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THE BUDGET DEFICIT, THE U.S. ECONOMY AND FEDERAL BUDGET POLICY

Statement by
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to the
Committee on Ways and Means
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Summary

o The principal budget policy challenge is to find and establish an effective economizing constraint on federal spending decision making to assure that federal programs warrant their costs.

o Deficit reduction is important because deficits misinform the public about the cost of government, make us believe those costs are less than they really are, and weaken our insistence on economizing in the public sector. Budget deficits have not impaired the economy's performance, and did not cause the trade deficit.

o Much progress has been made in reducing budget deficits, and the current services budget projections indicate that further reductions will be made, even without tax increases. Deficit reduction depends on slowing spending growth. Tax increases would be economically injurious and would far more likely be devoted to funding more spending that to reducing the deficit.

o The deficit is overstated by inflation. The target of a zero nominal deficit by 1993 is inappropriate if inflation continues. Measured in real rather than nominal terms, CBO baseline deficits decline from $91 billion in fiscal 1988 to $5 billion in fiscal 1994. Reasonable scenarios show that a severe recession would only temporarily set back deficit reduction progress, provided policy makers impose moderate constraints on spending growth.

o Excluding social security flows from budgetary calculations and from Gramm-Rudman-Hollings targets would do nothing to improve the position of social security beneficiaries, now or in the future. If such exclusion led to higher taxes to reduce the deficit, the adverse economic effects would impair rather than improve the economy's capacity to service social security obligations. Setting social security apart from the rest of the budget would misinform policy makers and all of us about the real impact of the government's fiscal operations.

o Any tax increase would have adverse effects on the economy's efficiency and growth. Even if used to reduce the budget deficit, tax increases would not increase national saving; private saving would be reduced instead.

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o The current account deficit equals the gap between national saving and investment. A tax increase would not close that gap except by reducing investment, growth and productivity gains, contrary to the stated purpose of deficit reduction. The only pro-growth means of reducing the budget deficit and the trade deficit simultaneously is to cut government purchases of goods and services.

o The "twin deficits" concept is a myth, with many counter examples around the world. Even among the Group of Five leading industrial countries one sees every possible permutation: the U.S. has a budget deficit and a trade deficit; Japan has a budget surplus and a trade surplus; Germany has a budget deficit and a trade surplus; Britain has a budget surplus and a trade deficit.

o To improve growth and productivity, we need to stimulate investment by taking every opportunity to reduce the cost of capital. The tax treatment of capital cost recovery, i.e., depreciation, should be improved. This will strengthen manufacturing and construction. It will not necessarily improve the trade balance. A country with a good investment climate attracts capital. If investment grows faster than saving, the current account would move further into deficit. To counter this tendency, we should encourage personal saving by reinstating and expanding IRA's, or by moving to a consumed income tax to end the income tax bias against saving.

o To improve budget policy, tax restructuring, not tax increases, is called for. The tax system should far more effectively than at present price out government activity. This calls for closely tying spending increases to anticipated revenue increases and for insuring that as many citizens as possible recognize that each of them must assume his or her share of the tax burden. These conditions are not met by many of the taxes and tax provisions in the present system.

o A number of specific budget process changes would move toward establishing more effective economizing constraints on budget decision making. These include:

-- Restatement of Gramm-Rudman-Hollings targets in real rather than nominal terms.

-- Revision of the Congressional budget procedure to require the Congress to set revenue targets for the fiscal year before taking up spending authorizations, with limitation of outlay increases to projected increases in revenues.

-- Requiring all programs and outlays to be on budget.

-- Revision of the budget accounting system to conform it as closely as possible with generally accepted accounting principals.

-- Measuring changes in budget outlays and revenues through time by reference to the preceding year's actual outlays, authorizations, and receipts; using current services budget quantities only to show the effect of proposed changes in authorizations or provisions in the law in the target fiscal year.

-- Making certain that, if a tax increase is enacted for deficit reduction, it is used only for that purpose, rather than to fund additional spending. To succeed, additional tax revenues should be impounded by requiring an equal increase in the Treasury's cash balance; the debt limit should be raised only by the amount of the previously projected deficit target less the tax increase so that added borrowing cannot cover increases in spending.

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Mr. Chairman, members of the Committee, I am pleased to have the opportunity to appear today to discuss with you the budget and tax policy issues confronting the Congress and the Nation. The views I express in this statement are my own and are not necessarily those of the Institute for Research on the Economics of Taxation, its board of directors, staff, or contributors.

Introduction: An Overview

As the Committee and the Congress, with the constructive cooperation of the Administration, begin efforts to frame the federal budget for fiscal 1990, they would do well to identify the challenges and issues to be faced in this undertaking. These far transcend mere questions of how much and in what specific ways to reduce the federal budget deficit in the coming fiscal year. Concern about the deficit has dominated fiscal, tax, and budget policies for many years past, too often to the neglect of other matters at least as urgent as deficit reduction. This Committee and others in the Congress have been at that work for several years now, and although substantial progress has been made, it clearly has not been adequate to eliminate deficit reduction as one of the most demanding items on the policy agenda. As I shall point out later in this discussion, the failure to accomplish greater reduction of the deficit is attributable in large part to the failure of both the Congress and the Administration to deal with the fundamental problems of budget policy.

I respectfully but strongly urge this Committee to begin its efforts by determining what are the major budget policy concerns it should address. Reducing the budget deficit to zero in some target year should not be seen as the principal budget policy challenge this Congress and the Administration face. Far more urgent is the need to identify and address much more fundamental issues of budget policy. In particular, it is essential to establish some more effective economizing constraints in budget policy making to assure that the uses to which the federal government's spending programs put the nation's production resources warrant the costs thereby imposed on us.

I do not mean to suggest that budget deficits should be of no concern to our public policy makers. At present, however, that concern is not well focused. It must be clear to all but those who refuse to see the world around them that the economic mischief commonly attributed to budget deficits hasn't materialized. The performance of the economy since late 1982 has exploded the unfounded notions that budget deficits generate inflation, raise interest rates, crowd out capital formation, and in other, generally unspecified ways undermine the economy and make it "fragile," whatever that term is supposed to mean when applied to so huge, so dynamic, and so complex an economy as that of the United States. If the growth record of the U.S. economy of the last several years and its current performance do not reflect economic strength, one will be very hard put to find a time when this economy has ever been strong.

The appropriate concern about budget deficits is much subtler but, I believe, much more urgent. That concern focuses on whether public policy decisions about what and how much government does reflect the informed willingness of the people to assume the costs of those activities. Deficits mask those costs; even worse, deficits mislead us about them. As a body politic, we can't effectively communicate our preferences to our elected public policy makers about what we want government to do if we are not acutely aware of what it will cost us to have government do it. Deficits let us believe that the cost is less than it really is. The disinformation effect of budget deficits makes us less intent on constraining our policy makers' proclivities to overspend.

We need to make further progress in reducing the deficit for this very reason. Since fiscal 1986 substantial progress has been made in reducing budget deficits, primarily as a result of the deceleration of the growth of federal spending. Realistic projections of federal budget trends and outcomes urge that progress is likely to continue, that continuing substantial reductions in the deficit can be achieved, with no tax increases, provided that our budget policy makers impose moderate restraints on the growth in total federal outlays. If Congress 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 it 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.

There is virtually no tax increase that will not adversely affect private saving and capital formation, economic efficiency, and growth. No significant increase in national saving will result from a tax increase. 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 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. 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.

The Budget Outlook in Real Terms

It is vitally important that the Congress look at where the deficit is headed, not merely where it is today nor where it has been. It is equally urgent that the Congress 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

The projections of current services outlays and revenues in the fiscal 1990 budget projections of the Office of Management and Budget and in the Congressional Budget Office's January 1989 **Economic and Budget Outlook** strongly urge that substantial progress in deficit reduction will continue. CBO projects the deficit slowly falling to $122 billion, 1.7 percent of GNP, in fiscal year 1994; OMB predicts a far steeper decline in the deficit to $8.7 billion in that year. In both cases, the national debt, measured in current dollars, 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 and 2.

Of particular interest is that both OMB and CBO project current services outlays growing over the projection periods at average annual rates well below 6 percent, 4.1 percent in the OMB projection and 5.7 percent in the CBO estimates.[1] These average expansion rates compare with 13.5 percent in the fiscal years 1973 through 1981 and 6.7 percent in the fiscal years 1982 through 1988. 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.

Examination of the major components of total federal outlays provides the basis for confidence that substantial continued progress in reducing the deficit without tax increases is not only feasible but likely. Net interest payments now represent over 90 percent of the deficit (net interest is the interest paid by the government less the taxes paid on the interest by those who receive it). Because net interest accounts for almost the entire deficit, almost all of the increase in the federal debt is accounted for by the amount of net interest. This is important, as it implies that the economy will grow faster than the debt, since the growth rate of GNP generally exceeds the net interest rate paid by the government.

The cyclical element of the deficit, the part that reflects the automatic increases in outlays and the loss of revenues due to the 1981-82 recession, is nearly zero. Measured on a national income and product accounts basis, the non-interest structural (programmatic) portion of the Federal budget will swing into surplus in fiscal 1990. That is, outlays on Federal programs other than interest will fall below revenues other than taxes on federal interest payments. At that point, the non-interest surpluses in the Federal budget will be subtracting from, rather than adding to, the deficit and the federal debt, reinforcing the tendency for the economy to outstrip the growth of debt due to net interest payments. The combined effect of these projected developments is that the deficit will continue to fall as a share of the GNP over time.

The Real Budget Outlook

Measured in constant dollars, rather than, as above, in current dollars, the deficit-reduction prospects, as projected by both OMB and CBO, are even brighter. Everyone has had enough experience with inflation to recognize the need for measuring economic and financial quantities in real terms, not merely in current dollars. Without adjusting for inflation, we get a distorted impression of economic magnitudes.

Everyone is familiar by now with the difference between nominal and real interest rates and with the effects of a change in the rate of inflation on the real value of outstanding debt and the interest paid on that debt. Regrettably, no adjustment to take account of inflation is made in measuring federal budget magnitudes or results. In assessing the magnitude of the deficit problem, however, it is essential to distinguish between the real and nominal deficit and the real and nominal debt. [2]

The nominal deficit in any year -- the excess of outlays over receipts -- is, by definition, also equal to the change in the nominal debt from the prior year. The **real** deficit, by the same token, is the change in the real value of the debt from one year to the next. The **real** value of the debt equals the real purchasing power that debt represents. If prices are rising, the increase in the debt measured in current dollars will overstate the rise in the real debt and overstate the real deficit. To put the reported, nominal deficit in real terms, one must adjust it for the effect of inflation on the outstanding nominal debt. This adjustment means subtracting from the nominal deficit an amount equal to the effect of inflation on the real value of the outstanding debt.

Suppose, for example, that at the beginning of a year the federal debt is, say, $2,500 billion and that during the course of the year budget outlays exceed budget receipts by $100 billion, measured in current prices. Suppose, moreover, budget receipts are just equal to program outlays, so that the $100 billion deficit just equals nominal interest, at 4 percent, on the debt. At the end of the year, the nominal debt is $2,600 billion. Suppose, however, that the overall level of prices at the end of the year is 2 percent above the level at the beginning of the year, such that each dollar only buys 98 percent as much as the year before. In this case, the real value of the debt at the end of the year, measured in terms of unchanged purchasing power, is $2,548 billion ($2,600x0.98 = $2,548). In real terms, the deficit is $48 billion. By the same token, the owners of the debt received $48 billion in interest in dollars of constant purchasing power, not $100 billion. From the $100 billion in nominal interest they must deduct the $52 billion decrease, due to inflation, in the real value of the debt they own.

With the current inflation rate of about 4 percent per year, the real value of that portion of the national debt held by the public (about $2,190 billion in fiscal 1989) may be expected to fall by about $90 billion in fiscal 1989 and by close to $120 billion in fiscal 1994, based on CBO baseline projections. This amount must be subtracted from the nominal year-over-year change in the national debt to find the real deficit for the year.

Making these adjustments, the real federal budget deficits, based on CBO baseline projections, decline from $91 billion in fiscal 1988 to $5 billion in fiscal 1994. These adjustments are shown in Table 3.

In dealing with deficit-reduction targets, the Congress should focus on real rather than nominal deficits. As long as inflation continues at rates significantly above zero, the goal should not be a zero deficit in current dollars, unless surpluses in real terms are deemed to be essential to achieve some meaningful policy objective.

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, in view of 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 1994. A recession, 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 recession would temporarily boost the deficit, it would not have a lasting impact.

In testimony to the National Economic Commission in September 1988, I presented several such scenarios. I'll be happy to submit for the record the portions of that testimony laying out those scenarios and their results, if the Committee wishes.

The central finding of the alternative scenarios is that the really effective key to deficit reduction is to moderate the growth in federal outlays. No drastic curtailment of overall spending is needed to achieve substantial deficit reduction, following the deficit surge that would result from the supposed recession. Even with spending growth rates noticeably more rapid than those in the CBO baseline projections, budget deficits fall in both absolute amount and as a fraction of GNP, with no tax increases other than those scheduled under present law.

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 a severe recession in the near term. Indeed, mindful of the admonition of focusing on real rather than nominal budget results, significant tax reductions would be possible without resulting in a real deficit. For example, if spending growth were prevented from exceeding the inflation rate, the nominal budget would move substantially into surplus in fiscal 1994. As before, no tax increases are assumed, and the pattern of recovery and of economic growth following the recession closely conform with actual experience following the 1981-1982 recession.

The zero growth in real total 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 just 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 neither implausible nor undesirable; 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. Many business and household decision makers often find it extremely difficult to exercise constraint on their spending, yet for the most part they find means for confining their outlays to amounts that their present and future resources can finance. Public decision makers should be able to do so, as well.

Restraining the growth of federal spending 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 Congress in addressing the federal budget deficit.

Accounting for Social Security

The Gramm-Rudman-Hollings deficit targets and the budget projections of the CBO and OMB are often criticized because they address the total budget, including the off-budget Social Security accounts (Old Age and Survivors Insurance and Disability Insurance, jointly referred to as OASDI). The usual argument is that by failing to isolate OASDI from the rest of the budget, the surpluses that are realized by the Social Security System are being used to finance other government activities rather than being saved to fund future retirees' annuities and other System benefits. It is indeed true that the excess of the current payroll tax receipts over System payments is used to finance other government programs; it is not true, however, that if this were not the case, these excess funds would be available to pay future benefits.

As the Committee knows, excess OASDI funds must, by law, be invested in federal government debt instruments issued for this purpose. This transaction involves crediting the trust fund with the federal bonds and adding the excess funds to the Treasury's cash balance. If these funds could not be used to pay for other expenses of the government, their impoundment in the Treasury's cash balance would reduce the nation's money stock, dollar for dollar. It would not add to the nation's total production resources. No additional capital, in any real sense, would be created to produce additional income that could be paid to OASDI beneficiaries.

Moreover, setting OASDI system flows apart from the rest of the budget would misinform budget policy makers and all of us about the real impact of the government's fiscal operations. These operations may be described on the spending side as the purchase of goods and services and transfer payments and on the receipts side primarily as taxes. The most significant way of analyzing the effects of these fiscal actions is in terms of their effects on relative costs and prices; accurately measuring the aggregate amount of these flows is also extremely important for evaluating the extent to which the nation's production and the income claims therein are directed or claimed by the government. Dropping OASDI flows out the budget reckoning would mislead and misinform the budget policy making-process.

The accident of a surplus in the OASDI accounts and a deficit in the rest of the budget is simply being used to argue for a tax increase to support additional spending. The apparent objective is to raise taxes to avoid deeper cuts in discretionary spending, that is, to spend more than GRH would otherwise permit, and to shelter Social Security from contributing to deficit reduction. This can be seen most clearly by considering the following question. If the total deficit were as currently projected, but OASDI were showing a rough balance into the future, while the on-budget accounts were showing a correspondingly lower deficit, would there be a cry to run a total budget surplus? It is highly unlikely.

The Economic Effects of Tax Increases

Any proposal for raising taxes to reduce the deficit confronts the need 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 would otherwise be saved, other things equal. Increases in real marginal income tax rates, irrespective of the way in which they are effected, also adversely affect 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 their consumption outlays, not necessarily 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 cannot increase private saving but must reduce it.

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 contrast, a cut in government spending primarily reduces national consumption and raises the national saving rate. A few years ago, I wrote two short essays that reach the same conclusions.[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.

Because of the adverse effect on private saving, tax increases will not raise national saving or reduce crowding out. Real crowding out is 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 purchases of goods and services not only directly reduce the resources available to the private sector, they also distort relative prices and costs. Government transfer payments almost invariably entail unintended and undesirable effects on the relative costs confronting the transfer recipients; they very often discourage work effort and saving, and hence retard capital formation and productivity advances. 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.

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 Congress would be what tax increases should be recommended. For the long run, 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.

In a very real sense, the most effective constraint on budget policy makers' spending decisions is the average citizen's perception of the out-of-pocket cost each such decision imposes on him. The effectiveness of this constraint clearly depends on establishing a close relationship, at least at the margin, between spending and taxing. Just as importantly, it depends on ensuring that the largest possible number of the citizenry recognize that each of them must assume his or her share of any such additional tax burden imposed by additional spending. 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:

o 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, correctly measured, 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 from the tax base of current saving and the most complete possible inclusion in the tax base 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 cannot 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 proposed tax increases that have been widely publicized can meet the test of effectively serving 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 whatever, 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 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 effect calls upon the producers and purchasers of the taxed products to pick up the check 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.

A tax that would reasonably satisfy the criteria spelled out above is a consumption-based income tax. The basic features of this tax have been spelled out in a number of books. Particularly useful are the expositions in **Blueprints for Basic Tax Reform**, by David Bradford and the U.S. Treasury Department's Tax Policy staff, 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 Congress.

Budget Process Changes

I recognize that undertaking a major restructuring of the federal tax system is not likely to be on the Congress's agenda in the very near term, however useful such a restructuring might prove to be in dealing with the basic budget policy issues. Let me offer a number of recommendations for budget policy and process changes of much less heroic proportions.

First, restate Gramm-Rudman-Hollings budget deficit targets in real rather than nominal terms, as discussed above.

Second, revise the Congressional budget process to require the Congress to set revenue targets for the fiscal year(s) for which the budget is to be adopted before taking up spending and outlay authorizations. Limit outlay increases to projected increases in revenues as targeted. The economizing process in households and businesses begins with projections of the resources that will be available; given such projections, one must set one's spending priorities, subject to the constraint that the total doesn't exceed one's resources. Congress could simulate this economizing in its budget making if it were to set revenue targets as limits on total outlays, before turning to spending authorizations.

Third, to improve the informational value of the budget and to improve decision making, all programs and outlays should be included on budget. It is essential to good budgeting to know the aggregate amount of the claims on resources, output, and income to be exerted and allocated by the government. Off-budget items are as relevant for budgeting purposes on this score as those now on budget. No government activity should be accounted for off budget.

Fourth, the budget accounting system should be revised to make it conform as closely as possible with generally accepted accounting principles. The present budget accounting system confuses balance sheet with income and expense statement accounts and transactions; it overlooks major categories of costs that the federal government's activities entail; it doesn't distinguish between investments and current expenses; and because it is essentially on a cash basis rather than an accrual basis, it fails to measure the liabilities that current actions create.

Fifth, insofar as budget decisions depend on measuring an outlay or receipt change through time, the Congress should use the preceding year's actual outlays, authorizations, and receipts as bench marks. Referring to current services or baseline amounts for the budget year to measure temporal changes as often as not transforms an actual year-over-year increase into an apparent reduction. This is purely and simply disinformation. Current service or baseline projections should be used as a measure of the effect in any given year of a proposed change in an authorization or provision of the law, as in "If we change the program authorization in the proposed way, outlays under the program will be such and so instead of the amount they would be under current provisions."

Finally, if a tax increase is deemed to be necessary, steps should be taken to insure that the additional taxes are used for deficit reduction, not to finance additional outlays. To implement this requirement, all additional revenues estimated to be provided by the tax increase should be impounded by requiring an increase in the Treasury's cash balance; in addition, the debt limit should be raised only by the amount of the projected deficit, taking the tax increase into account, so that added borrowing cannot cover increases in spending. Furthermore, no new off-budget financing or shifting of outlays off budget should be allowed.

None of these measures nor all of them together would solve the basic budget policy problem, but I believe that each of them would afford some improvement in the budget-making process.

The Balance of Payments

Much has been made of the supposed link between the budget deficit and the trade deficit. This is a serious misunderstanding based on a simplistic accounting identity in the national accounts. It is in no way reflective of real world behavior.

The current account (balance of payments) deficit equals the gap between national saving (private saving plus government saving) and national investment. Some have claimed that any steps taken to reduce the budget deficit will increase national saving and reduce the trade deficit. (See the top line of chart 1, labeled "myth".) This argument makes a long series of errors or unsubstantiated assumptions.

First, the budget deficit in this equation does not include transfer payments, just government purchases of goods and services. Second, it matters very much whether spending is cut or taxes are raised. If government cuts spending and takes less of the country's real labor, capital, goods and services, there is more for export or for replacing imports, and more real resources for producing plant, equipment and structures. Tax increases do not reduce government's use of real resources, quite the contrary. Third, Congress is bound to spend some portion of a tax increase, and, since a tax increase weakens the economy, some of the projected revenue increase will be lost. Thus, the deficit will never fall by the full amount of a tax hike. Fourth, tax increases reduce private saving, leaving national saving unchanged, and discourage investment directly by reducing its after tax return. Advocates of the "twin deficit" myth assume, incorrectly, that private saving and investment are insensitive to tax changes. (See Chart 1, lines labeled "reality".)

Even if a tax increase were to improve national saving, contrary to historical experience, it cannot, as its advocates claim, simultaneously improve national saving and investment dollar for dollar, and improve the trade deficit dollar for dollar. In fact the most likely outcome of a tax increase is to raise government spending and cut national saving by weakening the economy. Investment is sure to fall. The only way a tax increase could improve the trade balance is to reduce investment by more than saving, with adverse consequences for growth and productivity, contrary to the announced goal of deficit reduction. A government spending cut is the only way to improve the trade balance and the rate of investment at the same time.

Around the world, one may find examples of major nations with budget surpluses and trade deficits, trade surpluses and budget deficits, and deficits of both types. Even among the Group of Five leading industrial nations, examples of every permutation can be found: the U.S. has a budget deficit and a trade deficit; Japan has a budget surplus and a trade surplus; Germany has a budget deficit and a trade surplus; Britain has a budget surplus and a trade deficit. It is clearly the case that the simplistic juxtaposition of the U.S. trade and budget deficits proves nothing.

Conclusions

There are now numerous and persuasive indications that the federal budget deficit is on a steady 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."

As Congress considers the budget issue, it should bear in mind that proposals to raise taxes, no matter the nature of the tax increase, would be in direct conflict with numerous public policy objectives that it -- the Congress -- has formulated and endorsed. Foremost among these is that public policies should contribute to, not impede, the economy's economic progress, advance in efficiency, and increase in productivity and living standards. As a corollary, public policies should contribute to, not impede, American businesses' more effective participation in the ever-increasingly integrated world economy.

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 current budget projections show, 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.

The Congress's top priority task should be to adopt 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 proposals 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.

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

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4,780	909	1,064	155
1989	5,122	983	1,138	155
1990	5,454	1,069	1,209	141
1991	5,812	1,140	1,280	140
1992	6,184	1,209	1,344	135
1993	6,581	1,280	1,410	129
1994	7,006	1,359	1,480	122

Percent of GNP

Year	GNP	Revenues	Outlays	Deficit
1988	100.0	19.0	22.3	3.2
1989	100.0	19.2	22.2	3.0
1990	100.0	19.6	22.2	2.6
1991	100.0	19.6	22.0	2.4
1992	100.0	19.5	21.7	2.2
1993	100.0	19.5	21.4	2.0
1994	100.0	19.4	21.1	1.7

Growth Rates

Year	GNP	Revenues	Outlays	Deficit
1988	7.7	6.4	6.0	3.3
1989	7.2	8.1	7.0	0.0
1990	6.5	8.7	6.2	-9.0
1991	6.6	6.6	5.9	-0.7
1992	6.4	6.1	5.0	-3.6
1993	6.4	5.9	4.9	-4.4
1994	6.5	6.2	5.0	-5.4
1988-1994 average	6.5	6.9	5.7	-2.8

Source: Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1990-1994, January 24, 1989. Details may not add due to rounding.

Table 2. GNP and Budget Projections, OMB Baseline, Fiscal Years 1988-1994

Billions of Dollars

Year	GNP	Revenues	Outlays	Deficit
1988	4,780	909	1,064	155
1989	5,120	976	1,136	160
1990	5,476	1,058	1,185	127
1991	5,848	1,137	1,238	102
1992	6,208	1,209	1,278	70
1993	6,555	1,278	1,315	37
1994	6,888	1,342	1,350	9

Percent of GNP

Year	GNP	Revenues	Outlays	Deficit
1988	100.0	19.0	22.3	3.2
1989	100.0	19.1	22.2	3.1
1990	100.0	19.3	21.6	2.3
1991	100.0	19.4	21.2	1.7
1992	100.0	19.5	20.6	1.1
1993	100.0	19.5	20.1	0.6
1994	100.0	19.5	19.6	0.1

Growth Rates

Year	GNP	Revenues	Outlays	Deficit
1988	7.7	6.4	6.0	3.3
1989	7.1	7.4	6.8	3.2
1990	7.0	8.4	4.3	-20.6
1991	6.8	7.5	4.5	-19.7
1992	6.2	6.3	3.2	-31.4
1993	5.6	5.7	2.9	-47.1
1994	5.1	5.0	2.7	-75.7
1988-1994 Average	6.5	6.7	4.3	-26.9

Source: Office of Management and Budget, Budget of the United States Government, Fiscal Year 1990, January 9, 1989. Details may not add due to rounding.

Table 3. Real Federal Budget Deficit in the CBO Baseline (billions of dollars, except as noted)

Fiscal Years:	1988	1989	1990	1991	1992	1993	1994
Federal deficit	155	155	141	140	135	129	122
GNP deflator (%)	3.1	4.2	4.1	4.3	4.1	4.1	4.1
Debt held by public (incl. Federal Reserve)	2050	2190	2331	2469	2603	2732	2853
Inflation impact on debt (debt x deflator)	64	92	96	106	107	112	117
Real Federal deficit (deficit less inflation impact)	91	63	45	34	28	17	5

Source: Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1990-1994, January 24, 1989.

[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] An elegant, short paper on this important point, prepared at the Federal Reserve Bank of Philadelphia, is **Federal Deficits: A Faulty Gauge of Government's Impact on Financial Markets**, by Dr. Brian Horrigan and Dr. Aris Protopapadakis.

[3] See Norman B. Ture, "Dealing With The Deficit: Are Tax Increases The Answer?", IRET **Economic Report** No. 19, August 15, 1983, and "A Little More On Crowding Out", IRET **Economic Policy Bulletin**, No. 11, September 12, 1983. Also see Norman B. Ture, "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.