TAXES AND THE ECONOMY

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Mr. Co-chairmen and members of the Commission:

It is a pleasure to be with you today to discuss the budget and tax situations. In doing so, I shall try to relate my comments to the Commission's mandate to provide recommendations for reducing the budget deficit while promoting economic growth, saving, and capital formation. This qualifying charge, to promote growth, was given to the Commission by the Congress and the President. It should be taken very seriously.

I. Introduction: Issues Confronting the Commission

The National Economic Commission's mandate is to propose means for reducing the federal budget deficit and for fostering saving, capital formation, and economic growth. In response to this mandate, the NEC must determine whether significant reductions in the deficit can be achieved without raising taxes. If it concludes that tax increases are needed to achieve adequate deficit reduction, the NEC must then determine whether it can identify any tax increase that will not inflict more damage on the economy than that allegedly resulting from budget deficits.

One of the hardest things for any National Commission to do is to do less rather than more. In this instance, the Commission should work very hard indeed to recognize the progress that has already been made, and the limited job that remains to be done, in reducing the deficit to acceptable levels.

I believe that realistic projections of federal budget trends and outcomes urge that no tax increases are called for to achieve substantial deficit reductions, provided that our budget policy makers impose moderate restraints on the growth in total federal outlays. If it deems the prospects for constraining the expansion of federal spending to be so poor that a tax increase is needed to reduce the deficit, then the NEC should recognize that the economy's performance and growth will be impaired both by the expansion of the federal government's spending and by the additional taxes that would be raised to finance these additional outlays. If spending growth cannot be effectively limited, it is extremely unlikely that tax increases will, in fact, be applied to reducing the budget deficit; it is far more likely that additional tax revenues will be used to finance additional federal outlays.

I can think of virtually no tax increase that will not adversely affect private saving and capital formation, economic efficiency, and growth. No tax increase will result in any significant increase in national saving. No tax increase will reduce "crowding out." And realistically perceived, no tax increase will be restricted to deficit reduction. The reason to raise taxes, after all, is to finance more government spending, not less.

If, notwithstanding their adverse economic effects, taxes are to be increased, any such increase should satisfy a number of essential criteria. Merely raising taxes will not, in my judgment, serve very long to reduce the budget deficit. If budget deficits are to be reduced to acceptable levels and kept there, significant changes in the kinds of taxes we rely on to finance the federal government, not tax increases, will be needed. The federal tax system needs to be made far more effective than it now is in performing the basic function of a tax system -- to price out the government's activities. In my judgment, none of the tax increases that have been widely proposed would contribute to achieving this objective. Whether any of them would reduce the deficit in the short run is questionable; virtually all of them would surely contribute to faster expansion of the federal government in the long run.

II. The Budget Outlook in Real Terms

It is vitally important that the Commission look not at where the deficit is, but at where it is headed. It is equally urgent that the Commission look at the deficit in real terms, corrected for the distorting effects of inflation. The economically relevant real deficit is headed for virtual extinction under current law by 1993.

Looking Ahead

Are tax increases needed to achieve significant reductions in the federal budget deficit? The numbers indicate not. The projections of current services outlays and revenues in the midsession reviews by both the Office of Management and Budget and the Congressional Budget Office strongly urge that substantial progress in deficit reduction is likely to continue. CBO projects a deficit of $121 billion by FY-1993; OMB predicts $53 billion. Both reviews project the budget deficit falling below 2 percent of GNP in fiscal 1993; OMB, in fact, projects the budget deficit as well below 1 percent of GNP in that fiscal year. In both cases, the national debt would be growing more slowly than the economy, leading to a lower debt service burden on the budget over time. Neither set of projections includes any tax increases other than those specified in existing statutes; both include the increase in payroll taxes scheduled to occur in 1990. These projections are summarized in Tables 1 through 2.A.

Of particular interest is that both OMB and CBO project current services outlays growth over the projection periods at average annual rates well below 6 percent, 4.6 percent in the OMB projection and 5.6 percent in the CBO estimates.[1] These average expansion rates compare with 13.5 percent in the fiscal years 1973 through 1981 and 6.8 percent in the fiscal years 1982 through 1987. The lower rates projected for fiscal years 1989 and beyond are a testimonial to the efforts of the Administration and the Congress to curb the expansion of federal government activities. The fact that spending growth has been so sharply slowed demonstrates that, contrary to the conventional wisdom, changes in federal spending programs to reduce their size and growth are quite feasible.

Over 90% of the deficit now consists of net interest payments. If that were the entire deficit, we would be home free, as the economy normally grows faster than the net (after tax) interest rate. The cyclical element of the deficit is nearly zero. The non-interest structural (programmatic) portion of the Federal budget will swing into surplus by the end of calendar 1988 on a national income and product accounts basis. This is already true on a general government basis, counting state and local surpluses. At that point, the non-interest surpluses in the Federal budget will be eating into principal, and the economy will be growing out from under the debt at a rapid clip.

Looking at the Real Deficit

Inflation distorts the deficit. Everyone is familiar by now with the difference between the nominal and the real interest rate, and with the importance of making that distinction. It is just as legitimate, and just as important, to make the distinction between the real and nominal deficit and the real and nominal debt. An elegant, short paper on this important point prepared at the Federal Reserve Bank of Philadelphia is attached (Tab A). Let me explain it briefly.

At zero inflation, money borrowed must be repaid at full real value. With inflation, repayment is in devalued dollars. Lenders demand, and borrowers are willing to pay, a higher interest rate to compensate for the loss in value of the principal. This inflation premium is added on to the real interest rate to produce the nominal interest rate. Tax considerations aside (or putting the example on a net-of-tax basis), borrowing at 2% with zero inflation is identical to borrowing at 6% with 4% inflation. The real value of principal and interest over the life of the loan are the same in both cases.

The U.S. is a major borrower (as the Commission is acutely aware). Interest is a major element of the budget. Indeed, it about equals the budget deficit. That interest is about half

real and about half inflation premium. The half due to inflation is recorded on-budget just as any real expenditure. The current inflation of about 4% per year is reducing the real value of that portion of the national debt held by the public (about $1800 billion) by about $70 to $75 billion each year. This is a real capital gain (drop in liability) for the government, but it is not recorded anywhere in the budget, either "on" or "off". Yet these two items, the inflation premium on budget and the drop in the real value of outstanding debt not on budget, are a wash.

If inflation were reduced from 4% to zero, interest rates would fall from about 6% (after tax) to about 2%. As the debt rolled over, the on-budget interest outlay due to the inflation premium in the interest rate would fall to zero, and the nominal deficit would drop sharply. At the same time, the existing debt would cease to fall in value.

No one would complain about a budget deficit problem if inflation were zero, interest rates were 2% (all real), and the nominal deficit were zero. Yet, in real terms, this is identical to a situation of 4% inflation, 6% interest rates (2% real), and a nominal budget deficit of 4% times the existing publicly held national debt. In both cases, the real national debt held by the public would be unchanged from year to year, and the real deficit would be zero.

The following table compares three scenarios that are identical in real terms. It assumes a publicly held debt of $2500 billion (about what the U.S. will have in 1993); and inflation rates of zero, 2% (close to the OMB assumption), and 4% (close to the CBO assumption), and interest rates of 2%, 4% and 6% respectively. At zero inflation, real budget balance would require a zero nominal deficit. At 2% inflation, real budget balance would exist with a nominal deficit of $50 billion. At 4% inflation, a deficit of $100 billion would be a real balance; a zero nominal deficit would be a real surplus of $100 billion.

There is no economic reason to go beyond real budget balance. That is all the Commission should aim for. Under CBO assumptions, real budget balance would be achieved with a nominal deficit of roughly $100 billion in 1993, only about $20 billion below CBO's current services projection. With OMB's lower inflation and interest rate assumptions (not so different in real terms from CBO's), real budget balance would be achieved with a nominal deficit of about $50 billion in 1993, virtually at OMB's current services projection.

Real Budget Equivalents

(dollar amounts in billions)

Inflation rate	0%	2%	4%
Interest rate	2%	4%	6%
Debt, start of yr	$2500	$2500	$2500
Interest on debt	50	100	150
Real interest	50	50	50
Loss of value of debt to inflation	0	50	100
Debt, end of yr	2500	2550	2600
Real debt, end of yr	2500	2500	2500
Nominal deficit	0	50	100
Real deficit (= change in real debt)	0	0	0

Assume a budget in balance at zero inflation. Taxes cover outlays on government programs, plus real interest on the government debt (taxes $1150 billion, program outlays $1100 billion, interest covered by taxes $50 billion).

The above example is not substantially different from the current services baselines for 1993 published by OMB and CBO, summer, 1988, assuming debt were rolled over to adjust to the assumed inflation and interest rates. The OMB baseline is roughly equal to the 2% inflation example, CBO to the 4% case.

III. Impact of Recession

The deficit reductions projected by both OMB and CBO are widely challenged on the grounds that the continuing although slower economic growth over the projection period assumed by both organizations is unlikely, given the extraordinary length of the current expansion. Many have expressed concern that the optimistic current services forecasts could be derailed by a recession between now and 1993. A recession in the near future, it

is frequently maintained, would reduce current services revenues quite substantially while increasing current services outlays, thereby expanding the deficit and setting back efforts to reduce, if not eliminate, it.

In fact, however, quite plausible economic and budget scenarios strongly suggest that very substantial reductions in the deficit are attainable without tax increases, even in the face of a severe recession in the near future. While a cyclical deficit would temporarily boost the overall deficit, it would not have a lasting impact.

One such scenario posits a severe recession in the fiscal year 1989, as steep as that in fiscal 1982, followed by a brisk recovery in fiscal years 1990 and 1991 at a rate slightly faster than that following the earlier recession. This modestly more vigorous recovery is based on the assumption that, apart from the scheduled payroll tax hike, taxes would not be increased, in contrast with the very large tax increase -- the Tax Equity and Fiscal Responsibility Act of 1982 -- enacted just as the earlier recovery got under way and with the additional tax boosts enacted in 1983 through 1987. Sustained economic expansion at a much slower rate is assumed in fiscal years 1992 and following. Inflation at a rate of about 3.8 percent is assumed to persist throughout the period.[2] With no change in tax laws, tax revenues as a percentage of nominal GNP decline from 19.1 percent in fiscal 1988 to 18.7 percent in fiscal 1989, resulting in a decline in revenues of about $10 billion, despite the increase of $57 billion in nominal GNP. Tax revenues increase briskly in the recovery years and then more slowly; the ratio of federal budget receipts to GNP reaches 19.6 percent in 1992 and remains at that level through 1994.

Federal spending, measured in current prices, is projected in this scenario to increase by 6.6 percent in fiscal 1989, reflecting recession-generated increases in outlays. In the following fiscal years, spending is projected to grow at a steady rate of 6 percent. For the entire period, federal outlays are projected as growing at an average annual rate of 6.1 percent, significantly faster than the 5.6 percent and 4.6 percent average annual rates in the CBO and OMB baseline projections.

In this budget and economic scenario, the deficit soars to $235 billion in fiscal 1989, as a result of the impact of the recession on budget aggregates. In the ensuing years, however, the economic recovery and subsequent (slower) GNP expansion bring the deficit down, to $128 billion in fiscal 1994. In that year, the projected deficit represents 1.8 percent of GNP.

Although this deficit-to-GNP ratio may be deemed to be too high, it nevertheless represents continuation of the substantial progress of recent years both in reducing the deficit's magnitude

and its relationship to aggregate economic activity. This progress is particularly significant in that it occurs despite a severe recession in the near term and without any changes in the present tax structure. Moreover, the deficit reductions occur in the face of a faster rate of expansion of government spending than that projected in the CBO current services baseline. At the end of the projection period, the deficit in this scenario is only $7 billion greater than that projected by CBO (Tables 3 and 3.A.).

An alternative budget scenario assumes the same sharp recession and economic recovery with the same budget revenues that are are assumed in the preceding projections. In this alternative, however, budget outlays are projected to grow at a constant 5.6 percent rate after 1989. For the entire period, spending growth is slightly more rapid than in the CBO's baseline projections through 1984. The budget deficit results, however, are dramatically different. In 1994, under this scenario, the deficit falls to just over $100 billion, 1.4 of GNP in that year (Tables 4 and 4.A.).

With the 3.8 percent inflation rate assumed in this scenario, federal outlay growth in constant dollars is projected at an average rate of 2.2 percent per annum in the first of the 1989 recession scenarios and of 1.9 percent in the alternative. In the CBO baseline projections, constant dollar outlays increase by 2.7 percent in 1988 and at rates falling to 1.4 percent in 1994. The nominal and real spending growth rates projected in the recession scenarios are far faster rates of federal spending expansion than occurred in fiscal 1987, the last complete fiscal year, when nominal spending rose by 1.4 percent and real outlays fell by 0.7 percent. In short, although the spending growth rates in these recession scenarios are not exuberant, neither are the projected spending paths accurately perceived as niggardly (Tables 5 and 6).

The results of these economic and budget projections for the federal budget deficit are certainly acceptable in terms of any reasonable demands for deficit reduction. With moderate restraint on spending growth and no tax increases, very significant progress in reducing the federal budget deficit over the next several fiscal years is quite plausible, even if a severe recession were to overtake the economy in the near future.

If budget policy makers were to impose truly rigorous constraints on the expansion of federal outlays, the reduction in the federal budget deficit, indeed its total elimination, could be accomplished in very short order, without tax increases and even in the face of the same severe recession assumed in the preceding scenario. For example, if budget outlays in current dollars were permitted to increase no faster than the assumed inflation rate, that is, 3.8 percent a year, the deficit would

fall rapidly after a brief surge in the fiscal 1989 recession year. In fiscal 1992, under this projection, the deficit would be only $19 billion, 0.3 percent of GNP in that year. Two years later, assuming continued, moderate growth in GNP, the budget would be $58 billion in surplus (Table 7).

The zero growth in real outlays implied by constraining expansion of nominal spending to the inflation rate would assuredly require the exercise of a kind of budgetary discipline seldom seen in the United States in modern times. Unless entitlement programs were modified to reduce substantially the level of their growth path or their rate of growth, very significant reductions in the absolute amounts of other programs, not merely cutbacks from their projected current services levels, would have to be made.

In itself, this drastic pruning of the enormous array of federal spending programs is not implausible; it strains credulity to assert that every federal spending program and program element could be justified, relying on even the most genial cost-benefit test. There are enormous savings to be made by eliminating or reducing federal activities and programs that produce returns far less than the costs they impose on the nation. The problem in realizing these savings is the formidable difficulty even the most eager outlay-cutter would encounter in identifying these programs and in determining the extent to which they could and should be cut. One of the major sources of this difficulty is the effort by those in and out of government who have a stake in these activities and programs to protect them from cuts, indeed to expand them. Another source of difficulty is the lack of meaningful concepts of both benefits and costs of these programs and activities.

These difficulties have, of course, long been noted. Although no easy resolution of them has yet been discovered to be workable, this is certainly not to say that the task is hopeless. Perhaps the most important contribution the National Economic Commission could make to dealing with the problem of the budget deficit would be to produce practical guides for determining the worthiness of federal spending programs and activities to replace the long-standing ad hoc budgetary decision making.

The basic point of doing these exercises in budgetary arithmetic is to demonstrate that significant reductions in the federal budget deficit are attainable without tax increases, even in the face of recessionary economic developments. The key, of course, is budget policy makers' exercising restraint in their decisions about the composition and amount of federal government activities and spending.

This restraint is desirable in itself, irrespective of whether net budgetary outcomes are deficits, surpluses, or tidy

balances. When the perceived need to reduce the budget deficit confronts budget makers with the choice of spending restraint or tax increases or some combination of the two, the urgency in restraining spending growth is all the greater. Any tax increase will be injurious to the economy; a great many spending reductions will be economically beneficial. Disciplining federal spending decisions should be the highest priority objective of the National Economic Commission in addressing its mandate to recommend ways to reduce the federal budget deficit.

III. The Economic Effects of Tax Increases

Any proposal for raising taxes to reduce the deficit confronts the Commission's mandate to provide recommendations for promoting saving, investment, and economic growth. The argument on which such proposals are based is that properly designed tax increases will reduce consumption uses of private sector income and, by reducing the budget deficit, increase national saving, hence capital formation and economic growth. The argument mistakenly assumes that private saving is unaffected by a tax increase. In fact, virtually any feasible tax increase will reduce private saving far more severely than consumption, at least in the near term. Moreover, virtually all feasible tax increases will impair market efficiency by inducing less efficient use of our production capability than would otherwise be realized.

Every tax ever devised alters relative costs and prices and therefore induces households and businesses to use their income and the production capability at their disposal in ways that differ from the uses they would make of them in the absence of the taxes. Minimizing these distortions has long been recognized as the central economic objective of a constructive tax policy. Obviously, the lower the real marginal rate at which any tax is imposed, the less will be its distorting effects; by the same token, tax increases must accentuate distortions and additionally impair economic efficiency.

In the present federal tax structure, inherent, basic features of the income taxes impose a severe tax bias against saving and in favor of current consumption; the individual income tax also raises the cost of using one's time, skills, and resources in ways that produce taxable income streams compared to ways that produce nontaxed income. Payroll taxes have the same adverse effect in raising the cost of providing labor services compared with so-called "leisure." Excise taxes directly and explicitly raise the costs of production and/or prices of the taxed products, services, or activities relative to others. Unless one assumes that people are utterly unresponsive or perversely and irrationally responsive to these changes in relative costs and prices, the consequence necessarily is distortion of production and less saving and capital formation

than would otherwise occur. The higher is the amount of any one or all of these various taxes, the more severe are the distortions imposed on the economy's performance. Tax increases are injurious and should be assiduously avoided unless some more-than-offsetting gains can be identified.

As indicated, the offsetting gain that presumably is sought by raising taxes is an increase in national saving. If a tax increase is to achieve this result, it must somehow reduce private saving in an amount less than the increase in taxes (assuming, of course, that the additional tax revenues are dedicated to reducing the deficit rather than to financing additional government outlays). Neither economic analysis nor history support the contention that tax increases come out of consumption, rather than saving.

The largest component by far of gross national saving is gross business saving, consisting of retained corporate earnings and business capital consumption allowances. The direct, immediate effect of any increase in business taxes is to reduce business saving dollar for dollar with the tax increase. In addition, any such tax increase raises the cost of capital, hence the cost of saving and induces a reduction in the share of income that people commit to saving as opposed to current consumption. No increase in national saving can be achieved through any increase in business taxes. On the contrary, national saving will, in all likelihood, be reduced by increases in business taxes.

Much the same results are to be expected from increases in individual income taxes. Virtually all such increases will accentuate the income tax bias against saving and induce a decrease in the proportion of income that is saved, other things equal. Increases in real marginal income tax rates, irrespective of the way in which they are effected, also adversely affects the supply of labor services, resulting in higher unit labor costs and lower employment levels than would otherwise prevail. These tax increases raise the cost of increasing one's income-producing capacity and, therefore, lower the pace of productivity advance.

Increases in selective excises induce purchasers of the taxed products to change the composition of the consumption outlays, not to reduce the aggregate amount of consumption. They also result in cutbacks in output of the products subject to the higher tax rates, resulting in cuts in employment and labor income in the industries producing the products. Part of the additional excise tax revenue also is extracted from the payments for capital services committed to the taxed production. This raises the cost of capital in those industries and, in time, leads to higher capital costs in all parts of the economy, with a consequent reduction in saving and capital formation, along with

changes in the composition of the stock of capital and its industry allocation.

A broadly-based, uniformly applied value added tax of the consumption variety would not raise the cost of saving relative to the cost of consumption, but it would increase the cost of both in equal proportion. Whether one perceives the burden of the tax as resting on consumers or on those generating the value added, i.e., suppliers of labor and capital services, it should be obvious that the imposition of a VAT as an additional tax can not increase private saving but must reduce it, and at least in the short term, is likely to reduce that saving by much the same amount as the tax itself.

There is a substantial and growing economics literature attesting to the adverse effects of taxation on economic efficiency and on an economy's growth. There is also a substantial literature that shows that raising taxes has little if any positive effect on national saving. For example, a recent study, "The Impact of Government Deficits on Personal and National Saving Rates," by Darby, Gillingham, and Greenlees of the Office of Economic Policy, U.S. Treasury Department, found that, at least in the first several years, a rise in taxes and government saving is largely offset by a decline in private saving. By constrast, a cut in government spending primarily reduces national consumption and raises the national saving rate. A few years ago, I wrote a couple of short essays that reach the same conclusions. I have taken the liberty of attaching them to this statement. [3]

These conclusions about the adverse effects of taxation on saving, based on economic analysis, are supported by common sense observations and a look at the historical record. Consider the effect of an increase in individual income taxes. In the typical case, a substantial fraction of a household's expenditures are highly inflexible, at least in the short run. One cannot quickly reduce rent or mortgage payments or the service costs of other consumer indebtedness. It is, similarly, difficult quickly to alter patterns and levels of discretionary outlays, even those for which the household has no fixed commitments. The additional taxes reduce household saving dollar for dollar, at least until the necessary adjustments in consumption can be made. Even (mistakenly) ignoring the effects of individual tax increases in raising the cost of saving relative to consumption, therefore, the widespread institutional arrangements in the economy argue that individual tax increases erode saving to a far greater extent than consumption.

The historical evidence confirms that raising taxes reduces saving and by more than the tax increase. The income tax surcharge enacted in 1968 is a case in point. As a fraction of GNP, consumption went up during the surcharge years, while gross

private saving went down in relation to GNP. Had the saving rates in 1968-1970 remained at the same level as in 1967, gross private saving would have aggregated $47.6 billion more than the actual saving in those years. The loss in private saving was more than twice the roughly $23 billion in additional tax revenues produced by the income tax surcharge. The tax increase did not increase national saving; it reduced it. It didn't reduce "crowding out;" it increased it.

While tax increases will not raise national saving or reduce crowding out because of their adverse effect on private saving, neither will they reduce real crowding out -- the absorption of real resources by the government. No matter how it is financed, a government purchase of manpower, steel, concrete, or computers deprives the private sector of these resources and products. Government transfer payments almost invariably entail unintended and undesirable effects on the relative costs confronting the tranfer recipients; they very often discourage work effort and saving, hence capital formation and productivity advance. Government purchases of goods and service not only distort relative prices and costs, they also directly reduce the resources available to the private sector. Limiting these distortionary effects and preemption of resources available to the private sector is the compelling reason for imposing the greatest possible constraint on the expansion of federal outlays while avoiding tax increases in efforts to reduce federal budget deficits.

V. Attributes of a Tax that Prices Out Government Activities

If it were decided that tax increases are needed to reduce the deficit, notwithstanding the progress in deficit reduction that is likely in the absence of tax increases and the economic damage tax increases would do, the question confronting the NEC would be what tax increases should be recommended. It is to be hoped that the NEC will conclude that even more pressing than reducing the deficit is the need to introduce an effective discipline on government spending decisions in budget policy making. Federal finances will not long stay out of the red in the absence of something that confronts budget policy makers with the cost of increasing federal outlays. The basic need for enduring and significant budget policy reform is to move to reliance on a tax system that effectively prices out the activities of the federal government.

The attributes of a tax system that can effectively perform that function are simply summarized.

- Taxes must be imposed only on individuals. Corporations and other legal but not real persons do not pay taxes; only real, living human beings can pay taxes, whether in their capacity as sellers of productive services or

buyers of products and services. Taxes levied on corporations tend to escape perception by the individuals who will ultimately bear their burden.

o Taxes should be imposed on the broadest possible income base, allowing deductions only for the costs incurred by the individual in producing taxable income. In the interests of making the tax as nearly neutral as possible in its impact on the choice between current consumption and saving, there should be the broadest and most general possible exclusion of current saving and the most complete possible inclusion of all returns on saving.

o Taxes should be imposed at the lowest and flattest possible statutory rates, relying on a zero-rate bracket to afford whatever degree of progression in effective tax rates is deemed to be required. Marginal rate graduation is the equivalent of a system of increasing selective excises on income-producing, productivity-advancing activity. It is difficult to identify any meaningful objective of public policy that is served by this graduation.

o Taxes with the attributes just specified should be imposed on the largest possible number of people and in such a manner as to make each of them as aware as possible of his or her tax liability. The pricing out function can't be adequately performed if large numbers of individuals are excused from assuming tax liabilities or if they are unaware of the taxes they bear. Tax simplification achieved by removing millions of individuals from the tax rolls is directly at odds with achieving a tax system that will ensure the voting population's awareness of the burden that public spending imposes on them.

Virtually none of the tax-increase proposals that have been widely publicized can meet the tests of taxes that effectively serve to price out government activities, hence to constrain their growth. Proposals to increase corporate income tax liabilities, whether by rate increases, increases in alternative minimum taxes, limitations on capital recovery allowances, or what have you fail the test of adequately engaging the awareness of the individuals -- all of us -- who would ultimately bear the burden of these additional taxes. Such tax increases also raise the cost of capital and depress saving and capital formation compared to the levels that would otherwise be achieved.

Raising the income tax rate, or adding a higher tax rate, for upper-income individuals imposes the responsibility for defraying a larger part of the cost of government on a relative

handful of the population. Apart from the adverse effects of any such tax increase on saving and investment and on the productive, market-directed efforts of those bearing the additional taxes, this tax increase obviously would not inform the great mass of the population of the cost of government. Moreover, if deficit reduction is correctly seen as benefitting the economy as a whole, everyone should be called upon to contribute to that deficit reduction. Uncapping the wage and salary base for payroll tax purposes suffers the same serious deficiency and increases the relative cost of using some of the most productive labor and human capital resources in the country.

The same objections apply with respect to proposals to raise selective excises. Enhancing the distortionary impact of such taxes is bad public policy under the best of circumstances. Raising these taxes in order to reduce the budget deficit, presumably to the benefit of all of the economy's participants, in effects calls upon the producers and purchasers of the taxed products to pick up the chips for all of us.

There is much to be said on the grounds of tax neutrality and economic efficiency for substituting a value added tax for the income, payroll, and excise taxes in the present tax system. A value added tax, however, no matter the form in which it is levied nor the collection method it relies on, is not likely to meet the test of public awareness. As an additional tax, it suffers not only that disability but its adverse effects on the costs of saving, capital, and labor services, as well.

Only one sort of tax would reasonably satisfy the criteria spelled out above. That is a consumption-based income tax. The basic features of this tax have been spelled out in a number of books. Particularly useful, I believe, are the expositions in **Blueprints for Basic Tax Reform**, by David Bradford and the U.S. Treasury Department's Tax Policy staff and first published in early 1977, and **Consumption Taxes: Promises and Problems**, by Michael Schuyler of the Institute for Research on the Economics of Taxation. Moving to a tax of this kind as the mainstay of the federal revenue structure would pose difficult problems of transition, and post-transition compliance and enforcement difficulties. Its advantages with respect to the pricing out of government activities, however, warrant its receiving the very serious consideration of the NEC.

VI. Conclusions

There are now numerous and persuasive indications that the federal budget deficit is on a steeply downward course, particularly in relation to GNP, and that it will continue to decrease, without new taxes, even if a recession were to overtake the economy in the near term. It is fair to conclude, therefore, that

no tax increase is required to reduce the deficit to an acceptable level; this is certainly the case if we focus on the real -- inflation-adjusted -- deficit, as we should. The appropriate fiscal-budgetary prescription, insofar as the policy focus is on deficit reduction, is "steady as we go."

The NEC has been charged with producing recommendations for promoting saving, capital formation, and economic growth, as well as for reducing the federal budget deficit. Proposals to raise taxes, no matter the nature of the tax increase, would be in direct conflict with this part of the Commission's mandate.

Tax increases of any sort will impair the economy's efficiency by further distorting the market's price signals, hence the allocation of production resources and the uses of our incomes. Virtually any feasible tax increases will raise the cost of saving, irrespective of whether it also increases the cost of consumption. Virtually all feasible tax increases will increase the cost of labor as well as of capital services. Tax increases, no matter their form, should not be counted on to increase national saving by reducing the deficit more than they reduce private saving; to the extent that they do, we should question the desirability of socializing the saving function in our economy.

The real key to deficit reduction is limiting the rate of growth of federal spending and the expansion of federal government activities. If spending growth can continue to be constrained, as the midyear budget reviews project, tax increases will not be needed to bring deficits down very substantially. In real terms, indeed, the budget deficit would turn into budget surpluses in the relatively near future.

If spending growth cannot be or will not be constrained by our budget policy makers, tax increases should not be counted on to reduce the deficit. The unwillingness to limit spending growth urges that any additional tax revenues will be committed to financing more spending instead of to reducing the deficit.

Ironically, the continuing substantial deficit reductions might lead to acceleration in the growth of federal outlays. Giving Gramm-Rudman-Hollings its due, it nonetheless seems most likely that much of the achievement in limiting spending growth should be attributed to the embarrassment of the deficit -- the reluctance of budget policy makers to be tagged with responsibility for increasing spending more rapidly than revenues. As the deficit comes down, there is the hazard that its influence in constraining spending expansion will weaken.

I raise this only to give emphasis to what I believe the NEC should perceive to be its principal and most challenging assignment. The Commission's top priority task should be to recommend

means for subjecting federal government spending decisions to rigorous and meaningful economizing constraints, simulating the same sort of limitations that every household and business in the private sector necessarily confronts. To this end, what is needed are not proposales for tax increases but for revisions in the tax structure to make the cost of government more readily apparent to far more of the American population than is now the case.

[1] The differences between the OMB and CBO current services outlays and revenues primarily reflect differing assumptions about GNP growth rates, inflation rates, and interest rates.

[2] The Office of Management and Budget projects inflation rates, as measured by fourth quarter to fourth quarter changes in the GNP deflator, of 3.5 percent in 1988 and 3.7 percent in 1989, falling to 2.0 percent in 1993. The Congressional Budget Office projects year-over-year inflation rates of 3.0 percent in 1988, 4.2 percent in 1989, and 4.1 percent in ensuing years.

[3] Immodestly, let me also call the Commission's attention to my essay "Supply Side Analysis and Public Policy," in **Essays in Supply Side Economics**, David G. Raboy, Ed., Institute For Research on the Economics of Taxation and The Heritage Foundation, Washington D.C., 1982, for an exposition of the distorting relative price effects of taxation and government spending.

Table 1. GNP and Budget Projections, CBO Baseline, Fiscal Years 1988-1994

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4,769	908	1,063	155
1989	5,102	980	1,127	148
1990	5,440	1,064	1,200	136
1991	5,790	1,134	1,265	131
1992	6,165	1,202	1,329	126
1993	6,565	1,276	1,397	121
1994	6,992	1,354	1,475	121

Percent of GNP

1988	100.0	19.0	22.3	3.2
1989	100.0	19.2	22.1	2.9
1990	100.0	19.6	22.1	2.5
1991	100.0	19.6	21.8	2.3
1992	100.0	19.5	21.5	2.0
1993	100.0	19.4	21.3	1.8
1994	100.0	19.4	21.1	1.7

Source: Congressional Budget Office **The Economic and Budget Outlook: An Update**, August 1988.

Table 1.A GNP and Budget Aggregate Growth Rates, CBO Baseline Fiscal Years 1988-1994

Year	GNP	Revenues	Outlays	Deficit
1988	7.5	6.3	5.8	3.3
1989	7.0	7.9	6.0	-4.5
1990	6.6	8.6	6.5	-8.1
1991	6.4	6.6	5.4	-3.7
1992	6.5	6.0	5.1	-3.8
1993	6.5	6.2	5.1	-4.0
1994	6.5	6.1	5.6	0
1988-1994				
average	6.7	6.8	5.6	-3.1

Table 2. GNP and Budget Projections, OMB Baseline, Fiscal Years 1988-1993

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4710	913	1,065	152
1989	5039	973	1,106	133
1990	5394	1,053	1,164	111
1991	5755	1,131	1,224	94
1992	6106	1,192	1,272	80
1993	6447	1,263	1,316	53
		Perecent of GNP		
1988	100.0	19.4	22.6	3.2
1989	100.0	19.3	22.0	2.6
1990	100.0	19.5	21.6	2.1
1991	100.0	19.7	21.3	1.6
1992	100.0	19.5	20.8	1.3
1993	100.0	19.6	20.4	0.8

Source: Office of Management and Budget, **Mid Session Review of the 1989 Budget**, July 28, 1988.

Table 2.A. GNP and Budget Aggregate Growth Rates, OMB Baseline, Fiscal Years 1988-1993

Year	GNP	Revenues	Outlays	Deficit
1988	6.8	6.9	6.0	0.7
1989	7.0	6.6	3.9	-12.5
1990	7.0	8.2	5.2	-16.5
1991	6.7	7.4	5.2	-15.3
1992	6.1	5.4	3.9	-14.9
1993	5.6	6.0	3.5	-33.8
1988-1993				
Average	6.5	6.7	4.6	-16.0

Table 3. GNP and Budget Projections, Assuming 1989 Recession and Post-Recession Outlay Growth at 6 Percent Per Year

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4770	910	1065	155
1989	4827	900	1135	235
1990	5336	1030	1203	173
1991	5821	1137	1275	138
1992	6225	1217	1351	134
1993	6649	1301	1432	131
1994	7102	1390	1518	128
		Percent of GNP		
1988	100.0	19.1	22.3	3.3
1989	100.0	18.7	23.5	4.9
1990	100.0	19.3	22.5	3.2
1991	100.0	19.5	21.9	2.4
1992	100.0	19.6	21.7	2.2
1993	100.0	19.6	21.6	2.0
1994	100.0	19.6	21.4	1.8

Table 3.A. GNP and Budget Aggregate Growth Rates, Assuming 1989 Recession and Post-Recession Outlay Growth at 6 Percent Per Year

Year	GNP	Revenues	Outlays	Deficit
1988	7.5	6.6	6.0	2.7
1989	1.2	-1.1	6.6	51.6
1990	10.5	14.4	6.0	-26.4
1991	9.1	10.4	6.0	-20.2
1992	6.9	7.0	6.0	-2.9
1993	6.8	6.9	6.0	-2.2
1994	6.8	6.8	6.0	-2.3
1988-1994				
Average	7.0	7.2	6.1	-2.3

Table 4. GNP and Budget Projections, Assuming 1989 Recession and Post-Recession Outlay Growth of 5.6 Percent per Year

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4770	910	1065	155
1989	4827	900	1135	235
1990	5336	1030	1199	169
1991	5821	1137	1266	129
1992	6225	1217	1337	120
1993	6649	1301	1412	111
1994	7102	1390	1491	101
		Percent of GNP		
1988	100.0	19.1	22.3	3.3
1989	100.0	18.7	23.5	4.9
1990	100.0	19.3	22.5	3.2
1991	100.0	19.5	21.8	2.2
1992	100.0	19.6	21.5	1.9
1993	100.0	19.6	21.2	1.7
1994	100.0	19.6	21.0	1.4

Table 4.A. GNP and Budget Aggregate Growth Rates, Assuming 1989 Recession and Post-Recession Outlay Growth at 5.6 Percent Per Year

Year	GNP	Revenues	Outlays	Deficit
1988	7.5	6.6	6.0	2.7
1989	1.2	-1.1	6.6	51.6
1990	10.5	14.4	5.6	-28.1
1991	9.1	10.4	5.6	-23.7
1992	6.9	7.0	5.6	-7.0
1993	6.8	6.9	5.5	-7.5
1994	6.8	6.8	5.6	-9.0
1988-1994				
Average	7.0	7.2	5.8	-5.6

Table 5. Growth Rates of Federal Outlays in Constant 1987 Dollars in Alterative 1989 Recession Scenarios

Rates of Constant-Dollar Outlays Growth
Nominal Post-Recession Outlay Growths

Year	6 Percent	5.6 Percent
1988	2.1	2.1
1989	2.7	2.7
1990	2.1	1.7
1991	2.1	1.7
1992	2.1	1.7
1993	2.1	1.7
1994	2.1	1.7
1988-1994		
Average	2.2	1.9

Table 6. Growth Rates of Federal Outlays in Constant 1987 Dollars, CBO Baseline Projections

Year	Inflation Rate	Constant Dollar Outlay Growth
1988	3.0	2.9
1989	4.2	1.7
1990	4.1	2.3
1991	4.1	1.3
1992	4.1	1.0
1993	4.1	1.0
1994	4.1	1.4

Table 7. Budget Aggregates Projected with 1989 Recession and 3.8 Percent Outlay Growth

Billions of Dollars

Year	Revenues	Outlays	Deficit Amount	% of GNP
1988	910	1065	155	3.8
1989	900	1105	205	4.3
1990	1030	1147	117	2.2
1991	1137	1191	54	0.9
1992	1217	1236	19	0.3
1993	1301	1283	-18	-0.3
1994	1390	1332	-58	-0.8