for all taxpayers
Implement Universal Pre-K Education

Current Status

- Pre-K largely at the discretion of parents, with many options being self-financed
- Some government-funded Pre-K programs for low-income families, such as Head Start
- Rich data from Obama Administration’s Race to the Top Early Learning Challenge currently under analysis.
  - Data will inform future policymakers and administrators how to implement high-quality preschool best practices
- Studies currently show gains of $4-$9 for every dollar spent on Pre-K education

Effects of Pre-K on Student Outcomes

- Short-term gains in test scores
- Long-term gains in graduation rates and college matriculation
- Early targeting of special needs
- Reduction in crime rates, leading to huge savings for society
- Development of social skills necessary for high-paying jobs
Sources

Budget Projections

- Congressional Budget Office: https://www.cbo.gov/

Itemized Deductions

- U.S. Tax Center: https://www.irs.com/articles/should-you-itemize-your-deductions
- Tax Foundation: https://taxfoundation.org/who-itemizes-deductions/

Social Security

- Congressional Budget Office: https://www.cbo.gov/budget-options/2016/52184
- U.S. Social Security Administration:
  - https://www.ssa.gov/oact/trsum/
- Center on Budget and Policy Priorities:

Greenhouse Tax

- Environmental Protection Agency (EPA): https://www.epa.gov/cleanpowerplan
- Institute for Energy Research:
- Cato Institute: https://www.cato.org/publications/commentary/carbon-tax-climatically-useless
- Pew Center on Global Climate Change: https://www.c2es.org/docUploads/Taxes.pdf
Sources

Motor Fuels Taxes

Tax Foreign Subsidiary Income
- Congressional Budget Office: https://www.cbo.gov/budget-options/2016/52280
- Tax Foundation: https://taxfoundation.org/us-multinationals-paid-more-100-billion-foreign-income-taxes

Deduction for Domestic Production Activities

Corporate Tax Rates

Implement Universal Pre-K Education
- Center for American Progress: https://www.americanprogress.org/issues/education/reports/2013/05/02/62054/the-united-states-is-far-behind-other-countries-on-pre-k/
- Office of Senator Kirsten Gillibrand: https://www.gillibrand.senate.gov/issues/universal-pre-k