



## The Debt Limit Debate Is a Distraction

*Simon Johnson says the debate on the debt limit overlooks the need to address long-term healthcare and pension costs and to raise revenue, perhaps through a value-added tax (VAT).*

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Steve Weisman: The debate over raising the debt limit in Washington has raised the question of how the United States is going to address its deficit and debt burdens. Simon Johnson, senior fellow at the Peterson Institute, is here to talk about that subject. Simon, you have been testifying before several congressional committees about the budget outlook. What's your view of the debt limit crisis?

Simon Johnson: I think it's a very bad crisis to have, first of all. It's a completely unnecessary risk that's been thrown into global markets. I do think that they will stop short of anything approaching a default, but you could well get some sort of partial government shutdown.

Steve Weisman: The competing plans presented by the Democrats and Republicans would cut spending over the next ten years. What's your view of approaching it that way?

Simon Johnson: I think it's largely a distraction, to be honest. The big budget issue for the United States, which is very serious, is a longer-term issue -- 2030, 2040, 2050. The IMF [International Monetary Fund] has done some very good comparative work looking at the fiscal adjustment that all industrialized countries are going to have to make, as part of the process of ageing of these societies.

It's about pensions, it's about health care. And in that comparison, the US really stands out in terms of additional healthcare spending that we should expect based on current trajectories. We are in the worst shape of all industrialized countries on that dimension. On other things like our budget over the next ten years, actually we're fine.

Steve Weisman: Over the next ten years, what would be your approach on health care spending? There are various factors driving up the cost. Some are not easy to control, such as the demographic change in the offing. What's the urgency of dealing with these longer term problems now?

Simon Johnson: I think it would be a good idea. It would be good to have these points more central to the political discussion, but they're not on the table. I guess that's my bigger point. They're not coming up in the debt discussion process that we see today.

It's all about shortage and spending. It's all about so-called down payments on deficit reduction. But they're not down payments. They're unrelated or tangential to the increase in health care costs that are going to really damage this economy in 20 to 30 years if we don't deal with them.

Steve Weisman: Do we need to raise revenues and how should we do it?

Simon Johnson: I testified this week to the House Ways and Means Committee and a couple of weeks ago to a joint hearing of Senate Finance and House Ways and Means. Actually, apparently, the first joint hearing those two committees have had on taxes in 70 years, which is kind of interesting and surprising actually.

Steve Weisman: That would take us back to what?

Simon Johnson: It was 1940 and it was about a tax on war profits, I'm told. My point to these committees was that in the context of tax reform, they would do well to think about some form of VAT, consumption tax that operates in a...

Steve Weisman: VAT stands for?

Simon Johnson: Value Added Tax.

Steve Weisman: But it's a consumption tax.

Simon Johnson: It's a consumption tax levied at every stage of production. It's relatively efficient. It's used in a lot of countries. There are very modern versions being used by places like New Zealand and Canada. In Canada it works in a federal system, for example, where the provincial level has different kinds of sales tax arrangements.

So it's a pretty workable, durable model. If you had a VAT at a reasonable rate, you could generate two or three percent of GDP in revenue and then you could decide: do you want to use that as additional revenue to buffer the transition to an aging society or would you want to use it to reduce other taxes? You could substantially reduce the income tax or corporate tax, for example, if you had this tax revenue coming in at a federal level.

Steve Weisman: The criticism of VAT is, of course, that it's regressive. It falls especially hard on those people who have low incomes.

Simon Johnson: I think it's a very important issue and it's actually one point that I was emphasizing in my testimony. There are various ways to refund to people at the lower end of the income scale what they spend on the consumption tax. Some form of earned income tax credit, for example.

Then you have to have a way to increase the incomes of people who don't work -- for example, pensions or Social Security have to take this on board as well. Now that will deal with the lower income, lower part of the income distribution. The middle does still get squeezed.

President Bush had an advisory panel on tax reform in the mid 2000's that has some good analysis on this. They showed they can protect the lower end with this refundable tax credit. The middle will get a bit squeezed and the upper end gets something of a tax break if this all that you're doing. So there's still some regressivity, I would agree, in that kind of arrangement.

Steve Weisman: What was the reception you got to your ideas?

Simon Johnson: I think there was interest on Capitol Hill, but it's still very early in terms of thinking about tax reform. I don't think that the Republican majority in the House is willing to put concrete specific things on the table, and the Democrats don't feel that they should go first in this context. But there is interest in these issues.

And the US stands out within the G20 as the only country that doesn't have some form of VAT, apart from Saudi Arabia. There are two countries in the G20, US and Saudi Arabia. Saudi Arabia obviously has a very different kind of revenue base than we do.

Steve Weisman: Another criticism of the consumption tax is that it discourages consumption, of course. Wouldn't that hurt the economy?

Simon Johnson: My point about the issue [is], when is our budget problem? When is the real budget crisis? It's 20, 30 years down the road. So if VAT can be phased in quite gradually it could be timed so it doesn't choke off the economic recovery.

We are not in a situation of Greece or in the situation that the British claim to find themselves, where they need precipitate immediate fiscal austerity. If you do fiscal austerity, and if actually fiscal austerity or contraction in spending is one outcome of the debt ceiling debate, that will slow down the economy. The idea that we can have a so-called expansionary fiscal contraction is I think pretty serious illusion in the current American context.

Steve Weisman: But your bottom-line on revenues is that probably there's going to have to be an increase in maybe one or two percentage points of GDP in the amount of revenue that the federal government is going to have to take in.

Simon Johnson: It's a decision you have to make. You have to look at the changing nature of society. We're getting older. There are clearly problems with education, health care, for example, for children from lower income families.

Do you want these people to grow up to be productive, to have strong skills to generate tax revenue that you can use to support this aging society? Or do you want to cut them loose and go to some rather extreme libertarian model, where the market is everything? And we know what happens to education outcomes and to health for people in the bottom 40 percent of the income distribution, in that kind of world.

So that's a decision you have to make and I think you have to weigh the pros and cons. The way I see it right now some additional revenue would be good to have. In addition we should do some tax reform. We should clean up the income tax system and probably also limit the deductibility of corporate interest, because we give companies, including banks, an incentive to have way too much debt relative to their equity. So put this all together in a tax reform package and also, of course, control health care spending.

Steve Weisman: Simon, thank you.

