Economic Policy Bulletin 13

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THE ANATOMY OF THIS RECOVERY: NO CASE FOR TAX HIKES

Summary

Budget and tax policy makers seem to be laboring under false impressions about the economic recovery, and they are gaining support for punitive tax increases from business leaders who are also misinformed. The drive for tax hikes to reduce the deficit relies on the argument that the budget deficit is responsible for high real interest rates which crowd out business and household capital formation, artificially strengthen the dollar and erode our exports and trade balance, making the recovery uncertain and sustained economic growth improbable. But the fact is that gross private domestic investment, not consumption growth, has been the prime mover in this recovery. In fact, the surge in gross private domestic investment has been substantially stronger than in the average first year of all of our postwar recoveries. Record-breaking deficits have not impaired the recovery. In contrast, the tax increases we are likely to get as part of a deficit-reduction strategy will raise costs for all businesses and households and weaken our forward economic momentum.

One of the most distressing things about the current policy scene is that fantasies have overshadowed actual events in the real world as influences in the shaping of economic policy. The best example of this preference for fancy over fact in policy making is the well-nigh universal, albeit mistaken, view that budget deficits impair the economy's recovery and subsequent growth by (1) crowding out private investment (business capital formation, residential construction, and consumer durables) and (2) depressing our exports. Ostensibly, bad things happen because government borrowing competes with private borrowing and drives up interest rates. Higher interest rates, presumably, restrict private capital formation, housing, and purchases of consumer durables. Higher interest rates, allegedly, also act as a magnet

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for foreign capital, a torrential inflow of which so "strengthens" the dollar relative to foreign currencies as to make our exports too expensive for foreigners to buy and their exports to us irresistibly cheap.

Surely if there were any truth in these allegations, we would have seen substantial evidence of these unhappy effects by now. We can't rule out the possibility that some day we may see some such evidence. To date, however, these dire forecasts, which became fashionable beginning in 1981, have been dramatically at odds with reality. Notwithstanding, the forecasts have gotten all of the attention in the media and have displaced actual events as inputs to the deliberations of many public policy makers.

This misperception has affected business policy makers, as well as those in the public sector. Particularly in the basic industries, housing, and real estate, many chief executive officers, their chief financial officers, and their tax vice presidents have been led to believe that tax increases are the only way to reduce deficits, that only deficit reductions will reduce interest rates, and that only lower interest rates will allow a resurgence of capital outlays on which the future prosperity of their customers and their own firms depends. They have, in short, bought the fantasy that business and household capital formation is lagging, that this slow pace of capital additions accounts for the sluggishness of their own sales, and that only by increasing taxes can we reduce the deficit and its crowding out of capital formation.

These business leaders are overlooking two things. One is that if taxes are increased, the additional burden is not likely to fall on individuals as consumers but on individuals as savers, investors, and owners of business enterprises. Whatever advantage might be gained for capital formation as a result of smaller deficits and, allegedly, lower interest rates will be offset by the additional tax burdens on income which is saved and invested and on the returns on these investments. Some Congressmen and Senators, to be sure, would identify delaying if not repealing of individual income tax indexing as their principal target for tax increases. For some of these lawmakers, the fact that indexing insulates marginal and average tax rates and tax revenues from inflation is a political nuisance, because with indexing if additional tax revenues are to come in faster than economic growth affords, the lawmaker must ask voters up front for additional taxes. Indexing rules out of the "nobody-here-but-us-chickens" revenue gains which an unindexed tax system affords. For others, indexing epitomizes the stuffing of 1981's market-oriented tax policy down the throats of those for whom the principal function of an income tax is to redistribute income.

Most of the tax raisers, however, have taken up the battle cry that the 1981 tax reductions were "unfair," because the individual tax reductions were roughly proportional to individual income tax payments rather than being concentrated among those individuals in the lower brackets who bear only a disproportional small amount of the total tax load. The 1981 tax cuts did not follow the old redistributive pattern; they were designed, instead, to reduce tax distortions of market signals. For these Congressmen and Senators, the targets of opportunity, if major revenue raising is undertaken, are corporations and upper-bracket individuals. The kinds of tax increases these lawmakers would fashion are hardly likely to benefit capital formation for basic industry, consumer durable and real estate companies, their customers, their shareholders, or their employees.

Besides overlooking the fact that they or their customers very likely will pay the additional taxes, those business leaders who advocate higher taxes are also overlooking the simple facts of this recovery. Contrary to the the media's insistence, this has not been a recovery led by exuberant consumers, wallowing in the release of resources from private capital formation as a result of deficits. Personal consumption expenditures, in constant 1972 dollars, increased by 5.2 percent from the last quarter of 1982 through the last quarter of 1983. This is somewhat less than the 6.2 percent increase in real GNP over the same period; it is also a tad less than the 5.4 percent average for the first four quarters of all postwar recoveries. Consumer expenditures for durable goods increased much more briskly---by 15 percent---during the fiscal year of the present recovery, despite the current notion that such consumer capital formation is supposed to be a casualty of deficits. Even with the strength in consumer durables, the recovery has not, so far, been propelled mainly by consumption.

The fact is that the driving force for this recovery is real gross private domestic investment (GPDI). In the first year of the current recovery, GPDI surged by 35 percent, a rate almost seven times the growth in consumption. The postwar average increase in GPDI for the first recovery year is far less--26.4 percent. To be sure, a substantial part of 1983's vigorous investment expansion was in residential investment, the very kind of investment which, according to the deficits-do-us-in hype, should have been a victim of deficit-spawned high interest rates.

But the tremendous upturn in GPDI isn't merely a housing boom. The fact is that nonresidential fixed business investment has increased briskly since the recovery got under way. From the recession trough in the last quarter of 1982 through the fourth quarter of 1983, outlays for nonresidential fixed investment increased about 13 percent. The average increase for the first four quarters in all of the postwar recoveries is 7.8 percent.

This recovery, in other words, is marked by a substantially more vigorous upturn in business capital formation than is customary, notwithstanding the huge Federal budget deficit in 1983. Within this category of GNP, incidentally, outlays for producers' durable equipment have increased by 20.4 percent over the first year of recovery, almost twice as fast as the average rate in the first year of all previous recoveries.

Another victim of deficits, according to the prevailing fantasy, is our exports. Although certainly not the strongest element in the recovery, from the fourth quarter of 1982 through the fourth quarter of 1983, exports gained by 4.9 percent. The average for the first year of all postwar recoveries, not saddled by a huge deficit which allegedly depresses exports, is about a fourth less---3.7 percent. Clearly, whatever the deficit's magnetic effect in drawing in foreign capital and strengthening the dollar, it has not precluded a very respectable gain in U.S. export production and sales.

In fact, the alleged chain of causality between deficits and export constraint has a very weak link, viz., the alleged effect of our high real interest rates on international capital flows. We have argued repeatedly that there is no significant positive relationship in either theory or the historical record between deficits and the level of real interest rates. There remains the question whether there is a positive relationship between high real interest rates, whatever their cause, and the difference between private U.S. capital outflows and inflows. In seeking an answer to this question, we undertook a simple correlation exercise, covering the period 1960 through the first three quarters of 1983. The results show that neither the real 3-month Treasury bill rate nor the real long-term Treasury bond rate has any statistically significant value in explaining the difference between private capital outflows from the United States and private capital inflows. There was, to be sure, a very substantial net inflow of private capital in 1983, only the third time in the period we examined, but to attribute any such surge of funds into the U.S. to the miniscule increase in 1983 real interest rates---16 base points in the case of the Treasury bills and 20 points in the case of the Treasury bonds---is clearly absurd.

The really remarkable difference between the first year of this recovery and the average first year of all postwar recoveries is in the government sector. In the past, government purchases of goods and services have expanded in the first year of recovery by 2.1 percent on the average. This time around, they declined by 2.2 percent. A small increase of .5 percent in state and local government purchases was far more than offset by a 5.9 percent decrease in Federal purchases.

The anatomy of the first year of this recovery is compared with that of the average first year of prior postwar recoveries in the following table.

Growth Rates of GNP Components, First Year of Recovery, Average for All Postwar Recoveries and 1982-IV through 1983-IV.

	Average -- All Postwar Recoveries	1982-IV through 1983-IV
GNP	6.9	6.2
Consumption	5.4	5.2
Durables	15.1	15.0
Gross private domestic investment	26.4	35.8
Fixed investment	11.4	18.5
Residential	20.0	40.6
Nonresidential	7.8	12.9
Producers' durable equipment	10.4	20.4
Exports	3.7	4.9
Government purchase of goods and services	2.1	-2.2
Federal	1.4	-5.9
State and local	3.2	0.5

We've presented the simple facts, not the tax hikers' fantasies, about the current recovery. We urge their careful consideration by policy makers, as well as by the good people in the business community who have been taken down the deficits-crowd-out primrose path. They may look at their own companies' poor profit performance and believe they have nothing to fear from endorsing a tax hike, ostensibly in the interest of bringing down deficits and interest rates. But today's tax hikes, if they are enacted, should be seen as an installment in a series of hikes which before long will fall on today's loss companies as well. Tax hikes will increase everyone's costs of doing business. They are not the cure-all for sick companies.

The best prospects for all businesses, healthy or ill, lie in continued recovery leading to strong, sustained growth in a market-directed economy. Tax increases, whether selective or general, whether enacted as "reforms" or revenue raisers, impose needless impediments to that recovery and growth. That used to be a fact which virtually no one disputed. We must hope that the deficit-generated myths are soon dispelled and that solid facts may once more guide our policy making.

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President
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March 2, 1984