IRET Congressional Advisory

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THE TROUBLE WITH TRIGGERS

Defn.: **Trigger**. Proper noun: Roy Roger's horse, now stuffed.
Defn.: **trigger**. Improper tax policy: making rate cuts conditional on future surpluses. Treat as above.

Some Members of Congress want to impose a "trigger" on President Bush's proposed across the board cuts in marginal tax rates. Under a trigger, the various installments of the rate cuts would only go into effect if projected budget surpluses arise as forecast. A trigger would make the tax rate cuts less effective in strengthening the economy and could lead to the bad budget outcome its advocates claim to fear.

> ***This trigger, tied to the budget surplus, would let Congress block the tax cut just by spending too much... [W]hy haven't they proposed a trigger on federal spending instead of tax cuts?***

There you go again.

In the fall and winter of 1982-83, Budget Director David Stockman and "moderate" Senate Republicans tried to push President Reagan into a budget deal that would have made the pending 3rd year of his 3-year 1981 tax cut "conditional" on the deficit's coming down. They argued that the deficit would be a drag on the economy, and had to be cut.

They came up with a bizarre trigger formula, which went something like this. If the economy was strong (3%-plus growth) with a declining deficit, the 3rd stage of the tax cut would take effect. If the economy was strong, but the deficit was rising, the 3rd stage would not take effect. If the economy was only growing 1 to 3 percent, the 3rd stage would not take effect regardless of a declining deficit. If the economy was growing less than 1%, or was in recession, the tax cut would take effect to fight the slowdown. (Wait a minute, wasn't their twisted premise that deficits lowered growth?)

I was Deputy Assistant Secretary for Economic Policy at the Treasury at that time. As a joke, I tree-diagrammed this asinine proposal for Treasury Secretary Don Regan. I assigned probabilities to these four outcomes of .3, .3, .2, and .199999, with an additional branch of probability .000001 that an asteroid would collide with Earth and make the other branches moot. The Secretary took the diagram to a cabinet meeting! I went into shock. The President said "keister", and by the time his opponents had finished looking that up in the dictionary, the 3rd stage of the tax cut took effect and the economy boomed.

In 1999, Stockman's intellectual heirs forced Ways and Means Chairman Archer and Speaker Hastert to accept a "trigger" on that year's abortive effort to cut tax rates across the board. That trigger would have been tied to declining interest payments on the public debt, effectively handing control of the tax cut over to the Federal Reserve.

Institute for Research on the Economics of Taxation

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An invitation to over-spend.

This trigger, tied to the budget surplus, would let Congress block the tax cut just by spending too much. There would not even be an explicit vote to hold the Members accountable. If the surplus is the issue, rather than the urge to splurge, why haven't they proposed a trigger on federal spending instead of tax cuts?

The debt will be paid off anyway.

Some tax cut opponents fret that the tax cuts are too big. They boost the original $1.6 trillion revenue tab for the Bush plan by $500 billion if the tax cut is made retroactive to January 1, 2001, expiring AMT offsets are renewed, and the full tax cut is given to people who would otherwise be thrown into the AMT by lower ordinary tax rates. They add another $500 billion for interest if the debt is drawn down more slowly. The total, they claim, could reach $2.6 trillion over ten years, and leave little money "on-budget" to retire the federal debt.

There are three problems with this fear. First, new CBO budget projections are for $3.1 trillion in on-budget surpluses over ten years. Even with the tax cut, there would still be an on-budget surplus. Second, "off-budget" Social Security surpluses will total $2.5 trillion. Even with the tax cut, publicly held debt and interest payments to the public would be gone in ten years.

Making the tax cut uncertain would reduce its effectiveness at promoting growth... [W]hat are employers to think if a tax bill says "We might lower taxes for the next five years, or maybe not?"

The "neigh-sayers" contend that lowering the debt is the best way to increase saving and investment. They are wrong... Plain old horse sense tells us that we need the proposed rate cuts to reinvigorate the economy, no ifs, ands, buts, or triggers.

Third, the estimated cost of the tax rate cut is "static", not counting the added economic growth the rate cuts would make possible. The stronger economy would return about a third of the projected revenue loss to the Treasury. That puts the cost of the rate cuts far below the projected on-budget surplus, even adjusting for interest expense.

The trigger makes the tax cut cost more!

Making the tax cut uncertain will reduce its effectiveness at promoting growth. If people can count on the tax cuts, they will produce more in anticipation. If people doubt the cuts will occur, growth will be delayed. The revenue reflows will be less, creating the very problem that the trigger-happy tax cut opponents are afraid of.

Every year we <u>don't</u> have a tax cut, productivity gains and real wage hikes actually raise tax rates on workers and cost some jobs that would otherwise occur (because tax indexing only offsets the inflationary component of tax bracket creep, not the kind due to real wage growth). If, instead, employers know that the tax burden on workers will be dropping over time, and after-tax wages will be rising, they will expect wage demands to remain moderate. They will be more likely to hire people, today, on that assurance, than if taxes are not going to be cut.

But what are employers to think if a tax bill says "We might lower taxes for the next five years, or maybe not?" They'll hold off on the hiring until they see the green of the tax cuts. Similarly, savers and small business owners will wonder what tax rates they will pay on future interest and business income, and will cut their saving and investment accordingly.

A faulty world-view.

Why pay off the debt anyway? There are better things to do with the money (like fundamental tax reform or privatizing Social Security).

The "neigh-sayers" contend that lowering the debt faster is the best way to increase saving and investment. They are wrong. Small differences in the repayment schedule would have no effect on world interest rates, but the higher taxes would come straight out of private saving and investment. Cutting taxes on capital, at the margin, increases saving and investment more than would debt reduction. Cutting taxes on labor, at the margin, is also pro-growth because people work more for higher after-tax wages. Not all tax cuts spur enterprise, but the non-incentive parts of the President's tax plan are fairly small.

Letting the economy slump is an effective way to make the surpluses vanish. If Congress wants to make sure that surpluses continue and the debt is paid off, it should rein in federal spending and cut tax rates. Plain old horse sense tells us that we need the proposed tax rate cuts to reinvigorate the economy, no ifs, ands, buts, or triggers.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.