iret institute for research on the economics of taxation

Economic Report

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DEALING WITH THE DEFICIT: ARE TAX INCREASES THE ANSWER?

The budget resolution's call for substantial tax increases in fiscal years 1984 - 1986 presumably expresses the conviction of the Congress that prospective Federal budget deficits must be reduced and that major revenue increases are necessary to do so. These budget deficits, it is alleged, will have significant harmful effects on the economy, weakening if not aborting the recovery. Last year, it will be recalled, the deficits were asserted to be insuperable barriers to the recovery which is now very sturdily under way. There is no more substance to the deficit-abort than to the deficits-prevent recovery arguments, and one must hope that the Congress will recognize how flimsy the arguments are and turn its back on tax increases which could severely impede the course of economic progress.

The list of crimes of which budget deficits stand accused is by now familiar. Briefly summarized, these deficits allegedly

- preempt the economy's saving, thereby crowding out private capital formation;

- raise interest rates or keep them so high that they prevent recovery in housing and consumer durables and curtail investment in new plant and equipment; and

- by driving up interest rates, act as a magnet for foreign saving, which pushes up the value of the dollar relative to other currencies, thereby weakening U.S. exports and encouraging imports, slowing the recovery of employment and output.

If deficits, per se, did indeed produce these results, there would be some justification for the almost single-minded focus of Congressional fiscal policy on reducing deficits. Even so, it certainly would not follow that raising taxes is as efficient a means of reducing deficits as cutting spending, in terms of mitigating the alleged harmful economic effects of the deficits. The frequently expressed view that it is better to reduce deficits by reducing spending than by raising taxes but that if necessary tax increases are acceptable for this purpose is badly mistaken. Even worse is the aphorism that general taxes cut consumption but deficits cut investment. Views of this sort induce the Congress to adopt budget resolutions which direct the Federal Government into a very bad fiscal policy, indeed.

The by-now conventional views about deficits are mistaken on analytical grounds and have no foundation in facts. The impatience of government policymakers with theory is understandable, but their disregard of facts is inexcus-

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able. The facts are absolutely unrelenting in refuting the charges against deficits listed above. The facts also show that attempting to reduce deficits by raising taxes is counterproductive, will make matters worse, not better.

To begin with, deficits don't crowd out. Deficits are accounting residuals. The Federal Government spends; it collects taxes; it doesn't deficit. Spending does the crowding out by preempting some of the economy's production inputs and some of the economy's output which might otherwise be used for private sector purposes. The extent of the crowding out by a given amount of government spending, moreover, doesn't depend on how the spending is financed.

For example, if the economy produces, say, $3,600 billion of goods and services and government takes, say, $700 billion of that output, there is $2,900 billion left for the private sector, no matter whether the government runs a deficit of, say, $200 billion, zero, or no deficit at all but a surplus. And whether the government runs a deficit, balances the budget, or realizes a surplus doesn't itself determine how the $2,900 billion available to the private sector will be divided up between consumption and investment.

Suppose, for example, that the budget is balanced at the outset, that is, that taxes are $700 billion, the same as the $700 billion of government purchases, and suppose that of the $2,900 billion the private sector uses, $2,400 billion is used for consumption. Then the amount of the economy's gross private saving, by definition equal to total income (i.e., GNP) less consumption and less taxes, is in this case $500 billion, which is the amount used for private capital formation. Gross national saving, by definition equal to gross private saving plus government surplus or minus government deficit, is the same in this case as gross private saving, since the government's budget is in balance.

The first column in the following table summarizes this initial situation.

	(1)	(2)	(3)	(4)
Gross National Product	3,600	3,600	3,600	3,600
Consumption	2,400	2,400	2,350	2,350
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Taxes	700	500	800	700
Gross private saving	500	700	450	550
Deficit	0	200	0	100
Gross national saving	500	500	450	450

Next, suppose that instead of collecting $700 billion in taxes, the government collects only $500 billion, while spending the same $700 billion, resulting in a deficit of $200 billion, as shown in the second column. Unless one assumes that GNP is greater merely because taxes are lower or investment is lower merely because taxes are --- either assumption is obviously absurd --- consumption must be the same as in the first case. Then gross private saving is $200 billion more than in the first case, while gross national saving is the same as in the first case. The deficit, in short, didn't crowd out private investment or private consumption; it didn't change anything in the real economy.

In a third case, suppose that the government buys $800 billion, instead of $700 billion, of goods and services and also collects $800 billion in taxes, again balancing its budget. The fact that the government buys more doesn't itself mean that the economy has more production inputs or uses them more efficiently than when the government buys less. So unless GNP is magically increased, in this case there is only $2,800 billion of output left for the private sector's use. How that $2,800 will be split up between consumption and saving and investment can't be inferred from the fact that the budget is in balance. If the additional government spending were for goods and services to be made available to the public as substitutes for private consumption, one might reasonably infer that most if not all of the cut in output available to the private sector would be reflected in a reduction in private consumption. On the other hand, if the additional taxes are of such a character as to raise the cost of saving and investment relative to consumption, some of the cutback in output available to the private sector will be in the form of reduced capital formation. Column 3 in the table assumes that both of these factors are at work and the cutback is evenly divided between reduced private consumption and reduced capital formation. The result is that both gross private saving and gross national saving fall to $450 billion, even though the budget is in balance. Private spending is crowded out by the increase in government spending, not by a budget deficit, which is zero in this case.

Finally, consider the case in which government spending increase to $800 billion but taxes are not increased. As in the prior case, assume that half of the increase in government spending substitutes for private consumption which declines to $2,350 billion. With taxes remaining at $700 billion, gross private saving is $550 billion; with a deficit of $100 billion, gross national saving is $450 billion; so, too, is investment. Comparing this and the prior case (columns 3 and 4 in the table) with the first two cases, it is clear that it isn't the deficit that crowds out private sector activity; it is, instead, the government spending itself.

The view that deficits crowd out and that raising taxes to reduce the deficit leaves more saving available to finance capital formation fails to account for the relationship between taxes and gross private saving. As noted, gross private saving, which finances government deficits and capital formation, is by definition the difference between GNP, on the one hand, and consumption and taxes on the other. Raise taxes and you lower gross private saving, at least dollar-for-dollar. For every dollar of reduction in the deficit, there is at least a dollar less saving. There is no more available for capital formation.

In fact, there is likely to be less. No tax increase which might be enacted will have the effect of making consumption relatively more costly than saving and capital formation; many of the tax increases are likely to raise the cost of saving and investment relative to consumption. The result, then, is likely to be a greater reduction in gross private saving than the increase in taxes, and an increase in consumption. The tax increase, not the deficit, will crowd out saving and capital formation.

The historical evidence shows that raising taxes reduces, not increases, saving and by more than the tax increases. The income tax surcharge enacted in 1968 is a case in point. Consumption as a fraction of GNP rose during the surcharge years; gross private saving as a fraction of GNP fell during those years. Had the saving rates remained at the 1967 level in 1968 - 1970, gross private saving would have aggregated $47.6 billion more than the actual amount of saving in those years. The roughly $23 billion in additional tax revenues produced by the income tax surcharge cost more than twice that amount in lost saving. The tax increase didn't relieve crowding out; it aggravated it.

Even if one asumes that the drop in saving is no more than the increase in taxes, it is clear that raising taxes to reduce the deficit doesn't relieve crowding out. Government spending which preempts the economy's production capability and its output and taxes which inhibit private saving are the fiscal culprits.

The facts are just as intractable in refusing to support the notion that Federal budget deficits raise interest rates or keep them high. Historically, Federal budget deficits as often as not have been associated with falling, not rising, interest rates. One need not delve into the remote past to find the evidence that there is no reliable positive relationship between deficits and interest rates. Last year, interest rates dropped precipitously as the deficit soared and as the projected deficits broke through the $100 billion level and skyrocketed up to $200 billion or more. This year, as the projected deficits have come down with the more optimistic projections of economic recovery, interest rates have been rising. The facts keep insisting that there is little, if any, connection between deficits and interest rates, but this evidence, before everyone's eyes, doesn't seem to deter asserting that future deficits raise interest rates.

The historical record is just as intractable in failing to provide any solid negative association between the level of Federal deficits and the amount of fixed investment. One does find that investment tends to decline when deficits rise. But it is only the most naive sort of reasoning that attributes the ups and downs in investment to the downs and ups, let alone the levels, of the Federal deficit. The correct explanation is that rises in the deficits have been primarily the result of recessions that are associated with downturns in capital formation. In 1975, for example, the Federal deficit rose to a then record high and gross private domestic investment fell along with real GNP. The next year, the deficit remained very high — but investment boomed. The same thing happened in 1981: capital formation increased strongly in the face of the then third highest deficit in our history.

Nor will the facts support the argument that U.S. Federal deficits are leeching out the saving of the rest of the world. To be sure, there has been an impressive net capital inflow from abroad, for many years past. But these capital inflows show no relationship, in either amount or direction of change, with the amount or direction of change in Federal deficits. Recent history lends emphasis to this fact. In 1982, as the Federal deficit increased quarter by quarter, net capital inflows decreased.

If the fear of deficits continues to dominate Congressional thinking about fiscal policy, one must hope that the focus will shift from raising tax to reducing spending. Only by cutting back the growth in spending can the Federal Government reduce the pubic sector's preemption of the economy's production capacity and allow more resources to be devoted to meeting demands for additional capital as well as for additional consumption goods and services.

Raising taxes to reduce deficits will fail to reduce crowding out, as shown above, and cannot help but impede economic recovery. Virtually all taxes reduce the real reward for providing labor or capital services. For this reason, virtually all taxes increase the costs of production. How raising taxes, thereby raising the cost of production, can possibly promote recovery defies reason and common sense. The very meaning of recovery is to increase output, hence the use of production inputs, and the income generated in production activity. Raising the cost of production inputs by raising taxes burdens recovery rather than fosters it.

If an aesthetic or ethical preference for balanced budgets is to determine the course of fiscal policy and if the budget balance cannot be achieved by spending constraint, at the very least the decision to raise taxes should be deferred until recovery is fully achieved or its full achievement is assured. At such time, a far better perspective than is provided by the present projections of the future level and path of GNP, budget outlays, and tax revenues under existing provisions will be available. How much additional taxes will be called for to achieve the desired fiscal results will be more clearly determinable than at present.

Any such tax increases, moreover, should be carefully and deliberately designed to minimize their adverse effects on incentives for work, for saving, for enterpreneurship, and for other growth-generating activities. The sort of grab-bag approach to tax increases, guided by considerations of extracting the most revenue from the politically most unpopular, hence most vulnerable, groups of taxpayers, which characterized last year's tax legislation, should be avoided at all costs. There is nothing to commend specific tax-raising measures merely because their estimated revenue gains add up to the amount of additional revenue arbitrarily specified in the budget resolution.

In this context, neither the President's contingency tax measures, called for in the budget, nor the freeze approach should be seen as acceptable. The specific tax increases proposed by the Pesident would be poorly advised, indeed, for any purpose other than to slow the Nation's economic progress. Income tax surcharges are properly identified as special excises on saving and

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capital formation; excise taxes on oil must be expected to raise energy costs as a production input for virtually every business in the country. Bad as these tax increases would be for the economy, making them contingent upon the realization of specified conditions over which no taxpayer has any control maximizes the tax uncertainty which every taxpayer must face. Economic recovery requires growing confidence about future rewards for today's saving and capital formation, not the uncertainty which a contingency tax plan imposes.

The proposal to cancel or to defer the applicability of those provisions enacted in the Economic Recovery Tax Act of 1981 which are scheduled to take effect in 1984 and subsequent years is very much at odds with the requirement for a careful, deliberate approach to revenue raising, geared to minimizing adverse economic effects. If this proposal were enacted, indexing of individual income tax brackets, of the zero bracket amount, and of the personal exemption would not take effect beginning with the taxable year 1985, as now scheduled. The indexing provision included in ETA is one of the most constructive advances in tax policy made since the inception of the income tax. It is based on a solid political principle that requires the Congress to expose itself to the judgment of the voters when it seeks additional revenues from higher tax rates, rather than being able to hide behind a facade of tax inertia while inflation escalates applicable marginal tax rates. There is nothing to be said on behalf of repealing indexing. If there were no other reason for opposing the freeze, its elimination of indexing would provide ample grounds for doing so.

The estate and gift tax provisions in ERTA were another of the major advances in tax policy afforded by that legislation. ERTA provided a schedule for increases in the unified estate and gift tax credit to take account of the effects of inflation in exposing even very small transfers to the unified tax.

The imposition of the freeze would abort the scheduled increases in the credit, leaving transfers of very modest size subject to estate and gift tax. Similarly, the freeze would halt the reduction in unified estate and gift tax rates to a top rate of 50 percent. In both respects, the freeze would represent a major step backward in efforts to reduce the tax bias against saving and the adverse effects of these transfer taxes on the efficient use and disposition of property.

ERTA included a provision for progressively increasing the exclusion from tax of income earned abroad. The importance of this provision in support of U.S. business efforts to compete with businesses of other nationalities in foreign markets was extensively documented prior to the 1981 legislation. This support is as desirable today as when it was enacted. Its elimination via the freeze route would hardly represent constructive tax policy.

The several other provisions which would be prevented from taking effect by a freeze proposal also deserve far more careful consideration than the freeze proposal would afford. Such consideration conceivably might lead to the conclusion that one or more of these provisions should be modified or repealed in the interest of affording a tax law which is more conducive to efficient

use of the economy's resources and less of a tax barrier to growth-generating activities. This kind of decision-making, however, would be a far cry from the elimination of those provisions merely because they had not yet become effective.

A careful, deliberate approach to tax policy formulation is difficult to attain when the tax writing committees of the House and the Senate are required to respond to revenue directives which come from the present Congressional budget process. Somehow or other, the members of the House and Senate budget committees must be made much more acutely aware than they seem to be that taxes can't be levied or paid in the abstract, that raising revenue totals mean changes in the amounts of taxes one or another group of taxpayers must bear, and that any and all such tax increases must require adjustments, often painful ones, in what taxpayers do. The revenue decisions involved in the Congressional budget procedures should not be seen as focusing solely or even primarily on broad fiscal policy considerations; they must be seen, instead, as implying changes in the tax structure which may have very grave consequences for the effective performance and growth of the economy. Such changes should not be regarded as side effects, of secondary importance, of the budget process. One way or another, these fundamental concerns of tax policy must be given far higher priority than they now enjoy in setting overall budget policy and programs.

Dr. Norman B. Ture
Chairman of the Board
IRET
August 15, 1983

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In fact, there is likely to be less. No tax increase which might be enacted will have the effect of making consumption relatively more costly than saving and capital formation; many of the tax increases are likely to raise the cost of saving and investment relative to consumption. The result, then, is likely to be a greater reduction in gross private saving than the increase in taxes, and an increase in consumption. The tax increase, not the deficit, will crowd out saving and capital formation.

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