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FUNDING A TAX CUT WITH THE FEDERAL SURPLUS: WHAT ARE THE ISSUES?*

Recent strength in the economy and income tax revenues have led to projections of large federal budget surpluses, totalling nearly $3 trillion over ten years. There are a limited number of options for using the projected budget surpluses. They could be spent on government consumption or additional transfer payments and entitlements. They could be used for government investment in infrastructure or R&D. They could be allowed to draw down the national debt. They could be used to reduce taxes in a variety of ways, some of which would improve the functioning of the economy, some of which would not.

The best use of a large portion of the surplus would be to reduce taxes in a manner that would improve the functioning of the economy. The tax cuts should be part of a transition from (1) the current income tax to a saving-deferred consumed-income-based tax system and (2) from the pay-as-you-go Social Security System to funded private retirement saving accounts.

Additional government consumption and transfer payments (such as a new prescription drug benefit for Medicare) do not improve the economy, and should not be allowed to absorb any significant portion of the surplus. Government investment, while better for the economy than government consumption, is limited in scope. That limited scope is good, because government investment is not often based on a careful calculation of the rate of return, and is often less productive than private uses of income. That leaves us with two main options for using the surplus to improve the economy: debt reduction and tax reduction.

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Institute for Research on the Economics of Taxation

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Consequently, there are two real issues in the tax cut and budget surplus debate. The first is whether it is better for people and the economy to use the budget surpluses for tax reduction or to pay down debt. In fact, properly designed tax cuts would foster more growth, and are the superior choice. The second, longer term question is whether future deficits projected for Social Security and Medicare can or should be covered by the surge in income taxes, or avoided through serious reform of both programs that would trim their rising outlays and would encourage private saving to enable individuals to take control of their own retirement and health care decisions. The latter would provide higher income and better health care for the population.

A pro-growth tax cut is the best use of the surplus.

The best use of a large portion of the surplus would be to reduce taxes in a manner that would improve the functioning of the economy. The tax cuts should be part of a transition from (1) the current income tax to a saving-deferred consumed-income-based tax system and (2) from the pay-as-you-go Social Security System to funded private retirement saving accounts.

Better treatment of saving under a new tax system would permit workers to accumulate retirement income more easily in their new private retirement accounts, and would encourage other saving as well.

These reforms would be far easier to achieve in the presence of a budget surplus that would allow for substantial tax reduction. A revenue-neutral reform would create losers as well as winners and would derail the effort. The $3 trillion projected budget surplus should be reserved for these major structural changes to the tax and retirement systems. We may never have the chance to do this much good again.

Replacing depreciation with expensing and ending double taxation of corporate income would induce businesses to use the added retirement saving to increase fixed investment in the United States... enlarging the tax base, and easing the costs of the transition to the new retirement system.

These two major reforms, ending the tax bias against saving and investment, and replacement of Social Security with real saving, would be mutually reinforcing. Better treatment of saving under a new tax system would permit workers to accumulate retirement income more easily in their new private retirement accounts, and would encourage other saving as well. Greater personal wealth would then make people more willing to give up their federal transfer payments. Replacing depreciation with expensing and ending double taxation of corporate income would induce businesses to use the added retirement saving to increase fixed investment in the United States, rather than letting the saving drift into world capital markets. Higher domestic investment would raise productivity, wages, and employment in the United States, enlarging the tax base, and easing the costs of the transition to the new retirement system.

Every year without a tax rate reduction, incentives to work, save, and invest are eroded a bit as rising real incomes push people into higher tax brackets... The disincentives will reduce growth if not offset by appropriate tax rate and tax base adjustments.

One could privatize Social Security without full-blown tax reform, mandating that a certain amount of payroll be set aside in retirement accounts each year. One could even make the accounts tax deferred to eliminate the tax bias against saving. However, absent improvement in the tax treatment of domestic investment, the added saving by U.S. residents might finance investment abroad rather than at home, either by flowing directly into foreign financial assets, by discouraging and substituting for foreign capital inflows, or by being lent to U.S. businesses which, in turn, might use the funds to expand overseas facilities instead of investing in the United States. There should be no restrictions placed on where American savers put their saving. It is clear, however, that correcting both the anti-saving and the anti-investment biases in the tax code would boost domestic output, productivity, wages, employment, and income more than just correcting the anti-saving bias alone.

Not a counter-cyclical issue, but a question of growth.

The case for a tax cut does not rest on the idea that a tax cut is necessary for counter-cyclical purposes. However, a tax cut would allow us to continue to enjoy the recent unusually steady rate of increase in income and wealth for a few years longer than we otherwise might. One source of the prolonged strength of the economy since 1982 has been the decline in inflation, from double digit rates in the 1979-1981 period to about 2% today. The decline in inflation from 5.4% in 1990 to the current rate has been one source of strength for the current phase of the expansion. The reduction in the rate of inflation has reduced risk and boosted the value of capital consumption allowances, lowering the cost of capital and raising the rate of return on business investment. But with inflation already very low, the Federal Reserve cannot go much farther in lowering inflation and boosting investment, so any additional improvement in the investment climate must come from technological advances or reduced taxation of investment.

Every year without a tax rate reduction, incentives to work, save, and invest are eroded a bit as rising real incomes push people into higher tax brackets. Although less virulent than inflationary bracket creep in the days prior to tax indexing, this real income bracket creep (which is not offset by the inflation indexing provision in current law) also raises marginal tax rates on labor and capital income. Thus, tax cuts are needed to offset recent tax rate increases due to rising real incomes.

Some may argue that rising tax burdens as real incomes increase is an appropriate outcome of a progressive tax system. That, however, is a misrepresentation of the meaning of progressivity. Progressivity is a relative concept; it suggests that, in a given year, the rich should pay a higher portion of their income in taxes than the poor. It is not an absolute concept, suggesting that the entire population should pay a higher percent of its income in taxes over time as incomes rise across the board. Tax revenues as a share of GDP are at a record peacetime level, and the disincentives imposed by the rising implicit and explicit marginal tax rates are growing. The disincentives will reduce growth if not offset by appropriate tax rate and tax base adjustments.

There is no point in analyzing a tax cut in terms of its effect on aggregate demand. A tax cut does no more and no less to aggregate demand than does paying down the national debt. One gives the same money to the taxpayer or to the bondholder either way, and, for a given amount of government spending, there is no differential first order impact on aggregate demand.

Tax reductions, depending on their form, may favorably affect important choices that people make between labor and leisure, between saving and consumption, and between domestic and foreign investment... Debt buybacks, on the other hand, probably change few decisions by suppliers of labor and saving, and by investors in physical and human capital. They have little or no impact on interest rates.

There may, however, be a considerable difference in the economic outcomes of tax relief and debt reduction. Tax reductions, depending on their form, may favorably affect important choices that people make between labor and leisure, between saving and consumption, and between domestic and foreign investment. Tax cuts should be analyzed in terms of their price and incentive effects, and the resulting impact on economic efficiency and capacity. Debt buybacks, on the other hand, probably change few decisions by suppliers of labor and saving, and by investors in physical and human capital. They have little or no impact on interest rates.

Benefits of a saving-consumption neutral tax system.

Professor Dale Jorgenson of Harvard University told a recent tax conference in New York that a shift to a VAT (one of a number of possible consumption-based tax systems), with a properly designed transition, could boost GDP by about 9 or 10 percent, and raise real wage rates by about 6 or 7 percent. These increases are substantial, and worth pursuing.

Total reform.

A totally reformed tax system would have these attributes:

- A single low tax rate applied neutrally to all income, properly measured, with no tax-induced economic distortions.
- Neutral treatment of income used for immediate consumption and income used for saving and investment. The tax system would either defer tax on saving until it is withdrawn for consumption, or not tax returns on after-tax saving, i.e., all saving would get pension or IRA treatment (regular or Roth). Investment outlays would be expensed, not depreciated.
- No double taxation of corporate income.
- No death tax.
- No excise and "nuisance" taxes.
- No payroll tax. Social Security contributions and benefits would be replaced by personal retirement saving plans owned by individuals, and bolstered by a federal safety net as needed.

A simple saving-deferred cash flow tax for individuals meets these objectives. (A version of this type of tax, called the "Inflow-Outflow tax", was developed by IRET's late founder, Norman B. Ture, and is available from IRET on request.) It has the added advantage of being highly visible to the taxpayer/voters, enabling them to see the full cost of government so that they may make an informed decision as to the amount of government services they wish to consume.

Partial reform.

A tax plan should be judged by whether or not it moves us closer to the goals of fundamental tax reform — a simple, neutral, unbiased, pro-growth tax system. Short of total reform, useful steps can be taken:

<u>Move toward expensing of plant and equipment.</u> Proper treatment of investment for tax purposes is expensing (first-year write-off), not depreciation. Depreciation delays recognition of the cost of plant, equipment, and buildings, and understates their opportunity cost. The delay cuts the present value of the write-offs, overstates business income, and raises effective tax rates. Bringing the value

of the write-offs closer to the true cost of the investments would be the most powerful stimulus to the economy that a partial tax reform could provide. Either the write-offs should be accelerated, or interest should be paid on the unused balances to bring their present value up to 100% of the cost of the investment. All the major tax reform proposals would move to the expensing of capital outlays, rather than depreciation.

Phase out the federal estate and gift (transfer) tax. The federal "death" tax is an added layer of tax on income that is saved, part of the anti-saving bias in the tax system. Every taxable dollar in an estate has been subject to the decedent's income tax and possibly the corporate income tax, or, in the case of tax-deferred retirement plans, will be subject to the heir's income tax. The federal transfer tax is an additional layer of tax in every case. The death tax should be eliminated.

Expand IRA contribution and eligibility limits. Under a tax that is neutral between saving and consumption uses of income, all saving should get front or back-ended IRA treatment. Every major tax reform proposal either defers the tax on saving or exempts the returns.

The real issue for Social Security and Medicare is how to expand real output of goods and services for the elderly to consume, not how to arrange the programs' financing... Appropriate tax restructuring to reduce the cost of capital is the most effective way to promote investment and saving and to raise output and income. Running budget surpluses to reduce the national debt is not the way to achieve those goals.

Cut the capital gains tax rate and the tax rate on dividends. Cutting the capital gains tax is consistent with fundamental tax reform. In a neutral tax system, there would be no separate taxation of capital gains. Cutting the capital gains rate reduces the basic tax bias against saving, and cuts the double-taxation of corporate income. Dividends and capital gains are both double-taxed. After paying the corporate tax, firms either pay dividends, which are taxed again as individual income, or they reinvest the earnings, which boosts share prices and triggers the capital gains tax. The Treasury has warned that tax relief for capital gains without relief for dividends distorts how businesses distribute their earnings. ("Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once," Department of the Treasury, 1992). The lower capital gains rate should be extended to dividends, as has been proposed by Senator Connie Mack (R-FL).

Reduce and flatten marginal tax rates. Once the tax base is adjusted to eliminate the multiple and non-neutral taxation of saving and investment relative to consumption, marginal tax rates should be set as low as is consistent with the level of government spending the voter/taxpayers desire. A flat rate is the least distorting. Income is compensation for production of goods and services. A graduated tax rate system imposes higher tax rates, at the margin, on the incremental output of those who produce the most. This is both unfair and economically inefficient.

The real issue for Social Security and Medicare.

The real issue for Social Security and Medicare is how to expand real output of goods and services for the elderly to consume, not how to arrange the programs' financing. The Social Security and Medicare programs cannot be saved by tinkering around the edges with federal debt levels. The retirement and health care needs of the elderly must be addressed by boosting future productivity, real output, and income, and by weaning future retirees away from federal transfer payments by helping them to become more self-reliant, drawing their retirement income from real saving.

Retirees consume goods and services each year. These goods and services are produced in the year they are consumed. Real product cannot be "stored up" by running budget surpluses to pre-pay federal transfer payments.

There are only two ways for future retirees to be able to obtain goods and services. They may seize a portion of the output of future workers via transfer payments, thereby diminishing the consumption of their children and grandchildren. Alternatively, they may save a portion of their income while they are of working age, and live on the returns. The saving would boost the capital stock and raise output. The elderly would then be consuming the added output their saving had made possible, not dipping into the product of future workers.

Appropriate tax restructuring to reduce the cost of capital is the most effective way to promote investment and saving and to raise output and income. Running budget surpluses to reduce the national debt is not the way to achieve those goals.

The vetoed tax bill and the Social Security flap.

The President's call to "Save Social Security first!" before cutting taxes was economic nonsense and bad policy, but wonderfully effective political rhetoric. It spooked the Republican Congress into its nonsensical Social Security "lock box" proposal. Thus, the recent tax bill was constrained not to touch the Social Security portion of the budget surplus.

The tax bill was not the ideal tax legislation. It spent a good deal of money on the social issue of the marriage penalty, and did nothing, directly, for business fixed investment. However, it had some good features that moved in the direction of fundamental tax reform: modest tax rate reduction, elimination of the estate and gift tax, expansion of IRAs, reduction of the capital gains tax and indexation of the basis of capital assets (although it is just as wrong to tax real gains as inflationary gains), and ending the AMT for individuals and easing it for businesses. These features would have reduced the multiple layers of tax on saving.

The projected surplus is $2.9 trillion over 10 years (FY 2000 - FY 2009)... The tax cut would have totalled $792 billion over 10 years, and the interest cost of not repaying that much additional debt would have eaten up most of the remainder of the on-budget surplus. That would still have left almost $2 trillion to reduce the debt held by the public.

Unfortunately, the bill was badly distorted by political considerations. To stay within the limits of the on-budget surplus, many of the features of the tax bill were phased in slowly or given effective dates several years in the future. The minuscule rate reductions were subject to a ludicrous "trigger" that would have blocked the rate cuts unless interest outlays were falling year-over-year (including the internal interest paid by the Treasury to the trust funds). This was a very sloppy proxy for a decline in the total debt, including the trust fund debt build-up, which was supposed to indicate that only the on-budget surplus was being used. Finally, to keep from running afoul of the Budget Act, the entire bill was sunsetted after 10 years. All these provisions made the tax rate reductions less certain and less effective at promoting growth.

Most arguments against a tax cut are either calumnious or confused.

There was no threat to essential spending. The Office of Management and Budget (OMB) issued some numbers on the spending "sequestration" that would occur under the budget rules if the Congressional tax bill became law. The report was "spun" by the White House to claim that the $792 billion ten year tax cut was too large, and would have resulted in across-the-board spending cuts in popular programs such as Medicare. This spin was untrue, and can best be described as scare tactics.

OMB set up a straw man. The tax cuts would only have triggered spending cuts because of the PAYGO (pay-as-you-go) budget rules, not because the cuts were too large relative to the projected budget surplus, and the PAYGO rules would have been waived if an agreement had been reached by the Congress and the White House on a tax plan. In fact, the same objection, and the same rebuttal, would have applied to the $300 billion tax cut that President Clinton and Congressional Democrats offered.

Buying back debt is a highly over-rated policy. By definition, the present value of the future debt service on a dollar of debt that is not redeemed is — one dollar. One has to pay a dollar to save a dollar. One should repay debt only if there is no other use for the money that would yield a higher return. In the case of a federal surplus, there are many potential tax changes that would boost GDP by more than debt reduction, while leaving the federal budget in good shape.

The tax cut would not have prevented paying down debt. The projected surplus is $2.9 trillion over 10 years (FY 2000 - FY 2009). About $1.9 trillion is projected to come from the Social Security accounts, and about $1 trillion from a surplus of general revenues over on-budget outlays.

In fact, the tax bill would have been less costly than the static revenue estimate made it appear, because it would have triggered additional growth that would have returned a portion of the projected revenue loss.

This is a misleading breakdown, however. According to the Congressional Budget Office (*Economic and Budget Outlook: An Update, July 1, 1999*), Social Security's operating surplus (the excess of payroll taxes and income taxes on benefits over retirement and disability outlays) is only about $900 billion over the FY 2000 - FY 2009 budget period. The extra nearly $1 trillion attributed to the Social Security surplus is really interest payments from the Treasury's general fund on the trust fund debt. The reality behind the $2.9 trillion projected surplus, then, is that the general fund is actually taking in about $2 trillion more over the period than the government is spending on non-Social Security outlays, while the true Social Security surplus is only $900 billion.

Nonetheless, the proposed Congressional tax cut would have used only the official $1 trillion on-budget surplus. The tax cut would have totalled $792 billion over 10 years, and the interest cost of not repaying that much additional debt would have eaten up most of the remainder of the on-budget surplus. That would still have left almost $2 trillion to reduce the debt held by the public.

In fact, the tax bill would have been less costly than the static revenue estimate made it appear, because it would have triggered additional growth that would have returned a portion of the projected revenue loss. Several provisions of the tax cut would have spurred growth by lowering taxes on saving and working.

The President vetoed the tax bill on the grounds that it was too large and did not save Social Security and Medicare. He proposed a tax cut less than half as large, offset by about $95 billion in higher taxes, especially cigarette taxes, and additional spending on a number of entitlements, including a new prescription drug benefit under Medicare.

Although the Congressional tax cut was bigger than the President's, the Budget Resolution projected smaller outlays than the President had requested. Consequently, the Republican proposals would have reduced the debt by more than the President's proposals, in spite of the larger tax reduction.

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Even if the alternative to the $792 billion tax cut had been no tax cut at all, it would have been a choice between paying down the debt held by the public by nearly $2 trillion instead of nearly $3 trillion over 10 years. The question then becomes, would it be better for the economy not to cut taxes and pay down nearly all of the publicly held debt, or to cut taxes and pay down only two-thirds of the debt?

<u>The distinction between on-budget surpluses and off-budget surpluses is economically meaningless, and the trust funds are a charade.</u> The debt held by the public is the only federal debt with any economic significance. As the Social Security surplus is used to buy down the debt held by the public, the reduction in the publicly held debt is matched by an increase in the debt held by the Social Security trust funds. That debt, however, has no economic consequence.

Using the surplus to "save" Social Security and Medicare is a very fuzzy concept, which makes it an ideal bit of political rhetoric. It can mean almost anything to anyone. Unfortunately, in reality, it means very little.

The Social Security trust funds are an accounting device. They merely represent unused budget authority, in that the Congress has allowed the Social Security Administration to authorize the Treasury to pay future benefits in excess of future dedicated tax revenues up to that trust fund amount without returning to Congress for a review of the programs.

The trust funds do not constitute real money with which to pay future benefits. When Social Security benefits begin to exceed dedicated revenues, the Treasury will either have to use general revenues to make up the difference, insofar as the rest of the budget is in surplus, or borrow in the credit markets, insofar as the rest of the budget is not in surplus. To avoid either reduced debt retirement or increased borrowing, the Congress would have to decide if it wished to raise taxes, curb benefits, or curb other spending to balance Social Security year by year, just as it would have to do if the trust funds did not exist.

As long as the Social Security benefits that the government owes are unchanged, it makes no difference whether the trust funds are large or non-existent. Last winter, the President proposed to use the projected Social Security surpluses to pay down the debt held by the public, and, instead of retiring it, to transfer that redeemed debt to the trust funds **over and above** the normal crediting of the trust funds for that same surplus. He was simply trying to inflate the trust funds with additional debt certificates to commit the country to paying a larger share of future retirement benefits out of general revenues than is implied by current law. The scheme gave the appearance of having fixed the system without trimming benefit growth, but it was meaningless, and set back the understanding of the real problem.

Does "saving" Social Security mean buying down the debt to reduce future interest outlays, so that the taxes that would have been used to pay interest could be used to pay for retirement and health benefits? Eliminate $3 trillion in nominal debt and you will save about $150 billion a year in nominal future interest payments. But ... Social Security ... and Medicare ... annual nominal deficits will exceed $150 billion by 2017, and will exceed $2 trillion in 2043, and $3 trillion in 2051.

<u>What does it mean to use the surplus to "save" Social Security and Medicare anyway?</u> Using the surplus to "save" Social Security and Medicare is a very fuzzy concept, which makes it an ideal bit of political rhetoric. It can mean almost anything to anyone. Unfortunately, in reality, it means very little.

Does "saving" Social Security mean buying down the debt to reduce future interest outlays, so that the taxes that would have been used to pay interest could be used to pay for retirement and health benefits? Eliminate $3 trillion in nominal debt and you will save about $150 billion a year in nominal future interest payments. But (according to the 1999 OASDI and HI Trustees Reports) the combined Social Security retirement and disability programs and Medicare Part A (not even counting the federal portion of Medicare Part B) will begin to run deficits in (calendar year) 2012. The annual nominal deficits will exceed $150 billion by 2017, and will exceed $2 trillion in 2043, and $3 trillion in 2051. Even in real 1999 dollars, the future deficits in these programs will exceed $150 billion in 2016, $400 billion in 2032, $600 billion in 2053, and $900 billion in 2073.

Does "saving" Social Security mean buying down the debt to make it "easier" (whatever that means) to reissue the debt in the future to debt-finance the retirement and medical benefits? Even paying back $3 trillion in debt would be a drop in the bucket compared to the future projected deficits of these programs. The cumulative OASDHI deficits will exceed $2 trillion by 2023, and $3 trillion by 2025, and will be rising by more than $1 trillion per year thereafter. In real 1999 dollars, the cumulative deficits will exceed $2 trillion by 2027, and $3 trillion by 2031. We can't possibly borrow the tens of trillions of dollars that would be needed to debt finance Social Security.

Does "saving" Social Security mean buying down the debt to make it "easier" (whatever that means) to reissue the debt in the future to debt-finance the retirement and medical benefits? Even paying back $3 trillion in debt would be a drop in the bucket compared to the future projected deficits of these programs... We can't possibly borrow the tens of trillions of dollars that would be needed to debt finance Social Security.

Neither of these ratiocinations for using the near term surpluses to "save" Social Security and Medicare makes sense.

<u>Simplistic thinking based on NIPA accounting is not good economics.</u> Economists within the Administration took a (slightly) more sophisticated view of the argument for using the surplus to buy down debt. They assumed that the surplus and debt reduction would lower interest rates and strengthen investment and real output. Even this reasoning is flawed. If, in fact, paying down the debt would make investment larger and the economy stronger, then the future reissue of the debt would make investment smaller and the economy weaker, just when we need it to be stronger. And reissuing the debt would reinstate huge interest obligations. What kind of a fix is that?

But even the fundamental assumption that debt reduction would lower interest rates and boost investment is based on faulty theory.

Some of the careless analysis surrounding the question of tax reduction versus debt reduction stems from the misuse of the basic GNP identity:

$$C+I+G+(X-M) = C+S+T.$$

This is often rearranged, minus consumption, as follows:

$$I = S+(T-G)+(M-X).$$

It indicates that investment equals private domestic saving plus the government surplus plus the net capital inflow.

The GNP identity is an accounting relationship, not a behavioral equation. It tells us nothing about how the public would react, or how the economy would change, if the government were to alter its tax and spending policies. Yet the debate over the future of fiscal policy given the projected budget surpluses is almost always couched in the overly simplistic terms of this tautological accounting relationship.

Oversimplification #1: Running a surplus increases national saving and promotes investment. Running a budget surplus (increasing T-G) does not necessarily increase national saving. It depends on how the surplus came to be, and how the public reacts to any of the policy changes that may have been involved.

Running a budget surplus... does not necessarily increase national saving... Private saving goes down as taxes go up... Raising taxes to generate a budget surplus may depress rather than increase national saving and investment... Higher taxes may induce higher government spending, so that the surplus does not rise. Higher taxes on investment may discourage investment and business saving directly. Tax hikes on personal saving may depress private saving, so that national saving and investment decline. A higher surplus may back out a portion of the foreign capital inflow and retard domestic investment.

Raising taxes to generate a budget surplus may depress rather than increase national saving and investment. I, S, and (X-M) are not constants, they are variables, and they are all sensitive to taxes and after-tax rates of return. Higher taxes may induce higher government spending, so that the surplus does not rise. Higher taxes on investment may discourage investment and business saving directly. Tax hikes on personal saving may depress private saving, so that national saving and investment decline. A higher surplus may back out a portion of the foreign capital inflow and retard domestic investment.

The idea that a tax increase must raise national saving relies on the unwarranted assumption that the tax hike comes primarily out of private consumption rather than private saving.

The usual assumption is that the tax hike is divided between consumption and saving according to the split between the marginal propensity to consume and the marginal propensity to save. This obsolete Keynesian notion views people as mindless automatons oblivious to the price signals and changed circumstances thrown off by the tax rate change.

In reality, for a given level of government spending, a tax increase substitutes for borrowing. People give up money through taxes instead of buying government debt. Private saving goes down as taxes go up, in equal amounts. Higher business taxes come straight out of business saving. Higher individual taxes depress discretionary after-tax income out of which people save.

In addition to this mechanical substitution, however, tax increases may also reduce the incentive to save and invest if they are of the types that reduce the marginal after-tax returns on saving or investment. This disincentive effect can alter the desired stock of financial assets or physical assets, and may lead to a stock adjustment (a cut in savings) that may be many times larger than the dollar flow amount of the tax change.

Running a budget surplus does not reduce interest rates... There are upwards of $100 trillion of debt and equity instruments in world markets. Plus-or-minus $1 trillion in U.S. government debt will scarcely be noticed.

Marginal tax rate increases due either to legislation (the 1990 and 1993 tax hikes) or to inflation (pre-1985) or real income growth (on-going), restrictions on IRAs and pensions (as in the 1986 Tax Reform Act), and increased double taxation of capital gains (also 1986), not only drain disposable income; they also reduce the incentive to hold assets and earn income from saving at any given level of income. Increases in the corporate tax rate (1993) and lengthening of depreciation lives (1986) reduce business saving directly, dollar for dollar, by depressing after-tax retained earnings. They also raise the cost of capital and reduce the incentive to invest.

Milton Friedman won the Nobel Prize for his theory of the consumption function and permanent income, which suggests that consumption is sticky. This suggests that a tax hike would come mainly out of personal saving, at least in the short run.

Michael Darby, while Assistant Secretary of the Treasury, along with Robert Gillingham and John S. Greenlees, conducted a study of the effect of tax changes on saving and consumption. (*The Impact of Government Deficits on Personal and National Saving Rates*, Research Paper No. 8702, Office of the Assistant Secretary for Economic Policy, Department of the Treasury, 1987; also, revised, August 1990 for presentation at the 65th Annual Conference of the Western Economic Association International, San Diego, CA, June 30, 1990.) They concluded that the data cannot distinguish, over the long run, between a "Barro" world model, in which taxpayers offset the change in the government surplus with a change in their saving, and a Keynesian world model, in which the tax change affects consumption more than saving. In the short and not-so-short run, up to seven years, however, both models suggested that the tax change was matched by offsetting changes in private saving. This study was quite Keynesian in its approach. It looked at the dollar amounts of the tax changes, not their price or incentive effects, and did not distinguish between tax changes that were targeted at saving incentives and tax changes that were not. Had the study been able to make those distinctions, it might have found an even stronger result.

Whether we pay down $3 trillion in debt over ten years or pay down $2 trillion in debt and cut taxes with the other $1 trillion will have little effect on world interest rates, but a tax cut could make a world of difference to the allocation of world credit and the amount of investment, employment, and income in United States.

The following graph shows an apparent inverse relationship between private saving, especially personal saving, and federal budget surpluses since 1969. While not proof of cause and effect, it suggests that the bland assertion that surpluses raise national saving should be tested before being swallowed whole.

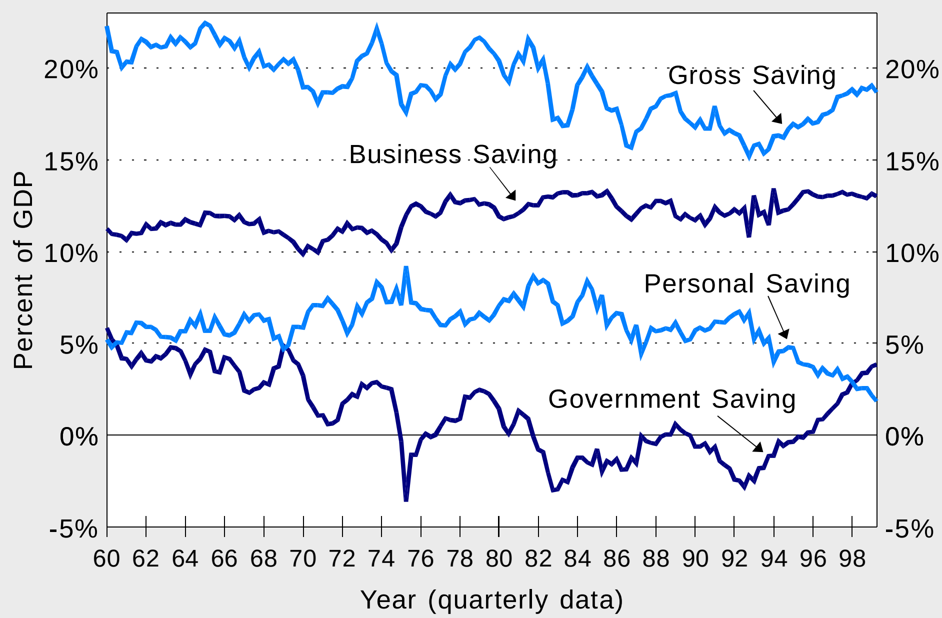
Cutting government transfer payments and spending on government goods and services, on the other hand, probably raises saving and investment. Reduced incentives for leisure and reduced government absorption of physical resources increase the labor force and lower the cost of investment goods and materials, all of which encourage private saving and investment.

A properly-designed tax reduction would do more for growth than paying down the national debt. Tax reform and reform of the nation's retirement arrangements, abetted by a significant reduction in taxes, should be our top fiscal priorities.

Oversimplification #2: Running a surplus reduces interest rates and promotes investment. Running a budget surplus does not reduce interest rates. Interest rates are the sum of the real return on capital, an inflation premium, a risk premium, and an added amount reflecting the tax imposed on the preceding components. The budget surplus is not on that list. The credit markets should not be analyzed by looking at the flow of funds. The market for debt and equities is a market for the stock of financial instruments, not the flow. One cannot determine the price of such instruments, and their yields, by looking at the supply of and demand for net new issues, any more than one can determine the price of gold by looking at the tiny annual changes to the massive stock of the metal that has been accumulated over millennia.

There are upwards of $100 trillion of debt and equity instruments in world markets. Plus-or-minus $1 trillion in U.S. government debt will scarcely be noticed. Whether we pay down $3 trillion in debt over ten years or pay down $2 trillion in debt and cut taxes with the other $1 trillion will have little effect on world interest rates, but a tax cut could make a world of difference to the allocation of world credit and the amount of investment, employment, and income in United States.

More Government Saving But
Less Personal Saving



Sources: Data from Bureau Of Economic Analysis (incorporating revised NIPA data); Chart based on Gary Robbins and Aldona Robbins, "Robbing Peter to Pay...Uncle Same?" Economic Scorecard, 2nd Quarter 1999, Institute for Policy Inovation, accessed at www.ipi.org.

Consider a recent example. In 1981, the United States cut taxes on labor and saving, and began to slash inflation from double digits to less than four percent in two years, reducing the tax rate on investment. In 1982, U.S. bank lending abroad was about $120 billion, annual rate. In 1984, U.S. bank lending abroad was about $20 billion, an 83% drop. Even with little rise in foreign lending to the United States, and only a modest increase in domestic saving, funds for domestic investment and government borrowing soared.

The economic literature is full of studies showing little impact of deficits on interest rates. A survey of the literature, plus testing of the relationship, can be found in *The Effect of Deficits on Prices of Financial Assets: Theory and Evidence*, by then-Assistant Secretary Manual Johnson (Office of the Assistant Secretary for Economic Policy, U.S. Treasury Department, March, 1984).

The supply of saving is very elastic, even in the short run, in an open economy. The effect of changes in the U.S. budget deficit or surplus on the world stock of debt and equity, and on interest rates, is negligible. We had this argument in the 1980s, and anyone who looked at the evidence instead of the newspaper commentaries knew the right answer. The United States is even more integrated into the world economy today than it was then.

Conclusion

Tax cuts are needed to correct the anti-saving, anti-investment bias in the tax code to allow the economy to reach its optimal level of output. The resulting rise in personal income and consumption would be significant. Tax cuts are also needed to offset recent tax increases due to rising real incomes, which are not sheltered by the inflation indexing provision in current law. The recent excellent growth in the economy has been sustained by falling rates of inflation, but that spur to growth cannot carry the expansion much further.

The recently-vetoed tax bill was not ideal. If anything, the tax cuts should have been larger, not smaller; they should have been phased in sooner, not later; they should not have been "sunsetted" nor subject to a "trigger".

A properly-designed tax reduction would do more for growth than paying down the national debt. Tax reform and reform of the nation's retirement arrangements, abetted by a significant reduction in taxes, should be our top fiscal priorities.

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