Peterson Institute for International Economics

Grappling with US fiscal deficits and debt: Understanding the implications at home and abroad

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[00:05:36.45] - Maurice Obstfeld

Okay, okay, please, uh, take your seats. We're about to begin. Uh, welcome everyone to the Peterson Institute. I'm Maury Obstfeld. I'm the C. Fred Bergsten Senior Fellow here at Peterson, and we're very excited to host a great event today on grappling with U.S. fiscal deficits and debt, understanding the implications at home and abroad. The event's going to be in 2 parts. First, an expert panel will tour the horizon of our global public debt crisis, and then a one-on-one conversation between my colleague Kim Clausing here at the head table and Senator Sheldon Whitehouse of Rhode Island, who is a senior member of both the Senate Budget and Finance Committees. Senator Whitehouse has a boat this morning and is going to try to rush over here afterwards and be on time, but he may be a bit late, so I warn you of that. Public finances around the world are indeed entering a crisis phase, in my view. Debts around the world are reaching or projected to reach new heights, notably in a group of rich and aging industrial economies. At the same time, real government interest rates are sharply higher relative to the early 2020s in an environment of inflationary pressure.

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Just yesterday, the bellwether 10-year U.S. Treasury rates spiked well above 5%, and there were also upward movements in bond prices around the world. Interest costs are adding greatly to strained government budgets and could add even more soon. In the US, for example, the federal government's interest bill is way above its defense outlays. Aside from inflation, markets are demanding higher real returns, higher risk compensation for absorbing expanding public debts while the world rearms and fragments in the face of elevated geopolitical tensions and trade warfare and a transformative new technology, artificial intelligence, competes for funding but raises concerns about its financial sustainability and its disruptive potential. In the background is also a fast-worsening climate crisis that is sure to deliver bigger and more frequent economic and social shocks, as well as irreversible environmental damage. Addressing the climate crisis will require higher public investments around the world Yet the need has moved to the periphery of policy officials' concerns amid other priorities, including high energy costs. Will farsighted policymakers rise to the challenge? Voters seem angry and polarized,

increasingly embracing populist fantasies. They are less patient, less willing to make even small economic sacrifices, and they sour on political leaders with alarming frequency shortening policy horizons.

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Without reforms that trim spending, raise growth, and enhance government revenues, debt default through inflation or other means may result. As Jean-Claude Juncker, in a famous remark, the Finance Minister of Luxembourg and President of the European Commission, said, we all know what to do, but we don't know how to get reelected once we have done it. We're going to start out with our marvelous panel to discuss what we should do and if it is likely to happen. So let me introduce our first 3 panelists. First will be Jason Furman, who is a nonresident senior fellow here at Peterson since 2017. He's also professor of the practice of economic policy at the Harvard Kennedy School and in the Harvard Economics Department. He was chair of President Obama's Council of Economic Advisers and has had other policy roles and think tank roles. Aviva Arendine is going to be our second speaker. She is director of the Hamilton Project and a senior fellow in economic studies at the Brookings Institution, our friend and neighbor across the street. Aviva has a wide experience in government also. She was Acting Assistant Secretary for Tax Policy at the U.S. Treasury Department. She has been at the Office of Management and Budget both as Chief Economist and Acting Deputy Director, among many other roles.

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Last but not least, Oya Celisün is Deputy Director at the European Department of the IMF, where she oversees surveillance of the euro area, Germany, and some other European economies. Previously, she was in the Research Department working in the Multilateral Surveillance Division and also in the World Economic Studies Division, which produces the the WEO. She also has country experience in, um, uh, significantly, uh, in, in big Western Hemisphere countries including the US and Canada. So with that, I'm going to ask, um, Jason to come up and, and begin. Each speaker will, um, come up for approximately 12 minutes, and then we will have a joint discussion and Q&A.

[00:11:23.55] - Jason Furman

Thanks for having me and for this discussion. And I look forward to what Aviva and Oya have to say. What I have to say is that the problem is serious, but it's doable. And we're waiting for a deadline. That would be the summary of where we're going. And I should start out by saying I've ranged over my life from extremely concerned about deficits to extremely blasé about them. And

at the current moment, I feel slightly in the middle of those views. I'm going to talk about the US fiscal situation, just give you a little bit of context in terms of where we are with the numbers right now, ask the question about how worried we should be, and then finally, what should be done. And the short version is going to be US fiscal situation. Under most scenarios, debt is rising as a share of the economy. It's not sustainable. Something needs to be done. How worried is harder to tell, how immediate the problems it poses are. And then finally, in terms of what can be done, the adjustments I think are a little bit smaller than many people think. It doesn't mean adjustments aren't needed.

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So let's start with the US fiscal situation. This is debt held by the public. The first thing to see is we've been here before at 100% of GDP. The difference is the last time we were here, at the moment World War II ended, debt started to plummet as a share of GDP and fell for the next 30 years. This time around, we went through the financial crisis where debt went up too little in my view. We went through COVID where debt went up too much in my view. Either way, it should have gone up. And the difference is coming out of them under most projections, The debt is expected to continue to rise. I'm showing you the CBO baseline, and I'm also showing you my preferred baseline, which I will explain in a moment. If you look at the federal deficit, the flow, in some ways, that's more extraordinary. It's currently stabilized at around 6% of GDP. The only times we have ever seen 6% of GDP or more in our history were World War I, World War II, the financial crisis, and COVID. So this is completely uncharted territory for normal times. In fact, if you look at normal years that exclude events like those, the average has been 2.2% of GDP.

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So we're way, way beyond that. If you look at the deficit to GDP for advanced economies, this is one of the metrics that the United States can be proud and can truthfully say it is number one. No one else comes close at the moment. Part of why this is a concern is US debt to GDP isn't the highest, but it's towards the upper end of the range for these countries, and then the flow is going in the wrong direction. Countries like Italy, and Oya will say a lot more, and maybe she'll think I'm being too nice to Italy by comparing them favorably to the United States, has a higher debt-to-GDP, but it's running a primary surplus, so they're reducing it. Now, we're reasonably high debt and adding to it. Now, the question one should ask is, what are the assumptions underlying all of these forecasts? A good place to start is the Congressional Budget Office. If you do, the debt is rising to 120% of GDP after a decade, and that we would need to cut spending or raise taxes by 2.1% immediately to stabilize it over the next decade. They leave out, in my view, that there's a whole lot of plausible policy changes.

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There's expiring tax cuts. There's spending cuts that are being phased in that are very unpopular with at least one party. Tariffs are unpopular sometimes with some people and all the time with everyone in this building. And defense spending is basically set to decline continuously as a share of GDP in a way that might not be consistent. What I call plausible policy changes, I sort of take all of those and just multiply by 0.5. So I take half of all of those, and that's about 0.7% of GDP in new spending or tax cuts that's being added to get to something that's sort of like a current policy baseline. The second thing is the Congressional Budget Office is predicting interest rates that are about 75 basis points lower than where markets are today. Moreover, if you look at forward pricing, markets think that prices are going to— rates are going to stay where they are now. If anything, they think they're going to rise, not fall. whereas the Congressional Budget Office thinks they're going to fall. So I use current market interest rates. It's actually a little bit more conservative— I'm sorry, a little bit more optimistic, a little bit lower interest rates than even using forward rates would be.

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But then the last thing is the Congressional Budget Office incorporated an estimate of the effects of productivity growth from AI into their baseline. But their estimate was really, really minuscule. I think it's unlikely that they're correct. So in my preferred baseline, I'm adding half a point for faster productivity growth. That matters quite a lot. And sort of all these 3 adjustments end up getting you back to roughly the same place as the CBO baseline, with the productivity making up for the extra spending and extra interest rates. Now, there's a much wider range of possibilities, and this table illustrates those wider range of possibilities. In all of these, I'm holding so-called plausible government policy fixed. So all of these are our current policy-ish baseline. If you look at the upper left, the 0, 0, that corresponds to CBO. The 0.75 on interest rates and 0.5 on productivity, that 1.19, that corresponds to my preferred scenario. You need productivity boosts of about 1.25%age points to feel comfortable. And by the way, as you go out on productivity, you should probably go higher on interest rates too. I didn't build in CBO's interest rate rule for productivity.

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I neutralized that in this chart. So, they're 2 separate variables. So, 1.25, that would mean productivity growth of about 3% annual rate. I don't think that's outlandish to expect. But to me, it's like the 85th percentile of where we could be over the next decade, maybe the 90th percentile. And you don't want to make policy at the 90th percentile. You probably don't even want to make it at the 50th percentile. You probably want to make it more at like the 25th percentile in terms of optimal control and planning for bad things that might possibly happen. So

the last thing I'd say is we spend lots of time arguing over what the spending assumptions are, how fast healthcare is going to grow, what's going on with interest rates. If you look at most of the debt we have today, it's from large discrete events. And these are not 100-year floods because there's 3 of these in the last 75 years. And in some sense, all of our debt today is in some sense attributable to each of these events with then reducing it. in between. And that's another thing we need to be very mindful of is we can do all this forecasting and we don't have these sorts of things built in.

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And these sorts of things are very asymmetric. There's events that can cost you 50% of GDP in 2 years. There aren't a lot of events that save you 50% of GDP in 2 years, except maybe a hyperinflation. How worried should we be about all of it? Here's where I'm just much, much less sure. And I think if you're really worried, you do have to do the thought experiment of you're in the year 2000 and somebody comes and tells you the United States is going to have a debt-to-GDP of 100%. It's going to have a deficit-to-GDP of 6%. What does the world look like? And we've had this just massive change in our fiscal situation from 2000, and the unemployment rate's basically the same. And Treasury rates are a bit lower. And if you look at the real rate, it's even more lower compared to 2000 than what is shown here. Now, this is not a deficits don't matter. This isn't like any causal analysis. We don't know what the world would be like, but it puts some bound on the magnitude at which they are currently mattering. The way I think about it is throughout the fiscal debates of the last 25 years, we always had more fiscal space than the fiscal hawks would have us believe.

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It's also the case that we've used a huge amount of fiscal space. So in terms of how much we have left, that I'm much more nervous about. But you go back in a time machine and people were more worried about this than they should have been. That doesn't mean that they're wrong now. When you look at the magnitudes of the consequence, there's sort of the known knowns, which are like termites in the woodwork, where each year it's a little bit more than the last. The blue line was CBO's baseline last year for the debt. The black line is CBO's hypothetical scenario of stabilizing the debt at 100% of GDP. And the orange bars are on a different scale. They show the percent difference between those. And there's a few things to see. If you look on a 5-year time horizon, you're talking about less than 1% change in disposable personal income. Like, no wonder no one wants to stake their presidency on the 4th or 3rd little orange bar there. When you look out further, it grows quite large. It grows to something like 4% in terms of disposable personal income. Of course, the unknown unknowns are the bigger deal.

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There's the linear 2, 3 basis points per percentage point of debt added to our interest rates. Interest rates are 75 basis points higher now because of what we've done recently, all that type of stuff. The bigger concern is nonlinear dynamics and the problem there is there's just no good relationship between them and debt-to-GDP. We've seen much higher debt-to-GDP than we have without crises. We've seen much lower debt-to-GDP than we have with crises. In some ways, the Truss event is a reminder that institutions matter and perception matter quite a lot, just as much as the numbers. Last, what can be done? I'm going to scope the size of the problem. I think Aviva is going to talk more about the substance of what you would fit into it. And the first thing to say is, let's say we want to do 2% of GDP adjustment, maybe 2.5% of GDP. That's not totally unprecedented. In 1990, we did 1.8%. In 1993, we did 1.5%. So you take the two of those together, you're at 3.3%. That's almost certainly enough for where we are now. Now, they had defense spending cuts, the post-Cold War peace dividend that we don't have to work with now, but it's doable.

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Other deficit reductions we've done since then have tended to be smaller, but some have been half a point, including, by the way, the tariffs, which are not the best way to reduce the deficit in my view. There have been a lot of other things that have increased the deficit at the same time that's not shown here. I'm just showing the negative numbers, not all the positive ones. I think it's doable. What might force action? A fiscal crisis would, a rapid run-up in interest rates. A second is public opinion shifting. And this is where public opinion is now, share naming the deficit or debt as the nation's most important problem. In 2010 and '11, when we had a 9% unemployment rate, this was our nation's top problem to 10 or 15% of Americans. Now we have a 4.1% unemployment rate and it is the top problem for almost no one. But you can see also public opinion can shift quite quickly and maybe someone will catalyze on this in a presidential campaign. The last way though is I don't think super likely, but I think it's much more likely than any other way. of approaching this, which is that Social Security's retirement trust fund's exhausted in 2032, Medicare in 2033.

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The fiscal gap in the 2 of those programs is about 1.75% of GDP. So it says if you cared about the debt on a present value basis, if you address both of these— and by the way, I'm just doing numbers here. So you could do it by raising taxes. You could do it by cutting spending. You could do it by whatever combination. But just numerically solving the 2 of these, plus doing PAYGO, plus having a limited set of emergencies gets you pretty close. In some sense, they're like accounting forcing events. And I think we should try to hold onto them, use them, and shape

that well. So to summarize, the debt and deficit are high and rising. Higher productivity might get us out of the problem, but it feels like not a fringe tale, but a bit of a tale. The debt is undoubtedly costing our economy. We're seeing it in rates today. Don't think it's huge. The most attractive forcing event is Social Security and Medicare. And then finally, I do want to say, if you ask me my worry list, this is on there, but it's not number 1, 2, or 3. And what we can do to have a more people and future-oriented budget is beyond the scope of my discussion.

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But I'm hoping Aviva speaks to it more eloquently than I would have had I tried. Thank you.

[00:25:38.13] - Aviva Aron-Dine

Well, thanks, Jason. Thanks to Maury and Kim and Peterson for convening and for inviting me. I'm glad to be here. I was asked, I think, to speak to these problems from the perspective more of some of the underlying policy decisions. that drive them. I'll try to bring that perspective to bear on the question of how we got here, what we should do, and what might scramble the policy discussion. On the question of how we got here, Jason gave a bunch of numbers about where we are, so I won't repeat them, but I'll just underscore one, which is relative to the CBO baseline, preferred baselines, reordered baselines, it all gets you to a place of needing about 2% of GDP of deficit reduction to stabilize the debt over the 10-year window. So that's something like $8 trillion of a 10-year deficit reduction package. Now, I agree with Jason that these are numbers that are entirely plausible in the context of the US economy and things you could do that would be responsible and possible. At the same time, I don't think this is a very plausible target for near-term policy. It's difficult to impossible to imagine a bill passing in the next few years that accomplishes deficit reduction of that magnitude.

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That's quite different from, say, 10 years ago when that benchmark was lower and it was pretty widely used as a goal and a benchmark for actual plans that people were writing down, including even some people who had actually been elected to public office. What got us from there to here? What changed? There are 2, I think, natural ways to answer that question or to think about that question, comparing to where we were and comparing to where we were expected to be. Starting with the simple comparison between where we were and where we are, I think it's natural to compare 2025 to where we were several years into the past few economic expansions. It's well known we had a surplus in 2000. We also had deficits around or below 3% of GDP in the mid-2000s and in the mid-2010s before the Tax Cuts and Jobs Act. A simple comparison, in each of those other cases, revenues were higher. More than 2%age points of

GDP in 2000, close to 1%age point of GDP higher in the more recent expansion years. Non-interest spending was quite a bit lower by 1 to 4%age points of GDP.

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That's almost entirely a story about Social Security, Medicare, and Medicaid, all of which are impacted by population aging. Then interest costs are higher now. If this is how you parameterize the question, then the answer is mostly that population aging is driving up costs, keeping policy fixed. And rather than raising revenue, we've actually lowered revenue in the face of that. Then you can compare to where we thought we were going to be. This is a much more sort of choose-your-own-adventure exercise because all projections have so many ranges around them. And in fact, if you want to pick some of the more stark healthcare cost projections people were using, then we are doing great compared to expectations. But if you compare to sort of the midpoint of what CBO was projecting, in those same economic expansion years. There's been deterioration. I think the qualitative takeaways are revenues are well below where they were projected to be without changes in policy, including after the Bush tax cuts had been largely extended. The spending story is also different on this version of the question because overall, non-interest spending is roughly in line with expectations. Aging was already built into those projections pretty accurately.

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Some costs are higher, including generally speaking defense, but we've had very positive surprises with respect to healthcare cost growth, and that has sort of balanced out. And then interest costs are higher, but interestingly, not as much higher as you might have thought because CBO's projection that eventually interest rates were going to go back to historically more normal levels has indeed finally been vindicated. So on this version of how you parameterize the question, The answer does mostly come down to tax cuts. Now importantly, these tax cuts have been a mix of tax cuts for corporations and high-income people that have been quite polarizing and where the pendulum has swung back and forth a couple of times versus broader tax cuts for, say, particularly for, say, the 88th to 95th percentiles of the income distribution that have become quickly quite politically entrenched. So what do we do? I'll observe that obviously none of this history can tell us what we're supposed to do going forward. That depends on how you prioritize a dollar of deficit reduction versus a dollar of something else, and especially how you do that given real-world constraints on where you're actually going to be able to raise revenue or reduce spending.

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It's not actually necessarily that interesting that each of us individually in this room independently writing down our own preferred package of policy could come up with some deficit reduction. My preferred immigration policy alone could probably help the fiscal situation. But that's not really that interesting in this context. The question is what is realistically possible and how you value the different options in that context. I think one qualifier is that the historical situation that I just outlined does influence views on the durability of deficit reduction compared to other policy steps you might take to achieve different policy goals. And I'll come back to that because I think it affects this prioritization discussion. I think it's helpful to spell out the arguments for prioritizing deficit reduction. First, you might be concerned about an imminent fiscal crisis. As Jason talked about, this feels like a real possibility in a way it didn't even a few years ago, to the point that policymakers should probably have some contingency planning around it even if it's not the modal scenario. A related argument is that you should reduce the deficit to avoid a moment in the future where a fiscal crisis might force you to do so, either because you want to avoid a crisis, which itself is damaging, fair enough, or because you think you'll be able to make better policy decisions acting sooner than acting later.

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A cousin to this is that you want to make sure that you're in a position to take action in response to the next recession or the next COVID or whatever might be. In my view, those are the strongest arguments for prioritizing deficit reduction. And then there's a set of, let's call them the sort of standard economic arguments regarding debt and investment and interest rates, a few versions of this. There's a version that is clearly correct, which is it is not 2010 anymore. There is no macroeconomic benefit from fiscal expansion. And so the bar for a policy to be worthwhile is whether it's worth the resources it consumes. This is not the moment for paying people to dig holes and fill them up. Another version of this sort of standard economic case is the chart Jason showed of GNP per person. As Jason talked about, those numbers are small in the near term. Even in the medium term, they're not that large. And this is for a— that was for a scenario where you close the fiscal gap. A more realistic sort of big deficit reduction package that someone might pursue is maybe a of that, so commensurately smaller economic benefits.

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Dollar for dollar, it's certainly not the least growth-promoting policy you might pursue, but probably it's not the most either. And then when you build distributional considerations into that, that further complicates the story. I will say an argument I'm hearing more of and don't find that persuasive in arguing for deficit reduction is that it should be a big piece of responding to voters' concerns about affordability because you can bring down interest costs and help homeowners and other borrowers. I think when you think about taking this argument to a policymaker who's

deciding on their priorities, it's not all that persuasive if you're open about magnitudes. So if you take CBO's rule of thumb that a 1%age point reduction in debt-to-GDP lowers long-term interest rates by about 2 basis points, then you could spend $1 trillion over 10 years reducing the debt and bring down interest rates by maybe 5 or 6 basis points, I think it's hard to argue that if all you cared about was affordability, that would be the way to spend the money as compared to eliminating tariffs or other things you might do. And so as I said, I think the better arguments here are about reducing the macro risks.

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To spend just a moment on the specific priorities that deficit reduction competes with, we know what those competing priorities have looked like in the current Congress. Last year's reconciliation bill was quite quite large with quite significant spending cuts that were used entirely as a partial offset for tax cuts. Overall, a $3.4 trillion increase in the deficit over 10 years. Even if you were to compare to just extending the Tax Cuts and Jobs Act tax cuts that were expiring, and so you don't treat any of that as a cost, but you then also assume that the new tax cuts in last year's bill are similarly permanent, you're at about a $400 billion deficit increase over 10 years. Thinking about priorities supposing a change in congressional control, Leader Jeffries named 2 major competing fiscal items recently when he talked about his top priorities for a new Congress. One was restoring pre-2025 healthcare and SNAP, food stamps policy. That costs about $200 to $250 billion a year. What you get for it is health coverage for 15 million people and some significant reduction in poverty and food insecurity. security. He also named undoing the tariffs. On the numbers, these are a moving target.

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It's hard to even try. I think the Yale Budget Lab's current number is about $200 billion a year, and there's more built into CBO's baseline. What you get for it is some pretty, I think, progressively targeted affordability measures and presumably some opportunity to reset relations with the rest of the world. If I understood Jason's charts correctly, both of those are actually already assumed in the preferred baseline. To whatever extent—

[00:35:39.19] - Jason Furman

Half assumed.

[00:35:39.52] - Aviva Aron-Dine

Half assumed. To whatever extent you're paying for them, that might be deficit reduction. But changing the accounting doesn't change the basic prioritization question. If you're going to raise

$3 trillion, as Kim recently wrote for the Hamilton Project in a great paper about corporate tax reform, business tax reform, or raise money from other sources, do you prioritize lower deficits versus lower uninsured rates, lower poverty rates, better trade policy, whatever else? On prioritization, as I alluded to, I do think another thing that is carrying some weight with policymakers is the history and what it says about the question of durability. I think there's some sense that the last 25 years show that deficit reduction mostly opens up space for bigger tax cuts. whereas programmatic expansions are more likely to stick around. Now, last year's reconciliation bill shows that that's not guaranteed either, but I do think that is something that influences how people think about this question of which of their objectives they should put political and fiscal capital behind. Last thing I'll turn to is just briefly what could scramble this conversation. As Jason talked about, there are bad forcing events, which are front of mind for some obvious reasons.

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I do think you can also imagine scenarios where the world stabilizes along various dimensions relative to right now and interest rates come down, not to levels a decade ago, but enough that the fiscal situation looks less dire. And that is probably a sort of reverse scrambling. There's the Social Security and Medicare trust fund accounting, as Jason talked about. One piece of that is the accounting, which I guess I would characterize slightly differently as opening up an opportunity to dedicate resources to deficit reduction and also claim a tangible accomplishment of shoring up Social Security and Medicare rather than just deficit reduction. I think another aspect to this is that there may be revenue policies in particular that can be part of the conversation in the context of Social Security and Medicare and not otherwise. You see both Democratic and even a few Republican elected officials talking about tax increases for the upper middle class in this context. You don't see that in other contexts. Then the very last thing I'll say, which I think is less quantitatively important but might be an interesting possibility in terms of scrambling things, is we've been operating in an environment where budget reconciliation is the only way to get things done.

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The result has been that things have to be done through fiscal policy. For example, Maurie talked about environmental policy. Anything you wanted to accomplish on environmental policy, you had to turn into a fiscal policy rather than a regulatory policy, even if there might be regulatory options. Without going into gory technical detail, congressional Republicans in passing last year's reconciliation bill effectively bypassed the parliamentarian with respect to deciding what could go in a reconciliation bill. If that led to a broader rethinking of this question, or of course, if there were changes to the filibuster, I think that could change these dynamics. I

don't think it makes a huge difference to what we've been talking about, but at the margin, I think there would be less pressure to do everything with fiscal tools, and that might also be a bit of a scramble of where we've been.

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Thank you.

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Looking forward to your remarks.

[00:39:15.17] - Oya Celasun

Thank you very much. Good morning. Thanks for inviting me, Maury. I'm delighted to be here to try to tell Europe's story. So in the next 10 minutes, I'll talk about the nature and scale of Europe's fiscal challenges and what we at the IMF think should be done about it. So just to set the stage, here I have a chart showing the debt-to-GDP ratios of all the G7 countries. Japan is at the top and that little arrow says look at the right scale. So in all major economies, we see, but Germany, debt has risen as a share of GDP over the last 20 years. And in the next 5 years, the dotted lines, we project debt burdens to either stabilize in some countries or keep rising quite dramatically in the case of the US, to some extent France, and also Germany from a much lower level. But for Europe at least, the challenge is that these trends of rising debt are set to continue beyond our 5-year forecast horizon. So the main reason for that is what I will call— refer to as spending pressures. Those are shown here in those little upward sloping arrows. So there are 3 types of those.

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The first one is somewhat Europe-specific. So governments now have to accommodate new policy priorities in Europe, such as a NATO commitment to increase defense spending to 3.5% of GDP from a bit less than 2% of GDP a few years ago, and the cost of bolstering energy security. Something that Maury also referred to. Very recently, for example, we saw the European Commission ease the fiscal rules a little bit to accommodate somewhat higher spending on energy security. The second item is that interest bills are increasing due to higher bond yields combined with elevated debt levels. And the third one, another common one, and not the least one, is aging populations. That continues to drive up health and public pension spending. That, of course, is not specific to Europe. It's quite common. But it's quite strong a trend in Europe. So altogether, these pressures we estimate to increase spending over the next 15 years by about 5% of GDP. A bit less, closer to 4% in advanced— the advanced group of

European economies. A bit more, more than 5%, in the Eastern, Central, and Southern European economies. So, put differently, spending is set to increase by a third of a percentage point every year for the next 15 years.

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So, if we leave this trend unchecked, debt will be on an unsustainable path. So, what I'm trying to show here is that with the blue line, Under unchanged policies, so we let those spending increases happen and we don't change tax and other spending policies, the simple average of debt would go up from 65% of GDP to 130% over the next 15 years. And if you also consider that interest rates may rise further because of this high debt, as the CBO assumes, and if growth weakens, then you would have even a more So, what is the size of the deficit reduction we would need just to deal with this problem? So, we need a target. How do we determine that? Basically, in our calculations, we assume that if a country has more than 90% of GDP debt, it should stabilize it over the next 5 years and put it on a gently downward sloping path to be ready for the types of negative shocks that tend to happen. But if it's less than 90%, you can allow fiscal policy to remain unchanged as long as you don't hit 90%. Now, I'm referring to 90%, that's an average across countries.

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Actually, that level is quite a bit different across countries depending— we've made calculations on the level of safe debt, but let's simplify things and talk about the averages here. So basically, You would need deficits to come down by about 5%, a little bit less than 5% of GDP over the next 5 years. A bit more in advanced economies, a bit less in Central European economies. So such adjustments, we haven't seen many of them in the last 40 years or so. They are quite larger than what we have seen outside of crisis episodes since 1980. So we've seen some successful efforts that have delivered around 3% of GDP over 3 to 5 years. Germany in the early 2000s is an example. But achieving 5% of GDP like this will be very difficult. Of course, we could see adjustments like this under market pressure, but that comes with economic harm and hardship for many and therefore may not be sustained either. So that's exactly what the kind of situation that our advice is meant to avoid. And just one final thing, delaying the adjustment would be very costly. If you do the adjustment not in the 5 years, coming 5 years, but the subsequent 5 years, you add 1%age point to the adjustment need.

[00:44:48.05]

So the political economy is not our friend here. Policymakers have a challenge there as well. There's a lack of trust in institutions, and surveys like the one that I'm showing here show that

people expect spending on key social policies should continue, if not increase, but they are reluctant to accept higher taxes or higher deficits even. In any case, raising revenues will be hard. On the left-hand side, you see that European countries like Germany, France, Italy, the 2nd to 4th bars, have already very high tax-to-GDP ratios. The US has more scope there. Politics is difficult, of course. So, and letting this debt creep up will be costly as well. Okay, so the question is, what should be done? And our message on this at the IMF has been that given the scale of the challenge, the solution needs to be a package that also boosts growth. So some combination of growth-enhancing structural reforms together with entitlement reforms and more conventional deficit-reducing measures. We also have some European-specific ideas such as using the common European budget more effectively to cut costs. Okay, so these growth reforms, let me first focus on those. What are those and how much can they deliver?

[00:46:22.08]

So here I'm showing you something like a possibilities frontier. We've done some modeling and combined what we think the structural reforms countries should do, varying from reducing barriers in product and service markets, reforming employment protection legislation, in a few cases improving governance, combining them with EU-level reforms. So reducing— basically strengthening the single market, establishing a true single market, reducing barriers to the flow of capital, labor, firms within the single market so they can flow to where they are the most productive. So a package like that could, at the maximum, over the long run, deliver a 20% increase in productivity and a 35%— pulling together investment, more labor force participation, etc.— 35% of GDP, 35% increase in GDP per capita. So that would essentially close what we calculate to be the gap between the US and Europe in terms of GDP per capita. So again, this is like, think of this as a potential, maximum potential. For the fiscal question here, we've selected a bunch of those reforms that could be feasibly implemented in the next 5 years, delivering about a quarter of the growth gains that I showed you. So, and we find that that would deliver meaningful gains.

[00:47:58.29]

So basically, you see the red bars that I showed you, the adjustment need declining by about a fifth or a quarter if you implement that more plausible moderate pro-growth reform package, which could be thought of as a down payment on a more comprehensive agenda. So stronger growth would make the fiscal challenge easier to solve. It wouldn't It wouldn't do away with it. So there's a lot of diversity behind this which I want to touch on. About a quarter of European countries, if they do the growth reforms, don't need to do further adjustment. There's a middle group that would have to contend with a pretty feasible amount of 1 to 1.5% of GDP over the next 5 years. But then there's a third of countries, which tend to be the larger ones, Which would

still have more than 5% of GDP in adjustment needs remaining after the growth reforms. Beyond those growth-enhancing reforms, there's still a huge role for entitlement reforms and other fiscal strategies to cut the deficits. Entitlement reforms, every country's needs are different. What could be those more conventional structural reforms? Basically, we are fans of cutting environmentally harmful subsidies. In Germany, Slovakia, Austria, for example, we calculate that you could save about 1% of GDP in costs.

[00:49:29.48]

Germany has eliminated coal subsidies through to 2018, so that's a possibility. Another one is tighter targeting of welfare spending in a way that also strengthens work incentives. Sweden did that. After the great financial crisis. There is scope to reduce the public wage bill, and there are tax reforms possible, though typically that's in Central, Eastern, and Southern European countries where tax revenues are somewhat low. But that also will not be enough, so there's also a need to rethink the scope of the public sector in Europe. European governments fund more than 70% of public services, such as for healthcare, education, pensions, and infrastructure spending. So if they were to pull that share that they contribute down to the OECD level, around 3% of GDP could be saved. That doesn't need to be broad-based cuts. There could be greater targeting, for example, in education. So it could be, or in health, et cetera. so that there could be some more targeted ways of cost sharing. Of course, it's a very complex and sensitive discussion, but it has to be part of the solution. So let me wrap up. Some lessons from the past. What kind of adjustment programs have worked?

[00:50:53.53]

They've tended to be more expenditure-based with some supporting role of tax revenue. Tax reforms. And it's clear that given Europe's relatively weak growth record, around 1% per year as potential growth, pro-growth reforms and sustaining growth has to be part of the picture. So definitely avoiding public investment cuts and other cuts to items that are important for growth. But also actively taking reforms that can boost growth. But the big challenge is the politics. How do you bring people together to accept these reforms? Communication is key. Policymakers will have to explain to the public the scale of the problem, the consequences of not taking action, and the benefits of adjustment, which is clearly easier said here than done. Finland offers a nice example. You have all the parties except one coming together before the parliamentary election cycle, agreeing on the size of the problem, and then the campaign is about how to solve the issue rather than whether or not any adjustment is needed. So that's a very interesting model because clearly this type of adjustment will have to be spread over several governments and administrations. I'll stop there. Thank you very much.

[00:52:48.44] - Maurice Obstfeld

Okay, I'm gonna ask the panelists one quick question, though it's probably not an easy question, and then we'll move on to the Q&A. So one of the striking facts that Jason's presentation made clear is that, you know, the public just doesn't care. And It seems like the policymakers also don't care in many cases, certainly not in the US. Very little evidence that it's high on the agenda. But there was a time when people cared and when the Congress cared. It used to be that— and the very nice Brookings paper by Alan Auerbach and Danny Yagan showed this. There was a time when Congress would react to forecasts of higher deficits. This hasn't been the case for about a quarter century. So my question is, you know, how did we get here? And is there a way short of crises that we as economists can try to educate the public and educate policymakers about the risks that we can clearly see but they seem to be ignoring? So I'll ask each of the panelists to briefly respond to that. Very simple question.

[00:54:06.40] - Jason Furman

Let me first comment on that nice paper by Auerbach and Yagan that I'm sure everyone here has committed to memory. What they found was it used to be when deficits were higher, you were more likely to see tax increases or spending cut legislation. That was true before 2000. It wasn't true since 2000. It'd be fair to say their tone of the paper wasn't just documenting that change, but was a little bit lamenting it. What happened to people caring? I think from much of the period they document, the people were right and the old reaction function would've been wrong. We had interest rates near zero. We had heavily constrained demand. As Aviva was saying, it's not just, is spending worthwhile for the resources? It might create jobs, so even less worthwhile spending. So in some sense, the fiscal scolds were sort of scolding for that whole period. And they were wrong in real time in ways that were knowable. And the political system, if anything, at times was overly concerned about the deficits as it was in 2010 and '11, which would have showed up as too little stimulus. So it wouldn't show up in their data set.

[00:55:17.52]

Now, I think it's correct to lament it today. So I think their point has become true. So part of it may be an optimistic reading, which probably way overoptimistic, is that people sort of roughly cared about deficits more most of the time when deficits matter more. It was a big issue in the '80s and early '90s. The deficit really was an issue. Interest rates were higher. It receded as an issue when it wasn't as important. And maybe with some form of lag, it'll come back as one. I think that's one possibility. Another possibility is maybe admitting that if you sort of warn every year for decades, At some point, people stop listening to you. And so having the credibility to say, I sort of wasn't worried a decade ago, I am worried now, here's why, might persuade like 2

people. And then the other 100 million people, I think it will take an advertising campaign by the Peterson Foundation to reach them.

[00:56:12.18] - Maurice Obstfeld

OK. Aviva, do you want to take that on?

[00:56:17.34] - Aviva Aron-Dine

Sure.

[00:56:18.08]

I guess the first thing I would say is just In terms of the premise of the question, Jason, if I understood correctly, people were being asked for the most important problem facing the country. I'm not especially dovish on this issue these days, but I definitely would not name it as the number one problem facing the country. I'd be curious—

[00:56:38.38] - Jason Furman

Let me say one small thing about that is there were other data series that is like how much of a concern it is. They didn't go back as far, and this is pretty correlated with them. So if you look at how concerned you are, et cetera, it tells a similar story.

[00:56:50.17] - Aviva Aron-Dine

Right, right, right. Yeah, and I was sort of making a different point, which is there are a lot of other urgent problems facing the country. And I do think that's part of what feeds into this conversation. I do think the answer to this question, though, is inseparable from larger questions about the breakdown of certain political institutions. in the United States that feel beyond the scope of this conversation. But through much of that period, you were seeing bipartisan deficit reduction agreements that included revenue that just reflected a different kind of political conversation. And I think absent some larger changes in the sort of political context, it's, Easy to imagine, you know, it's easy to imagine sort of a commitment to PAYGO. It's easy to imagine a commitment to offsetting new policies. It's harder to imagine a single-party large deficit reduction package.

[00:57:57.13] - Oya Celasun

Thank you. Perhaps sometimes this issue is being picked up too much in a dramatic way. This many trillions in extra debt, the debt has crossed this line. Level, the discussion should perhaps be a bit more about the consequences, not the crisis fear, which is valid, but what would be the consequences of adjusting under market pressure. And for Europe, something that I wanted to say, I forgot, was this is about saving the welfare state, not actually eliminating it. If it's not protected by a sustain fiscal adjustment in an orderly fashion, they may lose it. So the nature of the debates, and I agree with the PIIE and other banks being on an advertisement campaign, there's not enough understanding of this. And another thing is what should we not do? Policymakers, politicians talking about central banks canceling public debt, easy way out. That can be very damaging.

[00:59:03.38] - Maurice Obstfeld

Are you referring to France in particular? Yeah, well, Europe has a much more recent memory of debt crises also than the US, which has a unitary central bank. So, let me turn it over to the audience for questions now. There's a standing mic. Jess has a Mobile mic, please identify yourself if you're asking a question. Yeah, Steve. Steve, well, identify yourself.

[00:59:39.28] - Audience

I'm Steve. Steve Cayman, American Enterprise Institute.

[00:59:43.10]

I had a question about the recent run-up in bond yields around the world.

[00:59:48.32]

Is this like a canary in the coal mine? Is this something that could accelerate a crisis, or is the financial media making a mountain out of a molehill?

[01:00:01.57] - Jason Furman

I mean, I'm happy to go first. So first of all, you were correct, obviously, in saying around the world. It's not just that over the last 3 months yields have risen in similar paces in different countries. It's week to week, they're very correlated. So it looks like there's a common factor basically everywhere. Except Japan. So that'd be the first thing to say is this is global. This isn't to say it isn't caused by US fiscal. It's a global capital market. It's the first thing to say. Second thing is I'm slightly skeptical of the fiscal adjustments in that we haven't since June, the most recent run-up, or if you look at a longer time horizon, gotten a whole lot of fiscal news. In fact, if

anything, in the United States, the fiscal situation, I thought it was going to be really bad and instead it's just pretty bad or quite bad. And that's because the tariff revenue exceeded what I expected. The spending cuts that they did exceeded what I expected. So I don't see where the fiscal news and fiscal surprise. So are interest rates 50, 75 basis points higher because of the run-up in debt over the last 20 years?

[01:01:08.43]

I think that's quite plausible. Are they 50 basis points higher than they were 3 months ago because of the run-up in debt over the last 20 years? I find that implausible. So what are some of the other things? Certainly, when you look at spreads, there's some repricing. So if you're talking about why France is different than Germany, you want to look to events in France. And that has a lot to do with it. So some of the spreads you get there. But in general, the recent run-up, at least to me, looks like central banks are extremely credible so that inflation expectations haven't risen. But that haven't risen 'cause they think they're going to raise rates a bunch to stop inflation. And so we're just expecting a higher rate path 'cause we're expecting more inflationary pressure and we think they're going to defeat it. And so this is much more an inflation macro central bank response function. And then underneath it is this bedrock of the debt, but that's not really what the last year and a half or the last half year is about.

[01:02:12.25] - Maurice Obstfeld

Over this table. Why don't you get up to the mic because it's right next to you.

[01:02:22.16] - Audience

Shahid Yusuf from the Growth Dialogue.

[01:02:25.17] - Jason Furman

And my colleague from 30 years ago.

[01:02:29.01] - Audience

Yes.

[01:02:29.56]

Yeah, we both worked with Joe Stiglitz. So my question is regarding what might happen if the AI bubble continues to grow till next year and then pops, and that leads to an increase in

unemployment, slows growth down, and particularly slows TFP growth down for, let's say, several years. How would that probably affect the deficit, revenue elasticity, and, you know, all of the other problems that we've been talking about?

[01:03:05.22] - Maurice Obstfeld

OK.

[01:03:05.37] - Jason Furman

I mean, I have views, but I just answered the last one. So if somebody wants to go first, you can. But no one seems that eager to. So first of all, you didn't ask whether there'd be a bubble. And I can give you all the reasons there'd be a bubble, except nothing about my stock portfolio, which is all buy-and-hold index funds, reflects any of those views. So then I question whether I really have those views. For the valuations to be sustained, you need both the productivity growth to materialize the capabilities to keep improving, and you need to be able to profit from them. For me, the better the capabilities get, the more you can use the 5th best model, and it'll be more than good enough for you. And that's a big threat to the business model of top one. So that's why I'd be concerned about a bubble. Conditional on one, to me, it feels more like 2000, than it does like the global financial crisis, 'cause financial crises are largely, you thought something was money, it was worth $1 for $1, whether that's your bank account or your money market fund or your AAA bond that you were using as collateral, and you discover that thing isn't actually money, it isn't worth a dollar.

[01:04:16.24]

And when that happens, just huge ramifications throughout the system. Here, all of this is already properly understood to be risky, so it's more like a stock that goes down At the end of that, you have less money, but it's not collateralized, et cetera, throughout the financial system. So to me, it would feel more like a mild recession. The Fed has a lot of room to cut rates. We have really low demand in every other sector of construction, at least. You could make up for that some. And so in some sense, I think this has some impact on what we've been talking about, but it's more like bumping around over a 2-year horizon. And the bigger question is, do we get productivity growth from AI? And that's to some degree orthogonal to the, is it a bubble question? And that I think our fiscal and our growth all rises and falls on that 10, 20-year horizon. How does the technology work out on the supply side, not what happens on the demand and financial side?

[01:05:16.05] - Maurice Obstfeld

OK, we are now at time. 11:00 AM. So we're going to have about a 7-minute coffee break. And then we will move to the next part of the program. Thank you very much. Let me thank the panelists for an excellent discussion.

[01:18:53.32] - Kimberly Clausing

I'm really pleased that you could come to Peterson. So I'm Kim Clausing. I'm a nonresident senior fellow here at PIIE. And it's my pleasure to welcome Senator Whitehouse. He is now in his 4th term in the Senate representing the state of Rhode Island. He has shown a lot of leadership on tax and budget issues, which is how he came to us today, but also other issues that are close to my heart on climate. So I had the pleasure of working with both him and his staff during my time at Treasury, but also in— for a much longer time as an academic working on these issues.

[01:19:31.55] - Sheldon Whitehouse

And Dr. Clausen is my favorite economist, so I'm thrilled to be here.

[01:19:35.38] - Kimberly Clausing

Well, thank you. So Senator Whitehouse has been on the Budget Committee for nearly 2 decades, including some time as chair. He's on Senate Finance since 2018. And he's now the ranking member on the Committee on Environment and Natural Resources, where he's also been a member for nearly 2 decades. So we're just thrilled to have him here at Peterson. So let me get right into it. And I'm going to open with just 2 small observations. One is that the United States is not particularly good at fiscal responsibility. And that seems to have real consequences for taxpayers and for households. For taxpayers, there's a big opportunity cost in spending so much on interest when we could be spending on other priorities. For households, interest rates are higher. Something we notice every day with the bond market. And that translates into higher mortgage costs and a lot of real consequences. A second observation is an international one. And this is Peterson where we care a lot about international things. So let me just mention that. I know you've had a lot of leadership on the international collective action elements of tax policy. But one issue, if we're looking at US fiscal imbalances, those are really related to our current account.

[01:20:49.47]

The US current account deficit all alone is nearly 2/3 last year and over half in recent years of all world current account surpluses. So all the excess savings in the world, we're absorbing somewhere between 1/2 and 2/3 of it with our borrowing. So there's big international

implications here. But also our tax policies affect other countries on issues like tax competition and climate change. So I hope we'll have a chance to talk about both of those. So let's just first start with the opener. How did we get here? The United States voters don't seem to care a lot about fiscal responsibility. Congress doesn't seem to care a lot about fiscal responsibility. I know you've been active in thinking about this for 20 years. And you've got a bipartisan budget reform suggestion. So tell us a little bit about how we got to this point.

[01:21:42.59] - Sheldon Whitehouse

I would say we had 2 major problems that have driven us to the point that we are at. One is the institutional problem of a malformed budget committee that in theory is supposed to address this problem, but is designed not to address this problem and was made worse by the determination in the Senate some time ago that budget reconciliation matters didn't have to be deficit reducing any longer. So what we're— I've been working for a while to try to reform the process of the Budget Committee to do things like tag it to a debt-to-GDP ratio, which when this reform was being considered had literally 100% support from every witness who turned up, to get healthcare spending into the process since it's such a huge driver of deficit and yet is not included in what the Budget Committee looks at, to get the debt limit out of the process. I describe it as the bear trap in the bedroom. It may not go off on you right now, but when it does, it's really going to hurt, and it can go off accidentally in a partisan and quarrel, and more technical things like move to biennial budgeting.

[01:23:11.46]

So there's a little bit more attention to that process. So there's an actual committee reform piece that needs to be done so that somewhere in the Senate is a group that is actually looking at this and looking at this in a sensible fashion. The second force that has driven this is the lust for tax cuts and tax breaks, which have driven in my lifetime the share of America's corp revenue contributed by corporations from around 30% of our revenue to maybe 6 or 8%. That missing 24 or 22% piled up over those years becomes a very, very big number that might even rid us of the— have rid us of the debt that we've piled up. And the desire to provide tax benefits to very wealthy people to very big corporations, all of that, has completely overwhelmed any desire to be fiscally responsible. Given that choice, particularly on the Republican side, they've chosen to go the tax cuts route every single time, which has for them the political benefit of keeping big donors happy so they continue to send big checks.

[01:24:44.00] - Kimberly Clausing

Yes, I sometimes describe this as a one-way ratchet where it feels like one party wants to cut taxes on everyone And then the other party only wants to raise taxes on a tiny group of people. And so then you end up with less and less revenue over time.

[01:24:57.28] - Sheldon Whitehouse

And actually, if we were going to do this right, I don't think this got into the measure that passed through the bicameral— out of the Budget Committee and through the bicameral Fiscal Committee that was set up. But in addition to putting health spending into the equation in the Budget Committee, you'd also want to put tax spending in as well. It matters just as much to the deficit when some special interest gets a slug of money through a tax spending provision as it does if they get an appropriated spending. And it's actually harder to get rid of 'cause the appropriation at least expires and gets reviewed every appropriation cycle, whereas zombie tax provisions live on indefinitely in the code.

[01:25:44.16] - Kimberly Clausing

Yeah, one thing I've noticed is that the United States is somewhat unique in its reliance on tax expenditures. Like, if you compare us to other countries, we have a very large amount of spending that we're doing kind of through the tax code.

[01:25:56.34] - Sheldon Whitehouse

It's a full-on industry in this town to deliver those things.

[01:25:59.31] - Kimberly Clausing

Yeah. So let's just take a moment on spending, and then we'll go back to taxes. So if we look at spending, one of the biggest drivers after interest and defense is the elderly, and in particular Social Security and Medicare. And we've got trust fund expirations coming down the road. On the prior panel, that was talked about as a possible forcing mechanism that would make us sort of deal with some of these fiscal imbalances. I know that you've thought a little bit about this. Can you share some of your ideas for what we should do at that moment?

[01:26:32.50] - Sheldon Whitehouse

Yeah. I think that this is a very solvable problem both for Social Security and for Medicare, and that there is revenue available to do that that falls well within the zone of what you would call responsible decorruption of the tax code, you know? And so there's a pretty obvious route there. I have a bill that would do that. There are probably 2 or 3 other Democratic bills that would do

that. There is no Republican legislation to address this problem. Instead, the Republican desire is to set up a commission or a tribunal or a workgroup or something. And my suspicion is that the purpose of that is to put benefit cuts into the equation that they don't want to propose because they know how unpopular they are. So the commission would be the Trojan horse through which they could get their beloved benefit cuts in without having to own that. It would be, oh, that came to us through our bipartisan commission. So I'm pressing that, look, if you're serious about this, write a damn bill. Don't just wait for some commission to come up with something. Put your cards on the table. That also makes for more honest negotiating.

[01:27:55.46]

So that is where we are. This is an eminently solvable problem if you're willing to walk away from benefit cuts And if you'll recall, there was that moment during President Biden's State of the Union when there was a kind of live exchange between him and the members present, and everybody rose to their feet and gave a big standing O to the concept of no benefit cuts. So that's okay. Let's do it that way then.

[01:28:24.40] - Kimberly Clausing

Yeah, that's one thing that we noticed in the last panel is that it seems like the public is quite enthusiastic for the spending side of things, but they're less enthusiastic for the tax side of things. And so maybe that's one place to start. So let's say that we did agree on a bipartisan basis that we didn't want to cut benefits, and maybe we don't want to cut defense, and maybe we don't want to default on the debt. So that really brings tax front and center.

[01:28:52.50] - Sheldon Whitehouse

Yeah.

[01:28:53.16] - Kimberly Clausing

There have been some really big tax cuts over the last few years, the Tax Cuts and Jobs Act, the One Big Beautiful Bill Act, and some tax increases that we're concerned about here, particularly in this building on the tariffs, but mostly tax cuts. Some of those seem difficult to reverse. I have some colleagues in the profession who've written a paper about, well, if we just went back to the 1990s tax brackets, everything would be fine. And that's true. But I also have a hard time imagining Congress being like, yeah, let's just go back to the late 1990s tax brackets. That seems difficult politically. So what do you see as sort of a possible path towards more revenue? Like, what are the big buckets that you can imagine Congress be— being willing to

take off, either to save Social Security or to meet other fiscal priorities that are coming down the road, including responding to climate change?

[01:29:48.24] - Sheldon Whitehouse

Well, most of the damage was done through budget reconciliation, so I think the solution can equally come through budget reconciliation. I think as a society, we're entering into a fairly dangerous environment where you have a significant portion of the population that feels under really serious economic stress, that are really unhappy every month when the bills come due and are uncertain about how they're going to pay that. And that's a really powerful burden on a family. They also have a feeling that that is happening in the context of a hell of a lot of economic injustice that exists in the country, and that gets augmented by the sense that that's being created by the wealthy people, by the big corporations who are getting the breaks, and that their power in the democracy that would counterbalance that is lost to the winners and the looters and the people who are, you know, take, take, taking when they have the least need. So I think there's a very powerful force out there that is so frustrated that they were actually willing to vote for Donald Trump. But that force, I don't think, has gone away, and I think we need to meet it with tax policies that undo that.

[01:31:14.58]

When you're a country where the top 1% has what, a third of the wealth? And the bottom 50% has 3% of the wealth. Those are roughly the accurate numbers. Something's gone a little haywire. And when people are reading not just about deca and centibillionaires frolicking around the world with massive grotesque personal lifestyles, but now a trillionaire, The tax policy has an important end in itself, but we also need to reboot the social contract so that the prospect that rich people successfully loot the country that made them rich and poorer and working people are left to pick up the cost of their mischief disappears from the political equation. It is a very, very dangerous proposition. And if you don't mind me adding, if you believe the warnings of a great climate insurance collapse that you're beginning to see in Florida and places where climate risk makes a property uninsurable, uninsurability makes the property unmortgageable, unless you're billionaires swapping Palm Beach mansions, that means the value of the property crashes because the buyer needs to have a mortgage that can't be got on that property, and you get a regional or national or even global, according to The Economist, crash in real estate values.

[01:32:52.25]

Things bad enough now, you add the heat and drama and anxiety of that kind of economic crash on top of it, and you get to like Europe in the '30s sorts of social dissension. So you could easily get leadership that even made this Trump administration look reasonable if, if we went down that road too far. So I think it's really important to rebalance while we can and try to restore that sense of social order and that we're all Americans together.

[01:33:26.04] - Kimberly Clausing

Okay, so let's take 2 implications from, from what you just said and Let's start with the first part of it with inequality, and then we'll turn to the second part with climate.

[01:33:37.20] - Sheldon Whitehouse

Yeah.

[01:33:37.27] - Kimberly Clausing

So with the inequality side of things, I've long argued that one way to deal with these disparities in the top 1% isn't to pursue novel new billionaires' taxes, but to recognize that a lot of the winners in our society begin with getting their income at the entity level. in the corporate form or perhaps in a pass-through business. But a lot of money is in corporate tax. Further, if we take AI as a challenge and we think that's going to generate corporate profits either through the firm selling the AI or through the adoption of the AI, maybe we don't know which, but it might also generate some disruption. So it strikes me the corporate tax can handle both of those because it can— It can deal with the billionaires that way, but it also can deal with AI even if we don't know which firms are going to succeed, because when they're profitable, they'll pay this tax. And one tricky thing with corporate tax is the international element. There's a lot of profit shifting where people move income offshore. And I know you've thought a little bit about that.

[01:34:46.13] - Sheldon Whitehouse

Yeah.

[01:34:46.14] - Kimberly Clausing

So if you were going to suggest a way forward on corporate tax for the future— and this may not be possible in the short the term— but if next you were going to suggest a way forward 2 years, but a little bit longer, like what kind of things would you want to do?

[01:34:57.10] - Sheldon Whitehouse

Yeah, I don't think you can get to levelizing tax rates so that you don't have the problem of billionaires paying lower tax rates than plumbers without addressing some of these technical tax avoidance aspects. So once somebody's wealthy enough to afford to incorporate themselves and manage corporate shells, that steer away their FISA tax liabilities, that's a benefit that accrues to the best-off people. And so it has a double harm. You lose the revenue and you make the injustice of the whole damn thing worse. And then I think the offshoring of revenue by corporate America is a completely unjustifiable outrage. Whose primary victims are the American companies that don't offshore and launder their profits through the Cayman Islands or someplace else and have to pay taxes like normal corporations, but they also have to compete in the environment with the companies that are big enough to be able to afford the infrastructure of offshore tax havens. evasion. So those— it's really essential that we look at the structure of how people divert their tax liability away from actually just paying it like a grown-up American. And those 2 things have to go hand in hand. I came to the Senate when Kent Conrad had my last job as chairman of the Budget Committee, and I'm in his Hart office.

[01:36:45.00]

So I think of him from time to time and his picture of Ugland House, which had— I forget the number he would use— like a 5-story building in the Cayman Islands that supposedly has, you know, 40,000 small businesses operating out of it. When you've got 40,000 businesses operating out of a little 5-story building in the Cayman Islands, That's a whole new meaning of what a small business is. But we shouldn't tolerate that nonsense. There are other tax havens where the revenue that putatively flows through that tax haven is more than the entire GDP of the tax haven. I think we need to worry a little bit about trying to eliminate the hiding of money and the— Tax dodging aspects of what a lot of small countries do to try to improve their own revenue. If we could make it where allowing secret hiding spots for money was as unpopular as child labor, and countries that did it faced a real consequence for doing it, and all that revenue came to light as opposed to having to wait for the Panama Papers to bring it to light, It would be a better world.

[01:38:06.47] - Kimberly Clausing

Yeah, this strikes me as an area where global collective action can make progress, and I think we got pretty close a few years back with the Pillar 2 agreement on the 15% minimum corporate tax, which is now being deliberately weakened, but that does suggest one optimistic path forward.

[01:38:25.20] - Sheldon Whitehouse

Sadly, the non-offshoring corporate world did not come forward to speak up.

[01:38:31.53] - Kimberly Clausing

Yeah, that was unfortunate. Another big international collective action problem where I think tax policy can play a role in facilitating cooperation is that of climate change. And I'm struck by the fact that if you look at the G20 countries, 17 have some form of carbon pricing. And the 3 exceptions, by the way, for those in the room that are curious, are Saudi Arabia, Russia, and the United States.

[01:39:02.49] - Sheldon Whitehouse

We're riding with that company pretty often now. It's a bit of an embarrassing crowd to be so constantly with.

[01:39:08.50] - Kimberly Clausing

So if we imagine— perhaps this is a little too optimistic— but if you can imagine a situation where, OK, we've got fiscal problems, we need to raise revenue, we've got international collaboration problems, we need to work better with other countries, one forcing device could be a climate club where countries agree that some minimum carbon price, kind of like the International Tax Agreement, and there were border adjustments that serve sort of like the UTPR. I know you have an approach with the Clean Competition Act that pushes a little bit in that direction.

[01:39:44.24] - Sheldon Whitehouse

Yeah.

[01:39:45.26] - Kimberly Clausing

Do you think that's promising? Can you imagine that happening down the road? And if so, do you think it would be better to divorce it from the fiscal problem and say, okay, well, maybe we can do carbon pricing, but we can't raise revenue, but we can give it back to industry, which many countries have done?

[01:39:59.21] - Sheldon Whitehouse

Yeah.

[01:40:00.00] - Kimberly Clausing

Because it's more important to do the decarbonization, or do you think there's a both-and opportunity there too?

[01:40:05.20] - Sheldon Whitehouse

Probably both-and. I'm on the climate hawk side here, so I'm inclined not to be too peremptory with my colleagues about where the revenue goes. If we can solve the looming problem of climate risk, which by the way is now fully out of the science department and into the economics department through that problem of insurance cascade that I already described, that would do a lot of good. The International Monetary Fund has calculated that the subsidy that fossil fuel enjoys every single year in the United States through its freedom to pollute is over $700 billion, with a B, dollars. So if you're an industry protecting a $700 billion subsidy, the amount that you're willing to spend to corrupt politics to get there is virtually unlimited. I contend that the most lucrative aspect of the fossil fuel industry's business is their political influence operation. Because it makes these enormous subsidies possible and protects them. That is inexcusable from a moral point of view, in the same way that you shouldn't rake your leaves into your neighbor's yard at night while they're not looking, or dump your effluent into the river so that downstream people have to deal with it.

[01:41:33.43]

This industry should do the right thing. It's also the economically correct thing to do, even Very conservative economists treat negative externalities like pollution as a subsidy. So there's really no case for it with any principle behind it. It's just raw political power and years of political influence. And it's a huge correction that we need to make because it's really burdening American consumers.

[01:42:05.34] - Kimberly Clausing

Yes, I've done some interesting work on this too about the cost to US consumers from the Natural disasters, for instance, is—

[01:42:12.59] - Sheldon Whitehouse

Not to mention, you can't fish in Montana this summer for trout because the Yellowstone and the Madison and these famous legendary rivers are so warm that a trout fighting the line as it's being reeled in kills the trout. So they've stopped allowing fishing during heated hours of the day. There's not just— You know, in my line of work, everything is like the house of the temple

of mammon. Everything has to be reduced to something that's monetized. But when you can't take your granddaughter fly fishing in the creek that you learned to fly fish in, there's a cost to that. There's an agony to that that you cannot monetize, but it's real. And I think we shouldn't overlook those non-monetary harms. They're pretty real for people.

[01:43:07.46] - Kimberly Clausing

So let me get that— with that useful reminder, let me bring it back to the budget deficit. Because one thing that we were struggling with in the first panel was how to get attention to this problem.

[01:43:19.37] - Sheldon Whitehouse

Right.

[01:43:19.43] - Kimberly Clausing

And as you point out, sometimes it's easier if you can point to a story or a personal element. I think one attention-grabbing mechanism is the interest rate, you know, because you can say your mortgage is higher, your— Consumer debt is higher. It's harder for you to take out a small business loan now that interest rates are higher. But I guess my final question for you— and I know you have a hard out in 7 minutes, and I want to leave the audience a question or two as well— but my final question is, like, what do you think is going to be that attention—

[01:43:48.53] - Sheldon Whitehouse

I think I have somebody here watching the floor to see how we're doing, so you can wave when I really have to go.

[01:43:54.05] - Kimberly Clausing

OK. But what do you think will get the attention? Like, what stories can we tell, or how do we How do we get the public to care and therefore Congress to care more about this fiscal responsibility? Or what do you think will be the forcing event? Do we have to wait for a Liz Truss kind of moment where the bond market gets crazy or something else come along?

[01:44:16.19] - Sheldon Whitehouse

We're not very good at bringing forward out-year dangers, climate being the perfect example of that. Of indisputably known for 40 years, even through scientists paid by Shell and Chevron and Exxon, what was going to happen if we didn't get our arms around this problem, and that there

was a super easy, economically correct solution to it. We just didn't, and we allowed the fossil fuel industry to, you know, manage Congress in ways that led us not to do our duty. So we sort of are living in that experience, and it's, it's really hard. The thing that's leading right now in the climate debate is this home insurance problem. I took a poll in Texas just to test the proposition. 92% of Texans are concerned about the cost of their home insurance, which is north of groceries and north of healthcare. Who here thinks that 92% of Texans own their own homes? Right. They don't. Which means that this issue is so alive in the Texas zeitgeist or whatever word you want to use, the conversation, that people who don't own homes are telling pollsters that they're concerned about the cost of home insurance. That means it's gone pretty viral there.

[01:45:46.09]

And behind that, 66% of those people ascribe that cost problem to climate-driven extreme weather. In red— purple, oil patch Texas, 66% of voters are already there. In Florida, 46% of Trump voters— Trump voters ascribe their home insurance crisis to climate change, we use the double C, causing worse storms and hurricanes. So this argument that there are now real costs for people has really settled in and is now, I think, a live political proposition. Behind that is this cascade risk and what it means to the fiduciary obligations in the real estate industry, in the insurance industry, in the financial industry, and whether those big industries are meeting their due diligence responsibilities at looking at that risk and planning for it. And at the moment, I would say that they are not. They're living in a fool's paradise with big liability possible if lawyers are later able to show on behalf of shareholders and stakeholders and investors and others to whom that fiduciary obligation is owed that— excuse my language— they fucked this up. And I think that's kind of where we are right now. And the sort of in terrorem approach of the Trump administration to anybody taking climate seriously is not helpful.

[01:47:36.52]

in terms of those industries meeting their due diligence requirements. But fiduciary responsibility is a real thing and it's not going away. And at some point they bump into it again, and then I think things move. It's crazy that the insurance industry is not fighting back on climate when you've got Gunter Thalheimer from the board of Allianz warning that climate change is signaling the end of the insurance industry and through it, real estate and finance as well. Those are pretty serious warnings coming from within the industry. The US president of Aon had similar warnings. The International Financial Stability Board has some similar warnings out about banks and what this does to the banking system. So there's a whole array of warnings that if I were still a lawyer, I would love to take before a jury and say, well, why didn't you read that? And why didn't you take it seriously? Who did you assign to the task of looking forward at this risk? Because when it happens, it's like the old Hemingway line.

[01:48:39.20] - Kimberly Clausing

The long run takes a long time to arrive, but then it comes swiftly, I believe. Yeah.

[01:48:45.20] - Sheldon Whitehouse

You go bankrupt gradually and then all at once.

[01:48:47.54] - Kimberly Clausing

Yeah. So hopefully that's not too much of a metaphor for the deficit. I think the first panel today was a little agnostic about whether it ends up being quite so dire with respect to US debt or not. We do have time, I believe, for a question or two from the audience. We have a mic in the center if people want to move to that. And we also have a roving mic. So just raise your hand if you have a question for the senator. Otherwise, I'll ask more. Now there's one.

[01:49:16.53] - Sheldon Whitehouse

One hand up.

[01:49:17.12] - Kimberly Clausing

[01:49:17.13]

[01:49:17.14]

Jump to current wordHere we go.

[01:49:18.04] - Sheldon Whitehouse

Somebody brave.

[01:49:19.07] - Kimberly Clausing

Yeah.

[01:49:20.09] - Audience

Hi.

[01:49:21.32]

My name is Selina Ozgurt. I'm a climate economist in the World Bank. I have lots of sympathy about the insurance, home insurance crisis you mentioned. But I would still like to come back to the US debt problem because my impression is what really bothers people today, because climate, we said, is for later, it's high interest rates for their businesses, for their mortgages, for their consumer debts because longer-term yields, they also affect what you pay out of pocket today. And also it forces the central bank to do something to anchor inflation expectations, because basically central bank cannot bring more oil or reverse tariffs. In this context, how important reducing the deficit is when you think of the social cost of it in everyday lives?

[01:50:19.54] - Sheldon Whitehouse

I think it's very important. We're like a blindfolded person walking off a diving board, and every step you put down that lands on the diving board convinces you that you can keep walking until the day comes when you step out into thin air and, you know, down you go like Wile E. Coyote. So we don't know when that happens, when things change abruptly and catastrophically. It's really hard to pick where the moment comes, where it goes from gradually to all at once. And that's one of the reasons I really would like to see my budget committee reforms adopted, because the harder it is to predict that moment and the harder it is to make that prospect real for people, the more important it is that the processes of government be responsible about looking at this problem in a real way and sending up flares when debt-to-GDP is out of line. having consequences for the budget process when things get out of line, having healthcare and tax spending in the equation. We don't even get the math right of what contributes to the deficit by leaving those 2 huge drivers out of the equation. And we've turned what should be a responsible approach to the deficit into a forum in which annually people get to take a kick at non-defense appropriated spending, which is only a slice of the problem, and it has completely distracted the Budget Committee from these larger responsibilities.

[01:51:56.47]

The structure of the Budget Committee's work is wrong, and if you can't fix that, then you can't fix where the ditch diggers are digging. If you don't have a good ditch digging plan, they're digging in the wrong place and they're not digging in the right places. And so what effort there is, simply isn't well organized. So I think it's really important that we support a reform like that so that somebody is looking at this problem. At the moment, it is not the Budget Committee.

[01:52:28.59] - Kimberly Clausing

There have been times in the past where people have been able to come together and, and do those things. So maybe if we're lucky, we're moving in that direction from Yeah. Well, I know you do have to go, so I hope everyone will join me in thanking—

[01:52:43.40] - Sheldon Whitehouse

Thank you all very much. Appreciate very much the work of the Peterson Institute, and I look forward to working with you on solutions.