# BUDGET AND TAX POLICY FOR 1992 AND BEYOND

Statement by
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Mr. Chairman, Members of the Committee, I am pleased to have the opportunity to appear today to discuss with you some of the topics of present concern to the Committee. The views I shall express are my own, not necessarily those of the Institute for Research on the Economics of Taxation, its board of directors, or its contributors. My statement deals with the current state and prospects of the economy, President Bush's fiscal 1992 budget proposals, and ongoing tax and budget policy issues.

## CURRENT AND PROSPECTIVE ECONOMIC CONDITIONS

The 1990-91 recession, I believe, will soon be coming to a close. Many of the concurrent indicators of aggregate economic performance continue to decline, but the rate of decline appears to be slowing, suggesting that for most of the economy, recessionary forces are materially weakening.

The sources of this recession are to be found in an unfortunate concurrence of natural economic developments and mistaken public policies. There is a widely held, but I believe erroneous, view among economists that economic fluctuations are solely the products of government policy changes, and that left to its own devices, a market-driven economy would remain on a smooth expansion path. My view, in contrast, is that absent government intervention, the economy's progress through time is likely to be less than perfectly stable, with periods of accelerating and decelerating output growth representing the customary rather than the exceptional experience.

Periods of economic expansion are impelled principally by substantial increases in business and household outlays for capital facilities and consumer durables, respectively. Growth in population and households, technological advances, and depreciation of existing facilities generate efforts to replace and expand the stocks of these facilities. Because some of these additions, particularly business purchases, can't be taken off the shelf, there is likely to be an extended period during which such outlays continue to grow. This part of the expansion is followed by materially slower growth in the output and purchases of business and household capital facilities, as stocks approach desired levels. The significant slowing of these major outputs, in turn, results in a marked slowing in the growth of incomes; the deceleration in output and income growth sometimes is sharp enough to produce negative growth rates, i.e., recession. The slowing rate of economic expansion or actual downturn in total economic activity persists until businesses and households once more undertake to replace, modernize, and expand stocks of capital. This adjustment initiates recovery and expansion. The cycle repeats, although the intensity and duration of its phases tend to vary.

These variations in growth rates are often magnified, rather than dampened by, public policy developments. Public policy developments may, of course, have either a wholesome or a deleterious effect on the nation's economic performance. It is regrettable that many of the most important public policy developments during the past several years have exerted a significant negative influence on the economy.

The 1980s provide a good example of this hypothesis. The recession of 1981-82 was initiated by the slowdown and decline in production and purchases of household durable, residential fixed investment, and nonresidential fixed investment in the late 1970s and 1980. These real developments were accentuated by the extremely rapid rates of expansion of the monetary aggregates in the late 1970s and the resulting sharp increases in the inflation rate and in interest rates. The recovery from the 1981-82 recession although sharper than that of any other postwar recoveries, was led, as usual, by upturns in the production and purchases of consumer durables, residential fixed investment, and business production facilities, primarily equipment. This recovery and the subsequent prolonged expansion were materially strengthened by the individual rate reductions, the capital recovery provisions, and a number of other important provisions in the Economic Recovery Tax Act of 1981 (ERTA). The ensuing expansion, longer than any other during the postwar years in which the United States was not engaged in prolonged, major military action, closely followed the pattern of the earlier expansions.

Even without any untoward policy changes, it was to be expected that the expansion of the 1980s would run out of steam and might give way to recession. In fact, a number of major policy developments contributed substantially to bringing the expansion to an end and to the ensuing recession we are now suffering.

Tax policy developments, beginning with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), have exerted significantly adverse influences on the economy. TEFRA offset a substantial part of the capital-cost reduction afforded by ERTA. The following year's social security legislation, increasing rates and the taxable wage base over an extended period of years, contributed substantially to increasing the cost of labor services. Additional tax increases of varying magnitude were enacted in every year, including last year's -- the second largest ever.

The Tax Reform Act of 1986 (TRA86) is scored officially as a revenue loser, but many of its provisions exerted a significant recessionary influence. The changes in the Accelerated Cost Recovery System, particularly as applied to real property, the elimination of the deduction of 60 percent of net long-term capital gains, and the limitation on the deduction of so-called passive investment losses had a seriously adverse impact on activity in real estate and caused a substantial drop in real property values. The drop in the real estate market, in turn, added to the woes of thrift and other institutions whose investment portfolios included significant amounts of mortgage assets. The too-hasty, poorly managed liquidation of the assets of failed or failing financial institutions exacerbated the difficulties in the real estate market, with seriously adverse feedbacks for new housing sales and construction, as well as for other types of real property. These developments in the real estate, finance, and construction markets, attributable in significant part to provisions in TRA86, were a major recessionary force.

The phased-in elimination of the deductibility of consumer interest, enacted in TRA86, has exerted an adverse influence on purchases and production of consumer durables, under downward pressure in any event from the contraction in home building and real estate. Numerous other provisions of TRA86 exerted upward pressure on the cost of capital, often substantial enough to outweigh the beneficial effects of the personal and corporate rate reductions. The corporate alternative minimum tax provisions, for example, are properly characterized as imposing a punitive selective excise tax on business growth.

More generally, the revenue-raising provisions in TRA86 had the effect of increasing the costs of operations for many businesses. In many of those cases, these cost increases outweighed the cost-reducing effect of the corporate rate reduction. The response to these cost increases are not necessarily immediate; they tend, instead, to cumulate over time, in this case to a level sufficiently great to exert a significant contractionary influence on major sectors of the economy.

Other public policy developments during the last several years also contributed to the recession. The Savings and Loan rescue legislation, particularly the more stringent capital requirements, substitutes regulatory oversight for market discipline of financial institutions' lending policies and financial structures. The response by many financial institutions has been to limit credit extension, to the point at which many businesses, particularly small firms, have not had access to financial resources adequate to support their operations at prior levels, let alone to allow for growth. The Clean Air Act, the Americans with Disabilities Act, the increase in the minimum wage -- all exert upward pressures on business costs, thereby checking the increase in production activity and, indeed, contributing to contraction.

Fortunately, the U.S. economy is so diversified and so resilient that these adverse influences tend to be assimilated and to impel adjustments that allow the resumption of economic growth. I believe that the economy has already adjusted to much of the negative public policy influences of the past eight or nine years, and that expansion of economic activity will get underway, perhaps this summer.

This does not mean that policy makers should be unconcerned about the adverse influences mistaken policies exert on the economy. For the most part, unless these policy developments are subsequently reversed, the growth paths of GNP, employment, the stock of capital, etc., are lower than they otherwise would be, even though the rates of growth along those lower paths may be much the same as otherwise. Many of the most important public economic policy developments of recent years have erected steep barriers to achieving the economic progress that otherwise would be realized.

## BUDGET POLICY

The word "policy" seems to be completely out of place as addressed to the federal budget. Policy involves meaningful goals and plans for their attainment, subject to recognized constraints. It is difficult to think of federal budgets, of the sort we have been familiar with for many years past, as the products of deliberate policies.

If federal budgets were the outcomes of policy, they would be designed in clear recognition of the fact that all government outlays impose costs. Government purchases of goods and service entail the direct preemption of some of the economy's production capabilities or output. The volume and composition of government purchases, in and of themselves, distort the relationships among prices that would otherwise prevail and tend to raise the cost of using production inputs throughout the private sector. Government transfer payments involve the costs of the resources used to manage the transfers. Even more important, many transfer payment programs tend to create disincentives for productive uses of the transferees' time and resources. Constructing a budget in a policy framework, therefore, would require weighing the benefits of the various programs and activities that government might undertake against the real costs these activities would impose.

There is scant evidence, if any, that the budget proposed by the President for fiscal years 1992 and beyond is the product of budget policy. It is, instead, principally the product of last year's Omnibus Budget Reconciliation Act (OBRA90). As such, it contains both good and bad features.

One of the bad features is that it incorporates OBRA90's fiscal 1991 spending levels, rather than proposing any substantial cutbacks. On a total policy budget basis, including off-budget as well as on-budget items, fiscal 1991 outlays are estimated at $1.410 trillion, $158 billion or 12.6 percent more than fiscal 1990's total outlays. Fiscal 1990 was not a year of budget parsimony either; outlays that year were $107.6 billion or 9.4 percent greater than those in 1989. In the two fiscal years 1990-1991, therefore, total federal outlays will have risen by $266 billion, or by more than 23 percent. Increases in outlays of these magnitudes would be difficult to justify under any circumstances. In the face of a concern about prospective federal budget deficits so great as to impel the Congress to enact the second largest tax increase in our history, these spending increases are unconscionable.

To be sure, the President's budget calls for much more modest increases in budget outlays in fiscal 1992 and beyond. From fiscal 1991 through fiscal 1996, the average annual rate of increase in projected budget outlays is only 1.8 percent. Even more impressive, the average annual rate of increase of projected spending, in constant 1982 dollars, is -1.94 percent. Achieving that result would be an extremely welcome change in federal spending trends.

These outlay projections, however, reflect OBRA90's spending caps rather than carefully delineated legislative proposals for changing the content of the various spending programs in order to reduce the outlays the programs call for. In the past, sharp increases in spending in a fiscal year have had the effect of raising the baseline for subsequent spending decisions. The very substantial spending increases in fiscal years 1990 and 1991 raise serious doubts about the sturdiness of the spending caps for the out years. Nothing in OBRA90 or in the President's 1992 budget proposals affords a guarantee that the Congress will maintain the spending caps. If the huge step up in outlays in fiscal years 1990 and 1991 becomes the take-off platform for federal spending in future years, there is cause for serious concern whether the federal government's demands on the economy's resources can ever be satisfied.

Something much more substantial than spending caps is required for true budget process reform and for the introduction of at least the rudiments of a budget policy. A giant step in that direction would be taken by adoption of H.R. 298, introduced by Congressman Chris Cox with well over 100 cosigners. Adoption of the Cox proposal would greatly simplify and expedite the budget-making process, avoiding the embarrassing displays of seeming legislative impotence and confusion of recent years. Even more significant, it would require the Congress to make choices about the relative importance of the principal categories of federal spending programs and to forgo micromanagement of spending programs. I suggest that close attention to H.R. 298 will provide the basis for truly constructive budget process reform.

Another very bad feature of OBRA90 that the President's budget endorses is the pay-as-you-go provision (paygo). Briefly, paygo requires that any increase in spending for non-exempt entitlement programs must be offset by revenue increases in equal amount; any legislated reduction in tax revenues must be offset either by equal reductions in non-exempt entitlement outlays or by offsetting revenue increases. Note, please, that paygo does not apply with respect to other spending, ostensibly because increases in other spending is to constrained by the OBRA90 caps. If those caps are raised, Congress may enact increases in spending other than on non-exempt entitlements without confronting the requirement for asking the public to pay more taxes. In other words, Congress can't vote for lower taxes without either cutting the politically best-loved spending programs or sticking some taxpayers with an offsetting tax increase. On the other hand, unless the caps prove to be better nailed down than anyone believes, Congress can vote to increase other spending without having to ask the voters for more taxes to fund the additional outlays. It would be difficult, I believe, to come up with a better prescription for atrocious budget making.

The caps do have the virtue of requiring policy makers to examine priorities more carefully. An important set of considerations to which, I suggest, Congressional policy makers pay close attention is the implications of their spending decisions for the costs of operations of businesses and households in the private sector. As suggested earlier, virtually all government spending entails imposing costs on the private sector, but the extent of these costs, as well as of benefits, is likely to vary from program to program. Setting priorities among government outlays should be guided by whether these decisions will increase private sector costs, hence raise additional barriers to growth in employment, output, and income.

## TAX POLICY

The word "policy" is as inappropriately used in the case of federal taxation developments as it is in talking about the federal budget. Tax policy should identify the basic objectives of the tax system, the attributes of a tax structure aimed at achieving those objectives, and the criteria the tax structure must satisfy to be suitable and acceptable to the body politic. In this context, policy makers should subject existing taxes and tax provisions to the most exacting scrutiny, seek out the elements of the system that don't measure up, and replace them with provisions that more nearly do so.

It has been a very long time indeed since federal tax legislation has conformed with constructive tax policy requirements. Since 1981, tax legislation has been virtually single-minded in its pursuit of additional revenue. In the process, lip service has been given to some fundamental principles of taxation, but these have been honored only in the breach. The result is, I believe, a tax system that does not serve the basic objective of taxation in a free society, that violates the long-standing canons of taxation, that is an antique in the emerging world economic scene, and is in more urgent need of constructive reform that at any time in our memory.

It is obvious that policy makers in neither the Administration nor the Congress agree with this assessment. Last year's tax legislation, enacted in OBRA90 with the Administration's urgent blessing, violates virtually every principle of good tax policy. This year's tax proposals in the President's budget are little more than a coy wink in the direction of constructive tax revisions. Some House and Senate members have proposed modest packages of tax changes, some of which would indeed move in the right direction, but in virtually every case the design of these packages has been constrained by paygo's requirement for "revenue neutrality," one of the most inane prescriptions ever devised for guiding tax legislation.

Let me impose on the Committee a brief recapitulation of what I believe to be the core function, the attributes, and the criteria of the kind of tax system this nation needs.

The core function of taxes in a free society is to cost out its government activities. Taxes should inform the public and the people the public chooses to represent them in government about what must be paid for what they ask government to do. Taxes should function as the prices people pay for government.

If people are to make efficient decisions about what they want government to do, they must know the cost of government activities. This cost is approximated if government outlays are fully financed by taxes. Financing government by borrowing hides the cost of government from the public until at some later time, if ever, additional taxes are imposed to service the debt.

To perform this core function efficiently, a tax system requires two attributes. One, taxes must be imposed only on individuals. Taxes on corporations tend to escape perception by the individuals who ultimately pay corporate taxes and bear their burden. Two, taxes should be imposed on the largest possible number of people and in such a way as to make each of them as acutely aware as possible of his or her tax liability. If large numbers of persons are excused from paying taxes or if they are unaware of the taxes they bear, they will underestimate the cost of the things they want from government and they'll want more than they would be willing to pay for.

Taxes should also meet certain fundamental criteria -- the long-standing canons of taxation. The most demanding of these criteria is equity or fairness. It is also the most elusive because its application confronts enormous ambiguities of concept and measurement. The customary articulation of the equity criterion is that persons in the same circumstances should pay the same amount of taxes. The problem is how to identify the circumstances that are relevant for this purpose. The standard answer is that income is the best measure of circumstance, but this merely finesses the problem, as the enormous size and complexity of the provisions in the Internal Revenue Code that seek to delineate taxable income clearly shows.

The equity issue criterion is even more difficult to come to grips with when circumstances differ among taxpayers. How much more tax higher income persons should pay than persons with less income is a question that defies resolution on objective grounds. Dealing with it is a continuing enticement for demagoguery.

I think tax policy makers would do well to shift their focus from equity to uniformity. The objective of uniformity is to provide similar tax treatment for similar economic actions and transactions, rather than focusing on attributes of individuals as taxpayers. The present income tax is rife with tax differentials, a great many of which have the effect of raising the cost of private saving and investment compared to what it otherwise would be. Greater emphasis on uniformity in tax legislation would, I believe, reduce the anti-saving bias in the existing income tax, as well as other tax obstacles to the efficient conduct of economic affairs.

Simplicity is another criterion of taxation to which much lip service is given while it becomes every day more remote. I take simplicity to mean that the tax statutes and regulations are readily understood by most, if not every, taxpayer. As a consequence, neither taxpayers nor enforcement and administration agencies need to commit significant amounts of resources to complying with or administering and enforcing the laws and regulations. The measure of tax simplicity is the size of the Internal Revenue Service and the revenues of private tax practitioners. By these tests, clearly, tax simplicity becomes dimmer and dimmer on the policy horizon.

It may be that the only way to simplify the income tax is to shift the focus from the particulars of each taxpayer's situation and toward broad and general rules that would cover most broadly classified economic behavior and transactions. This route to simplification clearly would be in line with the proposed shift toward uniformity in lieu of the will o' the wisp equity criterion.

Revenue adequacy is another important criterion of taxation. Conventionally defined, revenue adequacy means that the tax system should be able to raise the amount of money needed to defray the costs of government. This concept implies that the amount and composition of government activities should be determined without reference to their costs, presumably on the basis of policy makers' judgments about "needs," in some absolute sense. Instead, taxes should inform the public about what they must pay for differing amount of various government activities so that policy makers' decisions about how much government should spend on what are constrained by the willingness of taxpayers to pay for those activities. Revenue adequacy isn't a matter of raising revenues equal to predetermined government outlays but of assuring that taxes are an effective input in decisions about spending.

A final criterion, little understood but enormously important, is neutrality. Tax neutrality means that taxes would not alter any of the cost or price relationships that would prevail in an efficiently functioning private market, free of influence from government. No tax ever devised has been perfectly neutral. Every tax raises the cost of something relative to the costs of other things; every tax, in other words, has an excise effect. In an operational sense, neutrality calls for minimizing these relative cost and price distorting, i.e., excise, effects of taxes. Unfortunately, the present U.S. tax system, particularly the income tax, violates the equity criterion virtually on a wholesale basis.

The present federal tax system poorly, at best, performs the basic function of a free society's taxes. It sorely lacks the attributes of a tax system that might perform that function efficiently. It violates every one of the established criteria of good tax policy. It screams for reform.

Bad as the present system is, I almost hesitate to urge that the Congress undertake to reform it. The last such effort should give anyone pause. Indeed, the only redeeming virtue of TRA86 was the reduction in individual and corporate tax rates, a truly constructive achievement. Rate reduction in itself is a major reform. Moreover, the lower are the tax rates, the less distorting are the excise effects of base provisions that are at odds with the neutrality criterion requirements.

The base broadening provisions enacted to pay for the revenue lost by rate reductions and the increases in the personal exemptions and standard deductions, under the requirements of revenue neutrality, however, exacted a terrible price. With few, if any exceptions, TRA86's base broadeners violated the neutrality criterion. By transferring a huge fraction of total income tax liabilities from individuals to corporations, TRA86 further obscured the aggregate tax load and eroded the capacity of the tax system to inform the public about the cost of government. Except for the several million individuals excused from paying the income tax by the increases in the personal exemption and the standard deduction, virtually every taxpayer found the tax laws more of a nightmare of complexity than before; costs of compliance and of administration and enforcement have escalated dramatically. Uniformity of tax treatment was completely disregarded and in case after case additional differentiation of tax treatment was enacted. Little wonder that most persons in the tax policy community shudder at the thought of a new tax reform effort.

Nevertheless, there is, I believe, an urgency in addressing the manifold deficiencies in the federal tax system. Whether or not supported in this effort by the Administration, the Congress should, at least as a first step, seek to identify the major shortcomings in the existing tax laws in the light of the basic function, attributes, and criteria of a good tax system. A second step would be to produce an initial agenda of tax revisions that would move the tax structure in the direction of real neutrality, uniformity, simplicity, and revenue adequacy, appropriately defined. This effort should be free of any constraint of revenue neutrality; the objective should be to achieve a good tax system, not necessarily one that will fund some specified fraction of total federal outlays. I have appended to my statement a brief discussion of the kinds of tax revisions that I believe should be featured in that initial agenda. Suffice it at this point merely to list a few such revisions. Chief among these are the following.

o Initiate efforts to eliminate the corporate income tax by integrating it into the individual income tax on individual shareholders.

o Move toward much less punitive tax treatment of individual saving by adopting the Roth Super IRA proposal, the Bentsen-Roth IRA proposal, or the Bush Family Saving Plan.

o Restore the deduction for the excess of net long-term capital gains over net short-term capital losses and index the basis of capital assets for inflation.

o Improve capital recovery provisions by moving toward expensing of capital outlays, by providing a substantial first-year deduction for up to, say, $200,000 of capital outlays in the taxable year, plus, say, 10 percent of any outlays in that year in excess of $200,000.

o Allow expensing of all research, experiment, and development outlays.

o Reduce if not eliminate the alternative minimum tax on both individuals and corporations.

o Repeal the passive loss limitation provision.

o Simplify the tax treatment of inventory accounting by moving toward expensing of all purchases of raw materials and materials purchased for additions to work in process or to stock in trade.

o Repeal or modify TRA86's foreign tax provisions and initiate a move toward a true territorial system.

o Reduce FICA tax rates, while liberalizing the tax treatment of private employer-sponsored retirement income provisions in the interests of strengthening private retirement systems.

Reforms of this sort, I believe, would bring the tax system much more closely in line with one that satisfies the basic principles of taxation.

A tax system that conforms more closely than the present one with the attributes and criteria discussed above would also provide the tax climate in which the economy would perform more efficiently, on a higher growth path, and in a more effectively competitive manner in the world economy. The emphasis on efficiency and growth is, I believe, urgently warranted. Most of the world is on the brink of a new economic era, in which the globalizing of production and distribution promises enormous enhancements of economic progress. Around the world, nations are reexamining their tax and fiscal systems in the interests of reducing policy and institutional barriers to taking advantage of the change in economic opportunities. If the United States is not to be left out, it must also reorient its policies to these new realities. This is essential for advancing the well being of all Americans.

Improving the economic status of all Americans should be a basic concern of tax policy. To pursue this goal effectively, the existing tax barriers to economic growth of the private sector must be moderated, if not entirely removed. A major focus of tax policy, therefore, should be to lighten the excessive tax load imposed by the present system on private saving and capital formation. Increasing and improving employment opportunities depends on increasing labor's productivity, and productivity advances depend critically on providing labor with more, newer, and more productive capital resources.

Many Americans are not effective labor force participants. They must look to private charities for economic assistance, and where that proves inadequate they must rely on government programs. Government can provide that assistance as well as other services only by drawing on the resources of the private sector. The dependence of government at all levels on the private sector is clearly demonstrated in the current recession; the decline in income produced in the private sector has required state and local governments to slow the growth or cut back the level of the services they provide and has frustrated efforts by federal policy makers to reduce budget deficits. The greater are the demands on government for helping the needy and for providing social and other services, the greater must be the output and income produced by the private sector to provide the real wherewithal the government requires to meet these demands.

As a corollary, policy initiatives, however worthy their announced goals, that raise the costs of using capital and labor services not only injure the providers of those services but also constrain the real capacity of government to meet demands for services. Policies that limit the expansion of the production potential and the output of the private sector also limit the resources available to government.

This is a major reason that public policies should focus on enhancing the efficiency of the free market's organization of private sector activity, on reducing institutional impediments to the private sector's growth, on redressing policy barriers to the competitiveness of American businesses in the world market place. Pursuit of social goals, particularly income redistribution, in public policies is far more likely than not to have an opposite thrust -- to impair efficiency, to create new impediments to growth, and to erect new barriers to global competitiveness. The playing time of a zero-sum game is very short; it's an extremely costly game, to boot, one that the American society cannot afford.