IRET Congressional Advisory

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PULL THE TRIGGER (out of the tax bill)

Defn: *Trigger*. Proper noun. Roy Roger's horse, now stuffed.
Defn: *trigger*. Improper tax policy tying tax cuts to falling interest outlays. Treat as above.

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 fought.

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They came up with a bizarre trigger formula, which, if memory serves (close enough for government work), 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 hairbrained 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 render the other branches moot. The Secretary liked the diagram and took it 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. CBO lowered its deficit forecasts, and the issue faded, at least for awhile.

Stockman's intellectual heirs have forced Representative Archer and Speaker Hastert to agree to a "trigger" that could, and likely would, prevent the gradual 10 percent across-the-board reduction in marginal tax rates that is the centerpiece of the House tax bill. Each installment of the rate cuts would take effect only if interest payments on the public debt drop each year (July to July) from 2002 to 2009. The absurdities of this trigger are legion:

The trigger makes the tax cut cost more!

Some tax cut opponents fret that the tax cuts would take up most of the on-budget surplus, adjusted for interest. The projected surplus includes savings from reduced interest outlays on the assumption that the surplus would be used to reduce the debt. If we cut taxes instead, that part of the on-budget surplus would vanish. The tax reductions would take up most of what is left, with only a little left over to retire "gross" debt.

Institute for Research on the Economics of Taxation

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There are two problems with this fear. First, the estimated revenue cost of the tax cut is "static", before factoring in the added economic growth the tax cuts would make possible by lowering taxes on workers and savers. A forthcoming study by the Institute for Policy Innovation estimates that the stronger economy would return nearly 30% of the projected revenue loss to the Treasury. That puts the cost of the tax cuts far below the projected on-budget surplus, excluding interest savings.

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

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

Every year we don't 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 is going to be dropping over time, and after-tax wages will be rising, they will know that wage demands are likely to remain moderate. Consequently, they will be more likely to hire people, today, on that assurance, than if taxes are not going to come down.

But what are employers to think if a tax bill says "We might lower taxes for the next ten 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.

Second, it is a concern about the wrong kind of debt. Although the "gross" debt would drop only slowly, the large near-term Social Security surpluses would still be generating a large total budget surplus, enabling the Treasury to pay down the debt held by the public, which is the only debt that really matters.

The drop in the debt held by the public would be almost matched by an increase in the debt held by the Social Security trust funds (which will rise, with or without a tax cut, because of the Social Security surplus). However, this trust fund "debt" is debt that the government "owes" itself, but which has no economic consequences. It does not increase the Social Security benefits that the government owes to retirees (because the benefits are set by the Social Security benefit formulas) nor is it an asset that can help the Treasury pay benefits (because it is a marker for past tax surpluses that have already been spent).

These pseudo-trust funds are nothing but a bit of legal leeway for the Social Security System to continue to operate beyond the year in which its outlays exceed its revenues without having to go back to Congress for a review of the program, and either a dedication of new money or a change in benefits. In technical budget parlance, the trust funds are "budget authority". Budget authority isn't cash; the Treasury would still have to get money to pay benefits out of current tax revenue or borrow it by issuing real debt to the public, just as if the trust funds did not exist. The more the trust funds grow, the longer Congress can dawdle before undertaking serious reform of Social Security. The "trigger", by making the trust funds out to be something they are not, plays into this charade.

The longest way around may be a lot longer than a straight line.

If Congress wants to make sure the debt is falling, it should cut spending. Barring that, why isn't the trigger based on whether the debt is falling, instead of whether interest outlays are falling? They don't necessarily go together. Between 1992 and 1993, debt rose, but federal net interest outlays fell and gross interest outlays were almost flat because interest rates were falling. Conversely, suppose the debt fell but interest rates rose. Then interest outlays could go up even with the debt going down, and **boom!** no tax cut.

Does Congress want to delegate its taxing authority to the Federal Reserve?

Could anything like this happen in practice? Just look at current numbers. CBO forecasts a budget surplus of $161 billion in 2000, lowering the debt by about 3 percent. Suppose interest rates on Treasury bills rise from 4.5% to 5%, an 11 percent increase. Debt would fall, but interest outlays would rise! Chairman Greenspan and the Federal Open Market Committee have already raised the "federal funds rate" by a quarter point this year, and may well do so once or twice more before December. They could boost federal interest outlays even if the debt is falling. The Federal Reserve could block the tax cut by raising interest rates.

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"Special" interest at work?

The "interest outlays" in the trigger would not be the "net" interest paid on debt held by the public, which reflects the total budget deficit, and is the only interest that the government actually has to pay to real people and to the Federal Reserve. The trigger is based on "gross" interest on "debt subject to [the debt] limit", which would also count the "interest" the government pays itself on pseudo-debt held in government pseudo-trust funds, such as is "paid" on the "Treasury specials" (book entry "bonds") in the Social Security trust funds, the size of which matters not one whit. Worse, the Treasury, by law, is arbitrarily required to pay the trust funds a higher interest rate (the average rate on long term federal debt) than it pays the public (a mix of short term T-bill rates, T-note rates, and long bond rates). Consequently, equal cuts in the debt held by the public and increases in debt in the trust funds could raise interest outlays, if one counts the interest the Treasury general fund pays the trust funds.

Treasury could manipulate its interest payments by changing the mix of bills, notes and bonds that it issues, and block the tax cut.

Thus, even if the Social Security surplus is used to pay down the debt held by the public, the trigger may be tripped, for no good reason. If the trigger is tripped, the economy and the Social Security system will be weakened, not strengthened. Where is the logic in that?

Say good net, Grossie!

Trust funds aside, there are other, more real interest offsets to the Treasury's gross interest payments that should be considered. The Federal Reserve holds about $490 billion in government securities, on which it earns interest. After paying its operating costs, the Fed gives back any left-over interest income to the Treasury, about $25 billion a year. But this is counted as "miscellaneous receipts" on the revenue side of the budget, not as a reduction in interest payments. The government also earns interest on its "tax and loan accounts" at banks where it parks tax revenues before it needs to spend them, and it earns interest on various loans it makes to private sector and quasi-public agencies and individuals. Shouldn't the trigger count offsetting interest <u>income</u> of the government?

Does Congress want to delegate its taxing authority to the Secretary of the Treasury?

Treasury could manipulate its interest payments by changing the mix of bills, notes and bonds that it issues, and block the tax cut. Suppose a current or future Secretary, or even the Assistant Secretary for Domestic Finance, decides to issue more 20-year bonds at 6% and fewer T-bills at 3.5%, and ticks up interest outlays enough to block the next phase of the tax reduction? Suppose the Treasury keeps more cash on hand than it really needs instead of redeeming high-yielding 20-year bonds, thereby boosting its interest outlays? The Treasury pays the Social Security trust funds "interest" at the average rate on outstanding marketable Treasury bonds of four years or more to maturity. Any changes in the marketable debt mix and interest rate would be magnified by a corresponding swing in the interest paid to the trust funds. What fun and games! Congress has already delegated its telephone excise tax authority to the FCC via the Gore tax. Why not go whole hog?

Greenspan's and others' faulty world-view.

Why are people so set on reducing the debt anyway? It is falling at a rapid rate as a share of GDP. Interest outlays are falling as a share of the budget. There are better things to do with the money (like fundamental tax reform or privatizing Social Security). Unfortunately, none of this is registering with the Administration, some of the Congress, or the Federal Reserve.

For example, Chairman Greenspan's analysis of the tax cut and the economy at last week's House Banking Committee hearing was a disappointing throwback to 1950s Keynesianism. Chairman Greenspan said that lowering the debt was the best way to increase saving and investment and to keep the economy from overheating. This view is mistaken. Higher taxes come primarily out of private saving and investment. Cutting taxes on capital, at the margin, increases investment, saving, and growth more than would debt reduction. Cutting taxes on labor, at the margin, is also better, if one allows for the response of the labor supply to higher after-tax wages. There are some non-incentive money hand-outs in the House tax bill, but they are fairly small.

Sensible tax cuts are not inflationary, do not over-stimulate the economy, and do not require the Federal Reserve to tighten the money supply. Marginal income tax rate reductions cut the tax on capital and labor; they lower, not raise, the cost of production; they boost supply and hold down prices. They boost demand only in line with production, as people are paid for adding to output.

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Tax cuts do not boost demand in excess of any other use of federal revenue. The only other uses for the money are to increase government spending, which is "demand" too, or to pay down more debt, which gives just as much money back to the public (the bondholders) as a tax cut. Neither of these uses typically adds to capacity. The other provisions in the House tax bill that cut the excess tax burden on capital surely reduce the cost of investment and raise economic capacity even more than the income tax rate cuts.

Mr. Greenspan favored deficit/debt reduction over tax cuts during the Ford, Reagan and Bush years, and still does. This revelation of a perverse world-view at the Fed, as much as the not too surprising manifestation of Congressional reluctance to give up revenue and the silliness of the trigger itself, is the most discouraging aspect of this week's debate.

Chairman Greenspan recommended reserving tax reductions until the economy gets into trouble, and then cutting taxes to pump up "demand". For similar reasons, this does not work either.

Many had thought or hoped that the Chairman had put Keynesian Phillips curve/NAIRU nonsense behind him, but old ideas keep resurfacing. Mr. Greenspan favored deficit/debt reduction over tax cuts during the Ford, Reagan and Bush years, and still does. This revelation of a perverse world-view at the Fed, as much as the not too surprising manifestation of Congressional reluctance to give up revenue and the silliness of the trigger itself, is the most discouraging aspect of the current debate.

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Note: Nothing written 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 Congress.