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The University of Pennsylvania

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Webinar

Moderator: Jeffrey Holland
Vice President, Research
Peter G. Peterson Foundation

Introduction

President Barbara Van Allen

Good afternoon and welcome to the 722nd meeting of The Economic Club of New York. I'm Barbara Van Allen, President and CEO of the Club. The Economic Club of New York is known as the nation's leading nonpartisan forum for the discussion of social, economic, and political issues. More than 1,000 prominent guest speakers have appeared before the Club over the last century and have established a strong tradition of excellence.

I'd like to extend a warm welcome to students from NYU School of Business and Mercy College who are joining us today as well as members of our largest-ever Class of 2023 Fellows – a select group of diverse, rising, next-gen business thought leaders. As a reminder, starting October 1st, we will be taking applications for the 2024 Fellows Program, and you can find those applications on the Club's website.

Today, I'm really honored to welcome our special guest, Kent Smetters. Kent is the Boettner Chair Professor at the University of Pennsylvania's Wharton School and a Faculty Research Fellow at the National Bureau of Economic Research. Besides being a professor in Business Economics and Public Policy, he is also professor of Insurance and Risk Management as well as a faculty member in Applied Mathematics and

Computational Science at Penn.

Kent's research focuses on applied theory, fiscal policy, risk measurement, insurance, healthcare, and personal finance. His previous positions include the Congressional Budget Office as well as Deputy Assistant Secretary for Economic Policy at the Treasury Department.

He and a co-author won the TIAA Paul Samuelson Award for their study on annuitization. He is the host of "*Your Money*," a weekly personal finance radio show on SiriusXM 111, Business Radio, as well as a monthly contributor to the *Wall Street Journal*. Kent occasionally provides support on legal cases related to medical malpractice, ERISA, insurance, financial advice, and securities offerings. He received his PhD in Economics from Harvard University.

The format today will be a conversation, and we're honored to have Jeffrey Holland, Vice President of Research at the Peter G. Peterson Foundation, as our moderator. Time permitting, they'll take questions from those in the chat box. As a reminder, the conversation is on the record and we do have some media on the line. So without further ado, I'm happy to pass this time over to you, Jeffrey.

Conversation with Kent Smetters

JEFFREY HOLLAND: Great. Thanks, Barbara. Thanks for the introductions. On behalf of the Peterson Foundation, I'm really pleased and honored to be here with Kent, my former colleague at CBO and fellow participant in the federal budget world. We'll talk in general about fiscal policy today. I'll be starting with broader issues and then working down to some specific ones. As a reminder, if you have questions please put them in the chat and we'll try to get to them as we go along.

Anyways, to get started, Kent, could you give the audience an overview of what the Penn Wharton Budget Model is all about.

KENT SMETTERS: Sure. So the Penn Wharton Budget Model was printed about seven years ago really to solve a pretty big need by policymakers, mainly on Capitol Hill. And in particular they wanted to understand the impact of legislation, not on the back end after it's all been written and so forth, but on the front end while they're actually writing it. And in particular they also wanted a deeper analysis of the economic impact as well as, of course, the budget and distributional impact.

And so the goal of the Penn Wharton Budget Model is really to provide this very transparent analysis and it is not just nonpartisan work, actually non-normative, we don't

take positions. We don't recommend policies. We simply do analysis. So a lot of our analysis right now is private, behind the scenes, directly to policymakers. They come to us from really both sides of the aisle trying to get insights before they put pen to paper.

And we also try to remove some of the biases that exist in the budget, including things like a 10-year window that's very common, anything that involves an investment today with a return after ten years. Like Pre-K education is going to generally look bad in a standard 10-year window. And so what we want to do is do analysis that is holistic and also it doesn't just include the macro effects, say of tax cuts, but also spending programs as well.

JEFFREY HOLLAND: And how is the work that you do different from what other government agencies, the CBO or the administration, are doing in terms of informing the Congress?

KENT SMETTERS: Yes, we love both organizations and so forth, as you and I overlapped, in fact, at CBO for some years – my first job after my PhD, very non-traditional route. I really wanted to be involved in policy. And so the main difference is we work with policymakers typically when they're actually in the writing stages. In some cases like, you know, some of the major policies, the Inflation Reduction Act, different structure, things like that, we provide options ahead of time and then policymakers can

kind of pick and choose from those options. But again, it's a range. We're not advocating for any of those. But often they come to us with their own ideas and they want to understand it before they put pen to paper. So it's really the front-end aspect of it.

And secondly, we're not kind of handcuffed by law either. We're able to look at things on a longer term, shorter term, and also we can do dynamic analysis in terms of not just tax cuts, but also spending changes, like the impact of, say carbon, on total-factor productivity or the impact of education on individual productivity or how healthcare reform can lead to potential increases in longevity, things like that. And so it's a much more holistic approach in that way. We're not constrained by house rules or anything like that.

JEFFREY HOLLAND: And you sort of brought up dynamic scoring. Could you talk a little bit about how the model sort of incorporates the effects on the macro economy, things like that? What sorts of things are policymakers interested in when they're looking at potential policy options?

KENT SMETTERS: Yes, so typical, say Wall Street models or even models in D.C., they're often very top-down. They look at the macro economy. And they try to work their way down a little bit. We're just the opposite. In many ways, we're like academic

economics in the sense that very bottom-up, but the problem with most academic models is that they don't really scale to answer kind of big, interesting questions in policy. They're more about theoretical insights.

And so what we do is we start with what we call a micro-simulation that often is a few hundred thousand households, maybe even more than that, households that are differentiated by over 60 different attributes. Everything from education, gender, race, marital status, number of kids, infusion of education of the kids and things like that. And that then goes into very descriptive modeling of, say tax policy, Social Security, healthcare. And that also then feeds into a dynamic model that allows us to look at choices made by households and firms on the macro economy and how they affect prices and then in turn affect those choices.

And so that dynamics is really, kind of generally agreed with dynamics, but the problem is that it's often, the rules of scoring often create biases in how those dynamics are modeled. And so what we try to do is really make sure that we're conforming with the vast empirical evidence in our modeling, but really try to make sure that we're capturing dynamics in a very fair way. Often there's big interactions, big ones that we'll see going forward. Social Security reform, big challenges in Social Security. You can't really think about changes in Social Security without thinking about the impact on the economy and the rest of the budget. And so you can't think about healthcare that way either.

In particular, a change in Social Security rules will have an impact on how much people save, how much they work, and that will actually impact the rest of the federal budget as well and the economy. And so you really need to have this holistic, put together that way, and that also does not exist on Capitol Hill right now. These things are much more siloed.

JEFFREY HOLLAND: Great. Let's starting talking about some of our fiscal situation and hopefully we can bring in some examples that the Penn Wharton Budget Model has looked at directly. But just to start out really broadly, are you concerned about the trajectory of federal debt?

KENT SMETTERS: I am. I am. In fact, let me show a few slides here. Hopefully, this works out well here. Knowing that this would come, and you see presumably, something called, a simple screen called Debt. Is that right?

JEFFREY HOLLAND: Yes, we can see it.

KENT SMETTERS: Let's see what's happening, what we're projecting on debt going forward here. And that is, in particular what we're projecting is a very aggressive increase in debt by 2050 under current policy if there's no changes – a debt/GDP ratio of about 190%. And that's not long from now, especially with forward-looking capital

markets. And this is assuming that the Tax Cuts and Jobs Act, all the provisions that sunset in 2025 and so on, some of them have already started to sunset, that they, in fact, do sunset, that there's no extenders here. Because that, in fact, is current policy. We've also done analysis on our website, the Penn Wharton Budget Model, where we talk about the cost of extending the Tax Cuts and Jobs Act. But even without it, we face significant increases in the amount of debt.

And so if you put this into context we're talking about, how would you deal with this? If you were trying to just figure out how do we keep the government, fiscal policy minimally sustainable, what that means is that we're going to raise enough tax revenue so we can make good on all of our spending requirements plus interest on the debt. What's the minimum that would have to be done?

Well, here's a couple of combinations. One is that you could permanently increase immediately and forever all tax revenue, across the entire federal budget. That means all federal income taxes, payroll taxes, everything, excise taxes to the extent they exist, everything, by 40% immediately and forever, or you could cut spending by about 30% immediately and forever, or some combination of those two. And when we say cut spending, that would mean not just some gradual phase-in of cutting spending, that means your grandma who is 80-years-old, she would see a 30% reduction in Social Security and Medicare payments right there. And so we're talking about very sizable

imbalances right now. And it's scary when you look at it. And this is all converging at the same time that we're seeing big macroeconomic changes.

We had this blessing after World War II. We had things like more women entering the workforce. We had a lot of very productive, you know, America and allies won the war, and there's enormous productivity from rebuilding Europe and lots of other things that came after World War II, and it lasted for several decades. But now as Boomers go into retirement, we actually have peak capital right now. That's one of the things that's blessing the U.S. economy right now is that we're actually really flush with capital. But that capital is going to get consumed in retirement so productivity is going to also go down unless there's some big innovations that really change things.

But do keep in mind, and by the way we also have a slowdown in some participation in the workforce and so forth. We can go into a lot of that. But sometimes people say, well, how will inflation help or hurt? I mean this is something that's really misunderstood. For the most part, believe it or not, inflation is not bad for the fiscal picture because it wears down the real value of a lot of existing debt that exists. But at the same time, as long as the tax base continues to grow with inflation, it's not necessarily super harmful for the fiscal side even if interest payments go up, because the tax base has also gone up.

Where it is actually a bit discouraging is that a lot of our tax system is not, in fact,

gauged to inflation so capital gains, for example, is ___ indexed to inflation. So that means that effective capital gains tax, right?, goes up which discourages investment. But even a lot of our spending is automatically tied to growth, so things like Social Security and even Medicare and lots of our big spending are either explicitly or implicitly tied, are already indexed to growth. And so we can't just grow our way out of this either. We need to really have big, big changes.

And one of the things that we've done at the Penn Wharton Budget Model, we use enormous computational resources to solve really intricate models. And one of the things that we've found is that even our past work, from even five years ago, if anything, it underestimated the impact of debt on the macro economy. And sometimes we've, you know, been accused of overestimating the impact of debt on the macro economy. In fact, it's just been the opposite. If anything, these newer computational methods have allowed us, using neural networks, artificial intelligence type methods, to solve really complex, typically would be quantum computing type problems, have shown that, in fact, if anything, we were underestimating the impact of debt on the macro economy. It's even worse than what we expected.

So even just going from 70% to 100% debt/output ratio – we're close to 100% debt/output ratio right now – that's a reduction in GDP of about 5% right there on a level basis. So if we're talking about going from 100% to 190% over time, that's going to have

a sizable impact on our economic growth going forward. And, by the way, sometimes people say, well, suppose you spend the money for good things? Agreed. We can take that into account.

But even if you put this into public goods, all this new debt, and this public good has a much higher return than private capital, even then you would have to have about, almost a 500% basis point, I'm sorry 500 basis point increase in return on public investments relative to the private investment for you just to kind of break even on a small increase in debt. And, of course, that wedge is going to go down as you invest more and more in public capital. So it's not the case that we can just spend wisely or spend our way out of this or grow our way out of this. Real decisions have to be made.

JEFFREY HOLLAND: So that's all pretty daunting. Let's dive into that a little bit more. If you go back a couple of slides, you talked about the skill-adjusted labor force. What adjustments are you making so it's not just...so one issue is that the labor force is just growing more slowly due to lower birthrates and less immigration. So what's the skill adjustment going on here?

KENT SMETTERS: Yes, so the idea is, this gets a little deep in the weeds, but typically a lot of times what you hear, what's called TFP. This is what we call the X in our traditional macro economy. And so this would be like how much more productive per

person in an economy, to be a little bit loose about it, are we getting over time? That's just pure, kind of innovation. And, of course, there are big debates about exogenous versus endogenous growth and so forth. But from a government perspective, one of the things that we care about is not just productivity per person but also how fast the population is growing. Certain programs like Social Security and to a large extent even healthcare are what we call mostly pay as you go. Yes, there is some trust fund there, but it's very small in comparison to the future obligations.

So population growth itself plays a big role, even if productivity per person is not increasing. Of course, both are happening. Hence, the classic $1 + N \times 1 + X$ that macroeconomists see in the first week of graduate macro. And in particular it's the size of the tax base itself that's both a factor of productivity as well as the growth of the population.

What's happening over time is X itself, productivity, well known that that slowed down quite a bit, and big debates on why innovation has slowed down. We don't have to go into that in a lot of detail. But population growth is also slowing down. In fact, without immigration, the United States will actually shrink. We've now joined Europe in terms of not replacing ourselves anymore. And so, immigration, we can come back to that in a little bit, will play a big role going forward. But nonetheless, that is, from a budget accounting perspective, we care about both, and X .

JEFFREY HOLLAND: You also talk about inflation which, of course, has been a topic over the past couple of years. And the CBO has also done calculations where they know that the effect of inflation is largely offsetting, apart from the effect on interest rates. So that, you know, programs like Social Security, which are indexed to inflation will grow faster, but so will revenues which are typically keyed to, say nominal GDP. But interest rates seem to be a big part of that story and they kind of shift that to maybe making GDP worse because the debt is out there and it will eventually accrue higher interest rates. Have you all taken a close look at that?

KENT SMETTERS: Yes, absolutely. So there's really a couple of things. One is that sometimes those who are more budget hawks do make this point. Hey, you know, interest payments on the existing debt are going way up. And to the extent that that is what we call the increase in the nominal rate, in particular most debt in the United States, you know, tracks a nominal interest rate. Very little of it takes the form of I-bonds or TIPS and so forth.

So what happens is you have a couple of effects as the nominal interest rate, because of inflation, is going up. On the one hand, any existing debt becomes worth a little bit less in real value. That's actually good news for the government. But then on an ongoing basis, your increase in debt, that is your deficits, if the tax base is also growing with inflation like you were saying, that's fairly neutral as well. Most spending programs

are fairly neutral.

Here are two things that are not neutral, though. One is that the real interest rate, that is investors and government now say, you know what, I'm a little skittish about this. I don't believe you should just be compensated for the nominal return, the inflation rate. I need some additional risk premium because I just don't know if you're going to really hit those interest rates, that is, those inflation rates going forward. Are you really going to be back to 2% or are you going to try to monetize this debt in the future? So they demand some risk premium. That now contributes to the real borrowing rate that is net of inflation. That is not good news for the government.

Right now the real interest rate has returned to his pre-Covid levels. To the extent that that real interest rate continues to climb, that will actually be quite bad news for the government. And another aspect is again our tax code is not fully indexed to inflation, so things like capital gains. On one hand, people have proposed indexing that to inflation. And yes, that does from a distributional side, it tends to benefit higher income people who have capital gains. But from a macro side, failing to index capital gains to inflation and having higher inflation also means that that capital gains tax becomes more biting since you're being taxed on your nominal return, not your real return after inflation. So as a result of that, that can discourage investment going forward.

And so we have these offsetting effects and right now what we're finding is, you know, inflation is not good for the long term. But nonetheless, it's not quite as scary as some of the folks are saying. Instead, what is scary is that even without this inflation, even if we got back to a 2% inflation rate, I don't believe we're going to be able to hold it for a long time because either the Federal Reserve has to monetize that debt and cause significant inflation or Congress has to take action on the spending side, on the tax side or some combination of both.

JEFFREY HOLLAND: And it looked like you also, on one of your slides it was showing the relationship between growing debt and interest rates in the future. Did I interpret that properly? I think it might be the one after this.

KENT SMETTERS: Oh, yes, in fact both of these. In fact, you know, one of the things that, here's what some folks have said in the past. Well, listen, if you look at the past data, the relationship between interest rates and government debt has been kind of loosey-goosey. It hasn't been that strong. So why aren't you guys at the Penn Wharton Budget Model suggesting what's called the crowd-out effect of private investment?

And let me start with the crowd-out. In particular, households ultimately, who are the savers. We can think about firms, but firms are ultimately conduits for ultimate people who are savers. And households make saving, there's international capital flows as

well, and given that amount of saving initially, if the government is now trying to sell debt and competes with private offering of investment, that means that some of that saving that otherwise would have gone to the private sector now pays for immediate consumption that is being financed through government debt. That crowding-out effect means that private markets are going to get less capital. Interest rates, borrowing rates are also going to increase.

So if you look historically, people have said, but wait a minute, debt has a pretty loose relationship with interest rates. What's this big deal about crowding out and stuff like that? And they're making a big mistake. And here's the big mistake, and we're going to be publishing a lot more on this in the next few months, is that they look at historic data where lots of the debt increase is happening due to things like recessions. And during recessions, there's a flight to capital quality where the supply of debt is going up but the demand for safe debt is also going up at the same time.

Using this big computational framework that otherwise, five years ago would have been quantum computing type stuff but now we have ways of solving this, we're able to rigorously show how the demand for debt and the supply of debt are going up during recessions. And so that's the reason why you don't see this big historic relationship between debt and interest rates. But if what you're doing is a systemic increase in debt alone, that is you're just spending more than what you're taking in, it does have a big

impact on things like interest rates and crowding out of capital.

And so what this model actually shows is that we can easily replicate the past data where it looks like it's a loose relationship between debt and interest rates because of these recession shocks and the model replicates that. It also finds a pretty low correlation, but once you say, okay, now we're just being, you know, have a fiscal policy where we're spending way more on taxes, even without recessions, and that's the path that we're on, that's where you get this really big effect. And it's one reason why existing models, especially Wall Street models and reduced-form models, are way underestimating the impact of debt on the economy. They're just not accounting for the difference between recession-driven and as well systemic changes in debt.

JEFFREY HOLLAND: Yes, and so I think you actually just said this, but it sounds like you're saying that economists are underestimating the effect of the growing debt on future economic growth. Is that correct?

KENT SMETTERS: Yes. And even we've done it in the past where we've underestimated it. And again, we found pretty big effects. And what we're seeing now with our newer version of our modeling, we're finding even bigger effects. It's not reducing the impact. It's actually enhancing the impact.

JEFFREY HOLLAND: So let's talk maybe about some of the elements of this and some approaches to dealing with this rapid growth in borrowing. It seems like, you know, there's a structural imbalance in the U.S. federal budget, the aging of the population and the rapid growth in healthcare costs are rapidly pushing up Social Security retirement costs, Medicare costs. Interest rates are going up and we're not collecting enough tax revenues to deal with the promises that have been made. What are some of the possible approaches to dealing with this rapid increase in borrowing?

KENT SMETTERS: I mean we could break it down by area. Let's talk about healthcare. But before getting there, let me just say neither side of the aisle in D.C. right now are calibrated to the existing baseline problem. And so if you really have, for example, say we're not going to do spending cuts, we're only going to increase taxes on those making \$400,000 or more per year, there's not enough money there. In fact, we've done this hypothetical exercise, we actually did a wealth tax where we confiscated, we basically outlawed being a billionaire. We confiscated immediately all wealth of all billionaires above \$1 billion. So you can go right up to \$1 billion and we'll grab everything else. And let's suppose that we actually assume that the government could sell all that wealth. First of all, if they could actually get it, they could then sell it. It had no impact on market prices, no impact on – whether they're selling all that stock and so forth – on the price of those companies and so forth. So we're clearly overestimating the value of this.

Suppose you did that change, you could fund the federal government for about nine months. So people love to have this, you know, it's all about the rich. Well, yes, there's no question wealth inequality, in fact, there's a couple of slides I skipped here, wealth inequality has increased over time. It's also increased by race over time. Although fiscal policy has often largely offset a lot of that. We don't really have time to go into that in a lot of detail. But nonetheless, there's just not enough money up in the high-income bracket. We already have a very progressive tax system to start with.

In fact, the United States tax system is actually more progressive than, say in Europe, where there's a lot less concern about how taxes are paid and more about how the money is spent because they tend to have value-added tax, very broad-based taxes. And they also spend a lot more money, but they also have a lot more tax revenue. And the only way you can get more tax revenue is to go much more broad-based. And so the commitment to the \$400,000 and above, that's just not going to close the gap. And the commitment on the other side to, hey, no new taxes, we're just going to, you know, shave inefficiencies and we're not going to cut entitlement spending, that's not going to do it either. And so both sides are very uncalibrated right now.

But there are some surprises out there and a couple of those on healthcare, Social Security, immigration. Let's talk a little bit about healthcare. So we have a healthcare integrated model in this dynamic system. We don't have time to talk about it in great

detail, but here's what's kind of the neat takeaway about it.

Typically, if you think about universal care, coverage, covering everyone, well, there's a big problem right now. In the United States we do healthcare through the employer.

That's a historic accident coming from World War II and so forth. But nonetheless, suppose that we just basically said we're going to have universal health coverage, kind of a Medicare for All. We'll still have private signals in terms of some of the pricing and so forth. But nonetheless, we'll go full universal care coverage that way. Believe it or not, you can actually grow the economy that way provided that it's fully financed and it's financed correctly.

So we've done some experiments to show that if you just try to use payroll tax financing to basically expand healthcare, you're actually going to then potentially shrink the economy quite a bit. But there's this opportunity called premium financing, sort of premium support, and that actually has some bipartisan support to it as well. And the idea is that most people will still have to pay a premium for the healthcare like in Europe, in many countries in Europe. So, therefore, if you work a little less, your premium is still the premium. It's not going to scale with the fact that you work less. And only those who absolutely cannot afford to pay their premium, quite low income, then the Medicaid system in this example, would be used to support their premium and pay for their premium, either in part or in full.

And in that case, you have many fewer distortions and you can actually grow the economy because you actually have a healthier population over time and we deal with something called dynamic adverse selection that is, so right now about 10% of the U.S. population does not have health coverage. A lot of those people are actually healthier believe it or not. And they decide not to get coverage because they view themselves as healthier. It's a good deal not to get coverage for them.

And so what happens is that what we're projecting is that that 10%, if there's no change in policy, that coverage will actually go down. That is, the uncovered population will grow from 10 to 15 to 20% over the next couple of decades. And so we do need to deal with that and this excess cost growth that has gone down in the last few years, and things like Medicare we're predicting is not going to sustain over time. So there are some winds there.

In the case of Social Security, some winds there as well. In particular, if we increase the retirement age, it's already projected to go up to 67 over time, if we say go up to 72, if you don't account for macro effects on the economy, on how much you can build up the economy, yes, a lot of people could be worse off. That's what these negative numbers are showing. Here's White, Black, Hispanics, how much money they would essentially lose from this type of policy? But once you allow for the fact that you have macro effects, and the reason why we break it down by White, Black, and Hispanic is because

of the potential impact on different populations based on their longevity. It does vary quite a bit by race even after controlling for income.

And what we find is that for the most part we can get close to almost everybody being better off when you account for the fact that as you slowly increase the retirement age, more and more savers happen. And as you have more saving, you have more capital accumulation and higher wages and lower interest rates. Not everybody is better off, but we get pretty darn close to it.

JEFFREY HOLLAND: That's interesting. If you were crafting a policy around this, I'm just sticking with Social Security as the example, what might you do because it's clear there are some differences between the racial ethnic groups you have here? How might you craft an increase in the retirement age that maybe accounts for some of those?

KENT SMETTERS: You could. It's really hard to have legislation that's explicitly differential by race. What we do see is that, for example, if you don't have macro effects, almost everybody, a lot of the people are worse off with the increase in retirement age, simply because they get fewer benefits over time. And, by the way, we don't have time to go into great detail, it may seem weird to have minus, you know, 10, as an age. These are basically future generations who essentially become adults who enter the economy, oh, I'm sorry, that are born ten years from now. Age zero, people

are just born today, people aged 10 are 10-year-olds today and so forth.

And so these are what, we'll call them variations, how much are they different between this? And how does essentially the monetary value of this policy change? A lot of people are kind of worse off under this, people who are currently retired are almost held harmless. But they're just worse off simply because they're losing benefits if you just look at it in a very micro way. But once you allow for macro, what we see is that even most Blacks and most Hispanics are better off. There are some people who are in this in-between age, age 50. They're going to have a smaller benefit. They're not going to enjoy all the wage increases because the capital hasn't accumulated as quickly.

But one thing we can do there to offset some of that is to, in fact, look at things like maybe tweaking the benefit formula as well to say, you know, maybe the minimum benefit increases and so forth. But even those in the 1% income distribution, those are the lowest income, even Blacks and Hispanics are typically better off under this type of Social Security change even though it's counter-intuitive because Blacks and Hispanics tend to have a lower lifetime age, that is, a higher mortality rate than Whites, but it is true, Whites can potentially benefit a bit more from this because they live longer. Nonetheless, we can still construct policies that make Blacks and Hispanics mostly better off. And those who are maybe a little bit worse off or relatively not as better off as, say some Whites, we can potentially tweak the benefit formula in kind of a non-racial-ish

way to try to close that gap.

JEFFREY HOLLAND: Yes, I guess, so there have been some proposals to devise policies based on the type of job you had or something like that or other sorts of status, not dealing with race directly. But maybe there are certain types of jobs where working longer isn't possible, more manual labor and so on.

KENT SMETTERS: And you do see that in Europe, like labor-intensive jobs and so forth. What you also see, though, is intensive lobbying by groups. There's an incredible lobby, everybody wants to be deemed as a hardworking job so that they can retire early. So that's definitely a tradeoff.

JEFFREY HOLLAND: Yes, you can definitely imagine it getting political quickly. Let me just remind the audience to send in questions if you have them. So you talked about healthcare and Social Security and you talked about revenues as well. What other elements on the revenue side could be addressed? Like what sorts of tax expenditures perhaps, provisions of the tax code could maybe help alleviate some of the gap between spending and revenues?

KENT SMETTERS: Right. One of the things, if you look at our tax code, one of the things is that we have incredible complexity. We have, we have certainly above the line

deductions for things like healthcare, 401K and so forth. But even after all of that, we have the standard deduction, tons of itemized deductions, and then we have all sorts of alternative minimum taxes, preferred rates, and so forth.

A potential experiment, because we know how those historically came in, through lobbying, intense groups, you know, and so forth. Suppose that we just do the following. We get rid of all that stuff and we replace it with something that's really simplified, something that says, you know, suppose that we try to think through and really simplify the tax system. So if we get rid of a lot of the stuff here, basically tax expenditures, that will of course raise a bunch of revenue. But, on the other hand, some of these things help lower-income people as well. Not all of them, but certainly a lot of the child tax credits and a lot of the earned income tax credit focuses on lower income.

So suppose that we get rid of that and we replace it with just a simple tax credit. And this credit could be partly refundable, non-refundable, and so forth. And the real question is could we just have a very simple, get rid of it all essentially. Maybe keep some interest deduction there, maybe keep the charitable deduction there, but get rid of a lot of the other stuff. Could we do that, and if you want to make the new system more generous, you could have a liberal option or conservative options there as well.

And so we have this little simulator, we haven't promoted it on our website, but you can

go onto it and actually play with different combinations. And basically it tries to have some explanation about your input panel and the different options that you can look at. And then what you can see is the tax liability on different households and you can pick your household type. And then what economists call the marginal tax rate. And then what's the distributional impact and then ultimately, so what's the marginal tax rate, what's the distributional impact and what's the total revenue impact as well.

And the bottom line is as follows, is that we could dramatically simplify our tax system because we do so much redistribution through the tax system, but we could dramatically simplify it with what's basically an earned income tax credit-like system that maybe allows for some refundability, where even if you're making low or zero income, you get something still. Like a negative income tax. And you could basically raise the same amount of revenue in total that way. And many households would actually, at the lower income, would still be better off, even though they lose all these other tax preferences with just a much more simplified system. And also improve incentives to work and things like that. So I think there is a big opportunity there.

So right now we're exploring these big bundles of different packages to think about what are the different ways we can hit certain revenue targets but at the same time, that GDP stabilization across a big spectrum of different policies that loosely you can think of those as varying from liberal to conservative and then try to explain how they have

different distributional effects and different impacts on the economy. And are there opportunities for closing some of this imbalance that grows the economy instead of just contracts the economy. Yes, there are. And certainly we could do that with tax simplification. We can do that with some healthcare and Social Security reform. But there's even opportunities in carbon and immigration as well.

JEFFREY HOLLAND: It sounds like simplification could have some real beneficial effects on the macro economy. I saw you had carbon on your next slide. Maybe talk a little bit about carbon taxation.

KENT SMETTERS: Yes, so we've done certainly work on carbon. In the past, we've incorporated the effects of reducing some carbon and productivity, you know, the Inflation Reduction Act. We also have estimated the impact of certain provisions in the Inflation Reduction Act and what are the costs and so forth. What we're currently doing is some ongoing work where we're really trying to model carbon in much more detail because there's a lot of uncertainty about carbon. I think one of the things that we always have to do is ask ourselves, suppose that we're wrong and which direction could we be wrong in? And can we actually model the costs of that?

When it comes to carbon policy, suppose that your null hypothesis is, it sounds like it's a stats person, is carbon doesn't have an impact on temperature or global warming or the

economy and so forth. Now we can reject that with a very high level of precision. But suppose that, you know, you falsely reject that. We call that a Type 1 error. There is a cost to that because you could engage in certain carbon mitigation things that's costly for the economy so there's some costs of having that Type 1 error.

But suppose that you have what we call a Type 2 error that is you've failed to reject when you should have rejected, that cost is way higher. And in particular, if you potentially under-mitigate, it's not like this is a risk that we can trade with other galaxies and other planets and so forth, it is the most non-diversifiable risk that exists. In finance, we learn about non-diversifiable or systemic risk. Lots of risks – earthquake risk, tornado risk – a lot of that can be more globally diversified than it could be 30 years ago. Carbon is like the most non-diversifiable risk possible. It impacts everybody in a big way regardless of where the carbon is produced. The costs of a Type 2 error there is quite big.

And so when we think about optimal tax policy or optimal carbon taxes, we have to incorporate that uncertainty in our, yes, we're using this big, large-scale computational framework that has a lot of detail, and the general belief going into this is in what we see so far is that it's likely the optimal carbon tax, something like a value-added tax on carbon is going to be higher, larger than what some models today are suggesting. And so we really want to get that kind of right.

And keep in mind, you know, why is carbon a problem? It's a problem because essentially I get to pollute on your property and I don't have to pay you. There's no pricing mechanism. What a carbon tax does, it allows the free markets to work again by reintroducing efficient prices. And so it actually gets us back to more free markets and allows the free markets the power, you know, the economy, and create incredible economic growth. And there's no question capital markets have been the biggest force for good and improving human welfare. But capital markets require strong property rights and those break down when I get to pollute on your property without it being priced. And so carbon taxes are a way to reintroduce prices to let the free markets then allocate correctly after that. And also that carbon revenue, tax revenue, can then be used for reducing some of the imbalances that we see fiscally going forward.

JEFFREY HOLLAND: I see Barbara has popped on so I believe that means we're at the end of our time. We didn't talk about the current situation. We spent most of our time talking about the long-term, which is where the real sort of economic concern lies I think. But, Kent, thanks so much for talking to us. Thanks to The Economic Club of New York for having us. We really appreciate it.

PRESIDENT BARBARA VAN ALLEN: Well, thank you both. Kent and Jeffrey, great conversation and a lot to think about. And it's wonderful that this data is all being created there at Wharton. So kudos to you all.

So I want to just mention we have some great speakers coming up for our members that are on the line. And specifically this Thursday, September 21st, we will be hosting the Prime Minister of Japan, Fumio Kishida. And we're excited about that and there are still seats available. The following week, you can see September 27th, we have Brian Moynihan joining us again, the CEO of Bank of America, which is also proving to be a very popular event. That will be followed by Walter Isaacson on the 28th. This is a breakfast and we will be hosting him on his new book, *Elon Musk*, about which much is being written, and that should be a fun event for everyone that can get there. On October 2nd, you can see we have Dr. Richard Haass, who has just recently stepped down at the Council on Foreign Relations, and we'll get to have a conversation with him on his new book. And then you can see in front of you the October calendar. We're lucky enough to be hosting Mary Daly from the San Francisco Fed. We have one of the founders of OpenAI joining us on the 12th followed by the CEO of Intel on the 17th. And then, of course, Jay Powell, the Chair of the Fed, will be joining us on October 19th. So lots to come.

I just want to also mention quickly that next Tuesday, the 26th of September, at 6:00 pm, we have our One Member One Candidate event. And this is a complimentary reception for members who would like to introduce prospective candidates to the Club so that they can learn more about our programming and our membership. So again, that's next Tuesday, the 26th at 6:00 pm. And do again check out our calendar.

And I just also want to mention that we have launched, for the first time ever, a podcast titled, The Forum. The host of our podcast is Becky Quick, who is both a Club Trustee and a CNBC Anchor. I'm sure many of you are familiar with Becky. It launched last week. You can tune in to watch her podcast on Spotify, Apple, and Google Podcasts, Amazon Music, Pandora, iHeart Radio to listen actually to our incredible speakers on a wide range of subjects. So we're very excited about that.

And then finally as we always like to do, we want to recognize those of our 363 members of the Centennial Society joining us today as their contributions continue to provide the financial backbone of support for our Club and our extensive programming. So again, thank you, Kent. Thank you, Jeffrey. And thank you everyone who joined us today. We hope to see you again soon. Thank you.