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CUT TAXES, AND DEBT REDUCTION WILL FOLLOW

The economic expansion of the last 16 years, interrupted only by the brief and shallow 1990-91 recession, has generated a groundswell of income tax revenues. Combined with modest spending restraint, the revenue surge will propel the federal budget into surplus in 1998, according to the Administration, the Congressional Budget Office (CBO), and most private forecasters.¹ In March, the CBO predicted an \$8 billion surplus under current policies in 1998, and surpluses totalling almost \$680 billion through 2008.² In April, the CBO said the 1998 surplus might be \$8 billion to \$18 billion;³ in early May, CBO raised its estimate again to a range of \$43 billion to \$63 billion.⁴ The Administration had estimated in February that the federal budget would show a \$10 billion deficit in 1998, but in May it revised the estimate to a \$39 billion surplus.⁵ Many private forecasters see a 1998 surplus in the \$50-\$70 billion range.⁶

These emerging federal budget surpluses (if not forestalled by a recession) could be used to reduce the federal debt, cut taxes, or raise government spending. What mix of options to choose is being debated in Washington.

Economic analysis strongly urges that the government should reinvest a large part of the projected budget surpluses in growth-enhancing forms of tax reduction, for three reasons. First, sensible tax relief could increase the rate and duration of the economic expansion, sustaining the good outlook for revenues and the federal budget; without tax relief, the economic expansion will slow.⁷ Second, appropriate tax reductions and reforms could boost people's incomes by encouraging saving and investment, raising productivity and real wages, and encouraging additional work and employment. Third, tax reductions can achieve this added growth and income more surely than debt reduction, and far more certainly than increased government spending.

Unfortunately, there has been little focus on the economic consequences of the choice of options. Instead, politics and cosmetic budget issues seem to be taking the lead.

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One from Column A, one from column B, lots from column C. Some have suggested that arbitrary portions of the projected surpluses be reserved for debt

reduction and tax relief. For example, in 1997, Rep. Mark Neumann (R-WI) introduced legislation that he claimed would direct one-third of the surpluses to tax cuts and two-thirds to debt repayment.⁸

In fact, all of the supposed debt reduction in the Neumann plan consists of "repaying" various government trust funds, a technically meaningless gesture unless he intends to increase actual outlays for the trust funds' underlying programs.⁹ The plan's comments about the Highway Trust Fund and Superfund imply increased spending.¹⁰ The pork-laden highway bill that has just passed the Congress shows Congress's eagerness to spend the surpluses.

Tax relief can boost growth and incomes. Properly designed tax reform could reduce the current tax bias against private saving and investment, boosting both, and could encourage work and employment through lower marginal tax rates and increased productivity and real wages. Ideally, budget surpluses would be used to allow for net tax reduction to facilitate fundamental tax restructuring.

Net tax reduction is essential to build political support for the enactment of fundamental tax reform. Tax reform that is revenue neutral would create winners and losers. In particular, reducing excessive layers of tax on saving and investment would necessitate boosting effective tax rates on labor income. With net tax relief, everyone could win.

Taxes slow the economy because they distort and erode production incentives. Reducing the anti-production biases in the tax system would allow the economy to operate closer to its potential. For instance, because payroll and income taxes diminish the reward for working, some people, especially second earners in households, work less, and the smaller labor supply reduces the economy's output. Many taxes, including the individual income tax, the corporate income tax, and the estate and gift tax, penalize people for saving rather than consuming. People respond to these tax penalties by saving and investing less. The result is a smaller, less technologically advanced stock of capital and a less productive economy.

The magnitude of a tax cut's pro-growth effects will depend on the specifics of the tax change. For most people, a larger personal exemption would not increase their incentive to work because it would not lower their marginal tax rate. (When a person is deciding whether to change his or her behavior for tax reasons, it is the tax rate at the margin that matters.) On the other hand, a reduction in marginal income tax rates, a substantial widening of individual income tax brackets, or a cut in the

payroll tax rate would expand work incentives at the margin for much of the work force. Expanded individual retirement accounts, prompter write-offs for capital expenditures, abolition of the estate and gift tax, and lower individual and corporate income tax rates are changes that would help alleviate tax biases against saving and investment.

Budget surpluses don't spur growth. It is often said that budget surpluses add to national saving and thereby boost investment, growth, and future revenues. This is only true, however, if the taxes that finance the surpluses do not themselves discourage private saving and investment. For instance, an extra \$1 billion of tax revenue (with government spending held constant) will add \$1 billion to national saving if it does not reduce private saving. If the tax falls primarily on returns to saving, however, and depresses private

saving by, say, \$1.5 billion, the tax will actually lower national saving by \$0.5 billion. Capital investment will fall by a like amount unless foreign saving steps into the breach.¹¹

The common assumption that taxes have little impact on private saving and investment is false. Because many taxes harshly discriminate against saving and investment, reducing the offending tax rate in a manner that would be scored as a dollar of tax relief can easily trigger more than a dollar of private saving and investment.

Simply increasing national saving does not necessarily boost domestic investment, productivity, and employment. The added saving may simply displace foreign ownership of existing U.S.-sited capital, or be invested abroad. To ensure additional domestic investment, the saving increase must be accompanied by tax reductions that make domestic investment more attractive, such as faster cost recovery for spending on plant, equipment, and structures, or reduced double-taxation of corporate income.

[T]ax reductions can achieve this added growth and income more surely than debt reduction, and far more certainly than increased government spending.

A smaller national debt means the federal government will have lower net interest costs in future years. It might seem less costly in the long run for the government to run surpluses and retire debt than to leave the debt outstanding and continue paying interest on it. In undiscounted dollars, this is true. But in present value terms, it need not be. If the government's borrowing cost is used as the discount rate, the present value of the debt is identical to the present value of future debt service if the debt is not retired. In short, it costs a dollar to save a dollar, in present value. The government and the country would be better off if the money were used for private investment. In fact, if a tax reduction is enacted that strongly improves investment incentives and if the return on private sector investment is sufficiently above the interest rate on government debt, the tax reduction may actually boost future federal revenue. Leaving the money with investors will then result in a greater reduction in future deficits (or larger future surpluses) than reducing the present debt.¹²

Government spending does not spur growth. According to Keynesian pump-priming economics, additional government spending can promote growth. In recent decades, however, it has become apparent that government spending uses resources that would otherwise be available to the private sector, and is a substitute for, not an addition to, private activity. Government spending on infrastructure fails the growth test if, as is frequently the case, its returns are less than that of a comparable amount of private investment. Government-provided services are often of less value, at the margin, than goods and services that consumers would choose to buy for themselves. Government tax/transfer programs create perverse work and saving incentives. Hence, added government spending would tend to subtract from, not add to, economic capacity and output.

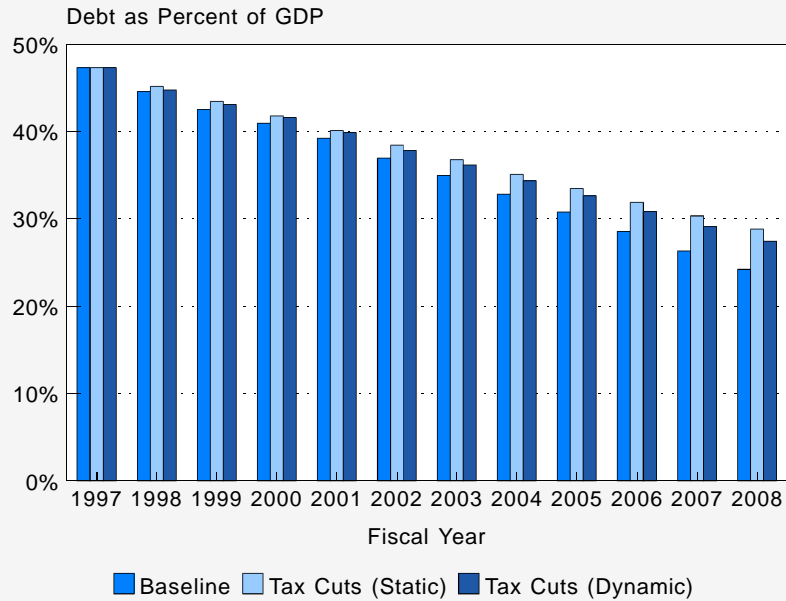
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The Debt: How Big, Where, Why, and So What? At the end of fiscal 1997, federal debt held by the public (including the Federal Reserve System) totalled \$3,771 billion, or about \$14,100 per capita¹³.

Additional Federal debt (mostly non-marketable "special issues") totalling \$1,599 billion, was held by the Social Security Trust Funds, the Federal Highway Trust Fund, the Airport Trust Fund, etc. The non-marketable debt held by federal agencies has no independent effect on financial markets or the public. Such debt is only a reflection of the taxes collected and credited to the trust funds but used for other purposes, thereby avoiding other taxes or direct borrowing from the credit markets to fund ongoing federal spending. It has further import for the economy only if it is ever "redeemed" with future general revenues from new taxing or borrowing to be spent on program outlays.

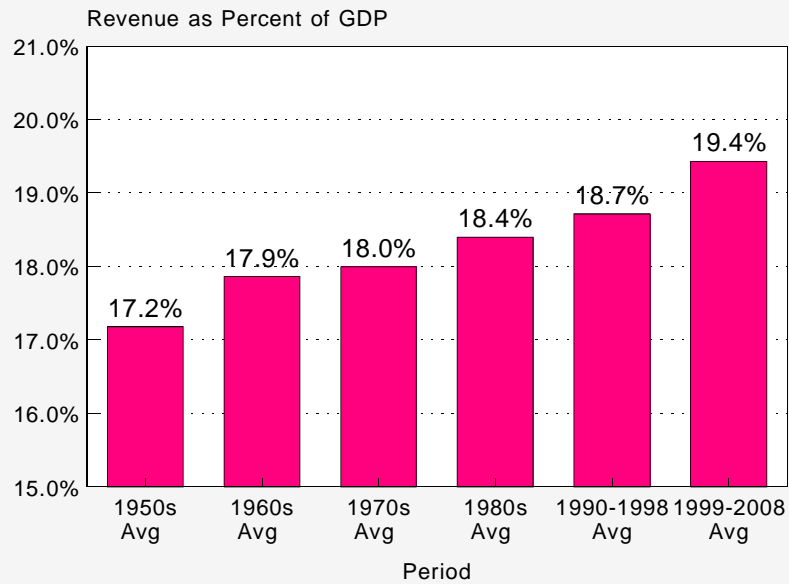
Federal debt is falling compared to GDP and in inflation-adjusted dollars. Examining the federal debt in relation to the nation's economic output and income gives a better picture of the nation's ability to handle the federal debt than simply looking at the debt in dollar terms. The debt will decline rapidly as a share of GDP when the budget is in balance, let alone when it is in surplus. In fact, the debt ratio will fall whenever the annual deficit is small enough that the debt grows more slowly than the combined rates of inflation and real growth. The CBO's March estimate, together with its May revision for 1998 and 1999, was that under current policies the public debt will fall from 47.3% of GDP in 1997 to about 24% of GDP in 2008. This is shown in Chart 1. The CBO has not yet provided re-estimates for the years 2000-2008, but it admitted in its May 5 letter that the projected budget surpluses for those years also need to be revised upward.

Chart 1 Ratio of National Debt to GDP



Sources: Congressional Budget Office and author's calculations.

Chart 2 Federal Revenue As Share Of GDP



Sources: Congressional Budget Office and Office of Management and Budget.

Larger surpluses—which most forecasters are now predicting—would produce an even more rapid decline in the debt both in dollars and relative to the size of the economy.

If one wants to examine the debt in dollar terms, it is best to adjust the dollars for inflation. That way, debt can be measured over time in units of consistent purchasing power. In inflation-adjusted dollars, the debt is declining absolutely. Under the CBO's March baseline and May partial revision, the debt will shrink by almost 35% in real dollars between 1997 and 2008.¹⁴ Based on the larger surpluses foreseen in most private forecasts, this actually understates the shrinkage in the national debt. In fact, the real debt will decline whenever the annual deficit is small enough that the debt grows by less than the rate of inflation.

Federal debt will continue falling as a percent of GDP if surpluses are converted into tax relief.

If taxes are reduced by the amount of the surplus so that the budget is just balanced, the debt reduction as a percent of GDP will still be steep. Suppose for a moment that tax relief has no effect on economic growth (an unrealistic, static assumption). Taking the CBO's numbers but assuming all the surpluses are converted into tax cuts, the national debt would drop to under 29% of GDP by 2008, as shown on Chart 1.¹⁵ Although not quite so large a decline as from 47.3% of GDP to about 24%, it is a major drop. Similarly, tax relief is compatible with a reduction in real federal debt; if surpluses are converted into lower taxes, real debt would fall about 22% from 1997 to 2008. The larger surpluses that now appear likely would not change this finding, but they would provide room for more tax relief while still keeping the federal budget in balance.

History shows that the debt-GDP ratio can fall sharply without substantial budget surpluses. By 1946, the massive borrowing to pay for World War II had pushed federal debt to a peak of 108.5%

of GDP.¹⁶ By 1974, the ratio had dipped to a post-war low of 23.9%. During this period, the federal budget was in surplus 8 times (the last in 1969) and in deficit 16 times.¹⁷ The surpluses totalled \$33 billion; the deficits, \$107 billion. Despite the net deficits, federal debt grew more slowly than the economy, which rose over six fold in nominal dollars during the period¹⁸, and the debt-GDP ratio plunged.

Taxes are high as a share of economic output and in inflation-adjusted dollars. While the national debt is moving downward both in inflation-adjusted dollars and relative to the size of the economy, taxes are taking a record share of people's incomes. In

1997, federal revenues reached 19.8% of GDP and this year they may be as high as 20.4%.¹⁹ Federal revenues as a share of GDP have not been so great since World War II.²⁰ The average revenue-GDP ratio in the 1970s and 1980s, 18.2%, was about

2 percentage points lower than the 1998 ratio. As shown on Chart 2, federal revenues have been climbing decade by decade as a share of GDP. The last bar on the chart is the CBO's baseline revenue projection (including its May re-estimates for this year and next year) for 1999-2008. Although revenues as a share of GDP would be below the 1997 and 1998 ratios, they would be higher than in all previous decades. Most private forecasts suggest that revenues as a share of GDP will be even larger over the period 1999-2008 than the CBO's already high projection, unless there is tax relief.

Looking at federal taxes in terms of inflation-adjusted dollars, the climb in taxes is even sharper. Real federal revenues doubled from 1970 to 1997; they ascended 25% just from 1990 to 1997.²¹ According to the CBO's baseline, federal revenues in real dollars will increase another 24% from 1997 to 2008. If all projected surpluses are converted into tax reductions, real federal revenues will still expand 19% from 1997 to 2008.

The debt will decline rapidly as a share of GDP when the budget is in balance, let alone when it is in surplus.

Dynamic revenue estimates show that tax relief has a smaller revenue cost and larger economic benefits than appear using static estimates. The revenue and debt pictures are even brighter if one takes into account the beneficial effect of appropriate tax reduction on the economy. If future surpluses are converted into tax relief and if the tax cuts take aim at anti-production tax biases, the tax relief would increase GDP. Because tax collections are sensitive to the size of the economy, the stronger economy would have a positive feedback on tax collections.

As an illustration, suppose a dollar of tax relief were to sufficiently ease anti-production tax biases that real GDP rose by a dollar.²² Also suppose that each extra dollar of real GDP would boost tax collections by \$0.25, assuming, conservatively, a marginal federal tax rate on additional real output of 25%. The \$1 of tax relief would cost the federal Treasury only \$0.75 of forgone revenue after the positive tax feedback, one-fourth less than in the static case. Further, citizens would receive a bonus: their production would increase by \$1, and they would keep \$0.75 of the additional income and output. Their after-tax incomes would rise by \$1.75.

In the static case, if federal surpluses were converted into tax relief, federal debt as a share of GDP would still fall, declining to less than 29% by 2008. If the same tax cuts assumed in the static case are applied in this illustrative dynamic case, the debt-GDP ratio would drop to 27.5% by 2008.²³ (See Chart 1.) The debt in real dollars would decrease over 25% from 1997 to 2008 in the illustrative dynamic case, compared to 22% in the static case. More important than the change in the federal debt, though, the tax relief would increase people's incomes by hundreds of billions of dollars over the next decade.

The political choice may not be greater debt reduction vs. tax relief but higher government spending and larger government vs. tax relief. Some would argue that it might be prudent to wait and let budget surpluses accumulate for a few years before easing taxes. This option is not viable, though, if expected surpluses that are not converted into tax relief quickly find their way into increased federal spending.

The President's budget proposal, for example, asserts that taxes, in aggregate, should not be cut, supposedly to protect the surplus. What the Administration's plan would actually do, however, is raise both taxes and spending. The CBO estimates that just over the period 1999-2003, the President's budget would boost taxes by \$80 billion, lift government spending by \$118 billion, and leave the budget in surplus (but by approximately \$40 billion less than otherwise).²⁴ Arguing that the federal debt should take precedence over tax relief, in other words, may be used as a handy cover for tax-and-spend budgeting.

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Focusing on the debt may actually boost government spending by directing attention to the wrong numbers. The federal budget deficit (or surplus) is only the arithmetic difference between federal revenues and federal spending. Revenues and spending are the real issues. The budget can be balanced or in surplus when taxes and spending are both low; it can also be balanced or in surplus when both are very high. The government absorbs fewer resources, and the economy is better off, the lower the level of federal spending. The level of the deficit is of secondary importance. For example, the private sector would be larger if government spending were 19 percent of GDP and revenues were 18 percent of GDP than if the budget were balanced at 22 percent of GDP.

Conclusion. The best use for projected budget surpluses is to reduce tax biases against saving, investment, and work, not paying down the national debt. The surpluses should be directed toward fundamental tax reform and/or replacement of Social Security by private retirement saving. Appropriate tax reduction would generate more saving, investment, employment, and income growth than could be achieved by debt reduction. Merely balancing the budget would be sufficient to cause

the national debt to fall rapidly in real value and as a share of GDP. The added economic growth generated by appropriate tax reduction would accelerate the reduction in the debt burden. Above all, the projected surpluses should not be frittered away on wasteful government spending.

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Endnotes

1. All numbers are for fiscal years, unless indicated otherwise.
2. Congressional Budget Office, *An Analysis Of The President's Budgetary Proposals For Fiscal Year 1999* (Washington, DC: Government Printing Office, March 1998).
3. See "Washington Wire: Lawmakers Salivate At The Prospect Of An Even Bigger Budget Surplus," *Wall Street Journal*, April 10, 1998, p. A1; and Bud Newman "CBO Decides Not To Revise Upward Earlier Budget Surplus Projections," *Daily Tax Report*, April 27, 1998, p. G-1.
4. Letter from CBO Director June E. O'Neill to Representative John R. Kasich, May 5, 1998.
5. See Office of Management and Budget, "Mid-Session Review of Fiscal Year 1999 Budget," reprinted in *Daily Tax Report*, May 27, 1998, p. L-1 to L-28. The Administration's mid-session review also projects cumulative surpluses of \$1.8 trillion over the period 1998-2008. These estimates incorporate the Administration's budget proposals, as the Administration scores them. The budget effect of the Administration's proposals is very small for fiscal year 1998, but would add about \$140 billion to the surplus over the period 1999-2008, due to approximately \$180 billion of tax increases and \$40 billion of spending increases. (Net of the policy changes, the Administration estimates the baseline surplus would be between \$1.6 trillion and \$1.7 trillion. The Administration's figures for the budget surplus under its policy proposals are based on the Administration's own estimates of the budget effects of its proposals.)
6. See "Washington Wire," *op. cit.*; John M. Barry, "Tax Revenues Glut Coffers At Treasury," *The Washington Post*, May 2, 1998, p. E2; and Eric Pianin, "Gingrich Wants To Tap Surpluses For Tax Cuts," *The Washington Post*, May 9, 1998, p. A1.
7. Recent growth owes much to the decline of inflation from 5.4% in 1990 to less than 2% today, which has acted as a huge tax reduction on investment by preserving the value of unindexed depreciation write-offs. The result has been a lower cost of capital, which has made it profitable to increase the stock of capital by several hundred billion dollars to a new, higher equilibrium level. The resulting investment boom will eventually run its course, however, resulting in slower growth unless the tax burden on capital is further reduced.
8. The National Debt Repayment Act Of 1997, H.R. 2191.
9. Neumann would exchange the non-marketable government securities now in the funds for marketable government securities. That exchange has no practical effect if the new marketable securities are not marketed, that is, if they are kept in the trust funds like the current non-marketable securities have been. The exchange matters only if the securities (which represent the trust funds' previously accumulated surpluses) are made marketable in order to be sold off to finance added

spending in excess of current revenues. For example, some of the marketable securities might be sold in order to spend more on highways than is being taken in currently by the gasoline tax.

10. See Office of Representative Mark Neumann, Fact Sheet describing The National Debt Repayment Act Of 1997, dated June 11, 1997. The fact sheet says of the Highway Trust Fund, "Money intended for upkeep and improvement of our nation's transportation system will be repaid to the Highway Trust Fund." For Superfund, it says, "Money intended to be set aside for environmental cleanup will be restored to the Hazardous Substance Superfund." These statements certainly suggest that more be spent in these areas. To be sure, greater highway and Superfund expenditures would not require higher total federal outlays if the money were taken out of other federal programs. If that were done, though, there would be no need to dip into budget surpluses. Thus, identifying budget surpluses as the financing source for increased outlays in these areas points to higher aggregate federal spending.

11. Similarly, if the tax increase is directed against investment, investment will tend to fall even if national saving rises. More U.S. savers will avoid investing in domestic capital, instead taking their investment dollars abroad, and less foreign capital will flow into the United States.

12. Current returns on private corporate capital are about 9.5%. Over half of that is captured for the government by corporate and individual income taxes, or about 4.8%. The corporate investment also boosts employment and taxes on wages, adding several percent to the Treasury's "return" on a dollar of corporate investment. Meanwhile, Treasury would save gross interest costs of less than 5% by redeeming Treasury bills, and less than 6% by redeeming Treasury 30-year bonds, before taxes, and only 3.5% to 4.5% in net-of-tax costs when the taxes collected on the interest are factored out.

13. Federal debt figure is from CBO, *An Analysis Of The President's Budgetary Proposals For Fiscal Year 1999*, and population estimate for 1997 is from U.S. Bureau of the Census, at internet site <http://www.census.gov/population/estimates/nation/popclockest.txt>.

14. Current-dollar amounts are adjusted for inflation using the CBO's projection for the GDP deflator. That series, for the period 1998-2008, is found in CBO, *The Economic And Budget Outlook: Fiscal Years 1999-2008* (Washington, DC: Government Printing Office, March 1998), Table 1-5, p. 22.

15. One technical adjustment is made in the calculations and should be mentioned. Converting surpluses into tax reductions slightly increases the federal debt relative to the CBO's baseline because in the baseline the surpluses are retiring debt. With more slightly debt than in the baseline, the government's interest cost is slightly above what the CBO estimated, and that extra interest expense slightly increases federal outlays. For example, if the debt added, relative to the baseline, by tax relief totals \$25 billion and if the government's interest rate is 6%, the government's added income expense is \$1.5 billion. Because outlays are slightly above the CBO baseline, the tax cuts that just keep the federal budget in balance are slightly smaller than the surpluses in the CBO baseline. In making this technical adjustment, it is assumed that the federal government's interest rate is 6%, which very closely matches the CBO's projection of the yearly interest rate on ten-year Treasury notes.

16. Office Of Management And Budget, *Budget Of The United States Government, Fiscal Year 1999, Historical Tables* (Washington, DC: Government Printing Office, 1998), Table 7.1, pp. 110-111.

17. *U.S. Budget, FY 99, Historical Tables, op. cit.*, Table 1.3, pp. 23-24.

18. In inflation-adjusted dollars, the economy more than doubled.

19. The latter number is based on the ratio of the CBO's most recent baseline estimates for revenues and GDP. The CBO issued baseline estimates in March for both revenues and GDP; in May, it increased its estimate for revenues. Before the May revision of the revenue estimate, the CBO had predicted that the revenue-GDP ratio would hit 20.1% in 1998.

20. Data on GDP and federal revenues before 1998 are from *U.S. Budget, FY 99, Historical Tables, op. cit.*, Table 1.2, pp 21-22.

21. *U.S. Budget, FY 99, Historical Tables, op. cit.*, Table 1.3, pp. 23-24.

22. The illustration assumes that the output effect is immediate. In fact, output would take a few years to rise by the full amount. The amount of the increase is likely to exceed \$1 if the tax reduction reduces the tax penalty on saving and investment. For example, Robbins and Robbins estimate that a \$1 billion change in the individual alternative minimum tax (AMT) would change GDP by about \$1.7 billion and that a \$1 billion change in the corporate AMT would change GDP by about \$2.9 billion. See Gary Robbins and Aldona Robbins, "Complicating the Federal Tax Code: A Look At The Alternative Minimum Tax (AMT)," Policy Report No. 145, Institute for Policy Research, 1998, at internet site <http://www.ipi.org>.

23. The tax relief raises GDP, which lowers the debt-GDP ratio. The positive tax feedback produces small surpluses that reduce the dollar amount of debt, which also lowers the ratio.

24. CBO, *An Analysis Of The President's Budgetary Proposals For Fiscal Year 1999*.