

Economic Policy Bulletin

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A LITTLE MORE ON CROWDING OUT

We've been at some pains this year to try to disabuse our economic policy makers of a lot of mistaken notions about deficits. We hold no briefs for deficits, but we very strongly believe that if policy makers are really concerned about the bad economic effects incorrectly attributed to deficits, they need to know what fiscal variable actually does do the economic mischief. We've shown that the historical record adamantly refuses to support any statistically reliable relationship between deficits and interest rates, that if this is the crowding-out nexus which policy makers have in mind, they're following a blind analytical trail. We've also shown that there's no reliable connection between our budget deficits and inflows of capital from abroad which allegedly escalate the dollar's foreign exchange value, crumble our trade balance, and thereby impair our economic recovery.

Our objective was to clear the analytical tracks of a lot of theoretical debris, so that we could demonstrate that what preempts the nation's saving, hence reduces the resources committed to capital formation, is not the deficit but government spending. In our Economic Report #19, DEALING WITH THE DEFICIT; ARE TAX INCREASES THE ANSWER?, we focused on the relationships among government spending, taxes, deficits, gross private saving, gross national saving, and private investment, presenting in table form a summary of what happens to saving and investment under differing budget outcomes, and showing that government spending, itself, is the out crowder.

A little elaboration is needed to nail down this conclusion. The direct crowding out effect results from government purchases of goods and services; the remainder of government spending --- transfer payments of one sort or another --- may indirectly contribute to crowding out by virtue of the effects of some of these outlays in raising the costs of market-directed uses of one's time and capabilities compared with so-called "leisure" uses, thereby eroding the economy's total output capacity. And much of the budget revenues comes from taxes which raise the cost of saving compared to the cost of consumption, in this way also contributing heavily, albeit indirectly, to crowding out. But, to repeat, the direct crowding out stems from the government's purchases of goods and services.

Some basic national income account relationships are useful in showing why only government purchases of goods and services directly crowd out and why deficits per se have no bearing on the crowding out phenomenon.

The fundamental relationship for purposes of understanding the effects of budget changes on capital formation is that between gross national saving (GNS), on the one hand, and the sum of gross private domestic investment (GPDI) and net foreign investment (NFI), on the other;

$$(1) \quad \text{GNS} = \text{GPDI} + \text{NFI}.$$

It is this necessary equality of gross national saving and capital formation which dictates the concern about any fiscal development which reduces saving; any reduction in saving means equally less capital formation, without any qualification whatever.

To understand the connection between fiscal and budget actions and saving, we turn next to the definition of gross national saving. It is the sum of gross private saving (GPS) plus the government's budget surplus or minus the government's budget deficit, which is, obviously, taxes collected (T) minus government spending (G). So,

$$(2) \quad \text{GNS} = \text{GPS} + \text{T} - \text{G}.$$

Gross private saving is the sum of personal and business saving. Personal saving is what remains of the flow of personal income after consumption and other personal outlays and taxes. Some of the income people receive consists of transfer payments, primarily from government and to a much lesser extent from business. Government transfer payments to persons consist of a wide assortment of payments made pursuant to one or another government program, including such familiar "entitlements" as old-age, survivors, and disability "insurance" payments, Medicare and Medicaid, unemployment compensation, railroad, civil service, and military retirement payments, food stamp benefits, veterans benefits, aid to families with dependent children, etc. In contrast with government purchases of goods and services, these transfer payments are not made in exchange for services currently provided by the persons receiving them. Since they therefore do not represent income generated by current output or payments for production inputs, they are not included in the measure of gross national product. A convenient way of handling them is to treat them as negative taxes. Much the same is true of interest payments received from government. These receipts do not represent income generated by current production activity or by the provision of production inputs. They may be treated the same way as transfer payments, i.e., as negative taxes, while interest payments made to government may be seen as similar to tax payments. For convenience, let's lump together the net amount of interest paid by government with transfer payments made by government to persons. Let's designate all of these transfer payments as G_{trans} while indicating government purchases of goods and services as G_{purch} .

Business saving consists of retained corporate earnings, i.e., the profits remaining after taxes and dividend payments, plus capital consumption allowances, i.e., depreciation, depletion, and other measures of the amount of production facilities currently used up in production.

Adding personal and business saving together, it must be clear that gross private saving is that part of the economy's total income flow which is not consumed and which is not paid in taxes. The economy's total income flow necessarily just equals the market value of the economy's total output (GNP). Gross private saving, then, is:

$$(3) \text{ GPS} = \text{GNP} - \text{C} - \text{T} + \text{G}_{\text{trans}} .$$

Looking at (3), a couple of interesting things emerge. One is that raising taxes in order to reduce the government's deficit also reduces gross private saving, at least dollar for dollar. Raising taxes does not increase GNP; not even the most enthusiastic proponent of tax hikes could make that claim without breaking into the giggles at trying to tell such a whopper. If we ignore what raising taxes in fact do, that is, reduce total inputs, hence total output, we are left with the same GNP as before. Then if the tax hike isn't to reduce gross private saving, it would have to cut consumption by as much as the tax increase. But with no change in total output and total income, total consumption will go down only if the tax increase raises the cost of consuming more than it raises the cost of saving. We don't have any tax in our tax system that does that; our major tax — the income tax — does just the reverse, viz., raises the cost of saving compared with consumption. But to keep things in focus, let's ignore that effect by pretending we could raise some neutral tax. Then, at best, a tax hike to cut the deficit leaves the economy with no more gross national saving than before.

The other thing is that taken by itself, government transfer payments — a very large part of the Federal Government's spending — don't directly erode gross national saving. What they add to the deficit is matched by what they add — as the equivalent of negative taxes — to gross private saving. Of course, many of these payments tend to make it relatively more costly to work and consequently lead to a reduction in the aggregate amount of GNP, but their direct impact on gross private saving must be just the opposite of the direct impact of taxes.

At this point, let's go back to our second equation, the expression for gross national saving, i.e., $\text{GNS} = \text{GPS} + \text{T} - \text{G}$, and spell it out in more detail. Specifically, let's spell out gross private saving as equal to GNP less consumption and less taxes and plus government transfers, as in equation 3. And let's spell out government spending as the sum of government purchases of goods and services and

government transfer payments. Then we have gross national saving equals gross private saving ---- gross national product minus consumption, minus taxes, and plus government transfers --- minus the government deficit ---- taxes less government purchases and less government transfers, or

$$(4) \text{ GNS} = \text{GNP} - \text{C} - \text{T} + \text{G}_{\text{trans}} + \text{T} - \text{G}_{\text{purch}} - \text{G}_{\text{trans}} ,$$

When we subtract the minuses from the pluses, we wind up with:

$$(5) \text{ GNS} = \text{GNP} - \text{C} - \text{G}_{\text{purch}} .$$

In other words, gross national saving, in the last analysis, can be expressed as GNP less consumption spending and government purchases of goods and services. The deficit is not in the crowding out act at all. Neither are taxes, except insofar as they raise the cost of saving compared with consumption, and thereby induce people to save less and consume more. And neither are transfer payments and net interest paid by the government, which combined are the largest part by far of government spending at the federal level and about 53 percent of all government (state, local, and federal) outlays.

This brings us back to the point we have insisted upon, over and over. If our policy makers are really concerned about deficits because of their concern about crowding out capital formation, they should direct their energies toward reducing government purchases of goods and services. Most assuredly they should not raise taxes; doing so would at best leave unchanged the amount of saving available for capital formation and more realistically would reduce gross national saving and total investment. And while there is much to be said for severely pruning transfer payments in order to reduce disincentives for production effort, dependency on Uncle Sam, and upward pressures on service costs, cutting these government outlays should not be seen as an effective means for easing crowding out.

On the positive side, the concerned policy makers should be concentrating on finding ways to reduce the tax barriers to saving, to work, and to productivity-advancing activity. The rapidly increasing interest in basic reform of the tax structure is evidence of a broadening awareness that ultimately that's what needs to be done if government is to facilitate crowding in rather than crowding out. It's time to convert that interest into solid legislative effort.

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