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ECONOMIC GROWTH, TAXES, AND DEFICIT SPENDING

A Colloquium of Republican Members of the Joint Economic Committee

June 22, 1993

Statement of Norman B. Ture
Institute for Research on the Economics of Taxation (IRET)

- The Clinton budget program, whether the House or Senate Finance Committee version, is an anti-jobs program that, if enacted, will frustrate the President's stated economic policy goals.

- The budget program, despite some modest spending cuts, is primarily a tax increase package. As such, it will raise additional barriers to economic growth, resulting in lower levels of employment, output, and income than would otherwise be attained.

- Spending cuts, not tax increases, should be relied on to reduce budget deficits. Tax increases are appropriate only to finance increases in spending.

- The proposed tax increases satisfy none of the basic criteria for acceptable taxes. The tax hikes called for in the Clinton program are examples of political expediency and demagoguery.

- Adoption of the budget package has no necessary implication for the rate of inflation. If the Federal Reserve were to attempt to offset the contractionary thrust of the program, inflationary pressures would intensify. It is unlikely that the Fed would move toward an expansionary policy.

- Contrary to Clinton's stated objectives, his deficit-reduction strategy will not increase national saving but is likely to reduce it.

- Even if the Clinton budget were to reduce the deficit, market interest rates are not likely to fall as a result. Moreover, a decline in market interest rates is more likely to be associated with a decline, rather than an increase, in private investment.

- Budget deficits should be shunned because they conceal the costs that government activities impose, hence interfere with constructive budget policy making. Deficits contribute to expansion of government in the nation's economic life, impairing the economy's performance. Public policymakers need to have an incentive to limit the size ans scope of government.

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The Clinton Anti-Growth Fiscal Program

President Clinton, the House Democrats, and the Senate Finance Committee Democrats have fashioned a fiscal program that will, if adopted, slow the nation's economic progress. Ostensibly, this program's central goal is to reduce the federal budget deficit, presumably as a means for reducing market interest rates, deemed to be a necessary and sufficient condition for expanding private investment, hence economic growth. I will examine this syllogism shortly. At this point, let me say that the program, whether the House or the Finance Committee version, would do little, if anything, to reduce the deficit, would raise rather than lower interest rates, and would impede rather than enhance economic progress. It is, contrary to the President's frequent assertion, an anti jobs program.

Although the program calls for some true spending reductions, Le, those that aren't disguised revenue raisers, these are modest in amount and overwhelmed by the proposed tax increases. The Clinton budget, whether the President's, the House, or the Senate Finance Committee version, is primarily a tax increase package. As such, it would raise additional barriers to economic growth, resulting in lower levels of employment, output, and income than would be realized under present law. As a result, the program would do little, if anything, to reduce the federal budget deficit, while intensifying the fiscal strains of state and local governments. It is far likelier to reduce than to raise national saving.

Virtually all tax increases directly or indirectly increase the opportunity costs that businesses and households confront for undertaking growth-generating activities. Indeed, with few exceptions, the same thing is true of government spending programs. A true pro-growth, job-creating fiscal program would seek to reduce the costs imposed by government spending and tax policies. The Clinton program does just the reverse.

Why, one may ask, should taxes be raised at this time? The basic function of taxes is to inform the public about the cost of government activities. Accordingly, taxes should be raised to finance increases in government spending, provided that the public deems the additional spending to be worth the additional taxes to be paid. Satisfying this condition requires that the additional

taxes are imposed on the largest possible part of the population, that taxpayers are knowledgeable about the content of the proposed spending increases, that taxpayers are keenly conscious of the additional taxes they will have to pay, directly or indirectly, hence, that the additional taxes are levied only on real people, not on businesses organizations. If these conditions were met, if the public as a whole, not merely some well organized rent-seeking interest groups, wanted the additional spending and was willing to pay for it, the spending increases and the tax increases needed to fund them would be acceptable, despite their adverse economic effects. It scarcely needs to be pointed out that the proposed program woefully fails to satisfy these conditions. There is, therefore, no acceptable justification for the proposed tax increases.

The proposed tax increases are splendid examples of the Willie Sutton approach to tax policy, viz., go where the money is most easily raised. Willie Sutton didn't have to heed any principles in determining which bank to rob; his guide was expedience. For far too long, this has been true as well of federal tax legislation. The present tax package takes this approach to new heights. Virtually none of the proposed revenue raisers can be justified as conforming the tax system more closely with meaningful criteria of fairness. Virtually none of the proposed tax increases will make the law more uniform in application, simpler, and less costly to enforce and to comply with. Virtually every one of the revenue-raising provisions will increase relative price distortions, thereby additionally violating the neutrality criterion. Most of the proposed tax hikes are exercises in demagoguery, aimed at increasing the tax liabilities of people that the Clinton administration and Congressional liberals identify as bad guys — the so-called rich and corporate businesses and their shareholders.

Clinton's proposed spending cuts for the most part reflect the same sort of Willie Sutton mentality. These spending cuts appear to have been proposed primarily on the basis of expediency, not on the basis of a careful weighing of their benefits against their costs. The decision-making criterion seems to have been "can we get away with this," instead of "is this something the federal government shouldn't do."

Taken as a whole, the package is a backward step in fiscal policy, creating additional barriers to economic growth instead of moderating existing impediments. If the President's ultimate objective is to promote economic progress, his tax and spending package is virtually certain to prove to be counterproductive. The tax increases will raise the costs of saving and investing and of market-directed personal effort, particularly on the part of the most productive and innovative individuals. Unless one endorses the ridiculous notion that people are unresponsive to tax-induced changes in the incentives and disincentives they confront in their daily lives, the inventory of tax increases now before the Senate, as well as those proposed by the Administration and those in the House bill, must be expected to reduce private saving and capital formation, productivity, employment, real wage rates, and GDP below the levels they would otherwise attain. The President's program, notwithstanding its modest spending cuts, is anti-growth. The only extenuation that can be offered on its behalf is that in a $6 trillion economy, this budget package is not large enough to bring the economy to a screeching halt.

Adoption of the budget package, either the House or Finance Committee version, has no necessary implication for the rate of inflation over the budget projection period. Each package contains provisions that would raise costs, but these cost hikes are more likely to result in lower levels of employment than in a higher price level. It is unlikely that the package would lead to any significant reduction in the budget deficit, but even were it to do so, we certainly should have learned by now that there is no positive relationship between the level or direction of change of the budget deficit and the inflation rate. The inflation risk in the budget packages stems from the possibility that the Federal Reserve Board would perceive the package to be highly contractionary, calling for an offsetting acceleration of money growth. There is little reason to believe that the Fed would respond in this manner; they did not do so following the 1990 budget fiasco, on which the present budget proposals appear to be patterned, and the Board appears to have a keen awareness of the anti-growth consequences of renewed inflationary pressures.

Enactment of the package, irrespective of whether it succeeds in reducing the budget deficit, is likely to exert upward pressure on market interest rates. The reason is that the increases in marginal tax rates, both the explicit rate hikes and those resulting from tax base adjustments, will impel lenders to seek higher pretax returns on their loans in order to maintain after-tax yields.

Clinton's Mistaken Fiscal Strategy

This brings us to the Clinton syllogism — his mistaken rationale for his fiscal strategy. Stripping it of its obfuscating rhetoric, the rationale is a) reducing the deficit will increase national saving, b) increases in national saving will reduce interest rates, c) at lower interest rates businesses will invest more, and d) greater business investment will enhance economic growth. Of these elements in the rationale, only the last is correct.

Saving is the reservation of current income for the purchase of income-producing assets. Since the federal government produces only 3.2 percent of total GDP, its capacity to save is extremely modest. Government is not a saver of any significance, as saving is defined above. Virtually all saving is undertaken by the private sector, and roughly 80 percent of private saving is business saving, i.e., retained corporate earnings plus capital consumption allowances. Government borrowing preempts private saving, and very little of that borrowing funds government investment in income-producing assets. Other things being equal, then, a reduction in the government's deficit, hence in government borrowing, would leave a larger portion of the saving undertaken by the private sector available for investment in additions to the nation's income producing capacity.

Other things are not equal, however. If the deficit is reduced by raising additional taxes, private saving is likely to be reduced by at least the amount of the tax increase, likely more. Presumably everybody can see that in the case of additional taxes extracted from businesses; any increase in business taxes, whether in the form of higher tax rates or changes in the treatment of expense or revenue items, reduces either or both retained earnings and capital recovery allowances,

as shown, the major components of private saving. Perhaps less obviously, very much the same is true regarding the effects of additional taxes extracted from individuals. In the Keynesian construction, an additional dollar of tax will reduce personal saving by roughly the same proportion as saving is to disposable personal income. Keynesian, therefore, believe that increases in personal taxes primarily reduce consumption and only modestly curtail personal saving — by 95 cents and 5 cents, respectively, per dollar of tax. In fact, however, this could be true only if the additional taxes were perfectly neutral with respect to their effect on the cost of saving compared with the cost of consumption. Tax increases that directly or indirectly raise effective marginal tax rates do not exert a neutral effect; they raise the cost of saving relative to the cost of consumption. Unless one argues that the price elasticity of demand for consumption is positive, one cannot, in logic, hold that tax increases that raise the relative cost of saving depress the amount of consumption relative to saving. The price effect of individual income tax increases must depress personal saving compared to what it otherwise would be. And because of institutional constraints, particularly the rigidity of consumption spending, at least in the short term, individual income tax increases are likely to depress personal saving by more than the tax increase.

Thus, the effect of deficit reduction on national saving depends critically on how the deficit is reduced. If the deficit is reduced by cutting government outlays, the reduced government borrowing draw on private saving will not be offset by cutbacks in private saving; a net increase in saving available for capital formation Will result. On the other hand, if tax increases are relied on to reduce the deficit, national saving is very likely to be less than it would be otherwise, because the higher taxes are likely to raise the cost of saving and to reduce the level of GDP. To the extent the deficit is reduced by tax increases, therefore, whatever benefits in terms of more vigorous economic growth one might conceivably ascribe to the deficit reduction are likely to be swamped by the negative effects of the tax increases. The best that could be expected from tax-financed deficit reduction is that the decrease in saving and capital additions would not be substantial.

Public policymakers should not look to the current budget packages as an effective means for increasing national saving. For the same reason, relying on the Clinton rationale, these budget proposals do not promise lower market interest rates.

The notion that deficit reduction will reduce interest rates rests on highly simplistic and mechanistic notions about the factors that determine market interest rates. In essence, the idea is that interest rates are the price paid for borrowing; hence the less is the demand for loans, the lower will be their market price. If the government borrows less, interest rates will fall.

The notion is analytically mistaken, which is why it resists empirical verification. Indeed, market interest rates appear to be negatively correlated with government deficits, i.e., the higher is the deficit, the lower is the level of market rates. There area large number of influences that contribute to this perverse result, but it is clear that the notion that in and of itself reducing budget

deficits will reduce market interest rates is at best simplistic and, more fundamentally, simply without analytical or empirical foundation.

Market interest rates are determined by the interaction of 1) the reward people require for forgoing a specified amount of current consumption in order to maintain or acquire a given amount of future income, and 2) the marginal productivity of capital. The return required to induce people to hold a marginal dollar of income-producing assets — or to acquire an additional dollar's worth — is net of a premium for expected inflation, a premium for the riskiness of the investment, and the amount of taxes to be extracted from the returns. While market interest rates show substantial variation over time, reflecting principally changes in expected inflation and in tax rates, net unit returns are remarkably stable, showing very little time trend over extended periods.

In this context, budget deficits might raise market interest rates if they were to raise the marginal productivity of capital, elevate inflation expectations, add to the riskiness of asset ownership, or convince people that their taxes were about to be raised. Budget deficits would raise the marginal productivity of capital only if they reduce the stock of capital relative to labor and other production inputs. In a closed economy, this might well result from the government's borrowing preempting significant amounts of private saving, thereby reducing the amount of such saving that is committed to adding to the stock of capital. In an open economy, on the other hand, any tendency for this to occur and to elevate the return on capital here relative to that abroad would induce an inflow of saving from abroad, tending thereby to quash the upward movement of market returns here.

Conceivably, budget deficits might intensify inflation expectations, but any such shift in expectations would fly in the face of objective evidence over many years that inflation rates are not positively related to budget deficits. Nor does there appear to be any evidence suggesting that the riskiness of acquiring and holding assets is positively associated with the size of budget deficits. On the other hand, persistent large budget deficits are likely to lead to expectations of tax increases, in turn leading people to require higher pretax returns to justify any given amount of saving. Validating that expectation by enacting tax increases to reduce the deficit will have the seemingly perverse effect of driving market interest rates up, not down.

One should not expect to find a statistically sturdy negative relationship between market interest rates and private investment. The simplistic assertion that business investment will be greater if deficit reduction lowers interest rates is analytically off the track and empirically invalid. A large number of factors enter into investment decision making, and the notion of any close relationship between the amount of investment and market interest rates, per se, is untenable. Indeed, a simple statistical test of the notion produces the damning result that gross private fixed investment is positively correlated with interest rates — investment levels tend to move in the same direction as market interest rates, and changes in investment tend to be in the same direction as changes in market rates.

To summarize, the Clinton deficit reduction rationale is faulty, depending on mistaken premises about the relationships between budget magnitudes and aggregate economic activity. Just as in the case of the reasons for the various tax changes proposed by the Administration, one gets the impression that decisions about what to do were made without the benefit of close economic reasoning, and the rationales for these decisions were dreamed up after the fact.

This leads to the conclusion that the gains Mr. Clinton seeks from his deficit reduction program are not likely to materialize and surely are not worth the costs that the tax increases will impose.

An Alternative Fiscal Strategy

I should not want my observations to be construed as indicating indifference to budget deficits. There is a valid, indeed demanding reason for shunning budget deficits and for seeking to reduce them in ways that will not impair the nation's economic performance. That reason is that deficits obscure the price that the nation must pay for government activities. If the public cannot accurately assess what government costs them, they are likely to ask for more than they would if they were more fully cognizant of that cost. The result is that deficits are a vehicle for expanding the government's intrusive, distorting presence in our economic lives. Much of the expansion of government spending occurs in programs that are the products of various rent-seeking groups in our society. If the cost of government's acceding to the demands of these groups for specialized services on their behalf are concealed from the public by the government's borrowing to pay for such programs, the amount and scope of government activities and the burdens they impose on us will continue to expand. I don't believe it's necessary for me to enlarge on this theme; its applicability to public policy developments over the last several years — indeed, over a much longer period with only a few, brief interruptions — must be obvious to the participants in this colloquium.

The core objective of budget policy should be to limit, preferably to reduce, government's presence in the nation's economic life. With so few exceptions that we need not here be detained by their explication, government programs raise the real prices that private sector entities must pay for production inputs and outputs. In some cases, conceivably, the government activities may provide benefits large enough to warrant the increase in costs these activities impose, but as these activities more and more address the demand of particular interest groups rather than the society as a whole, they are less and less likely to pass this cost-benefit test.

On the whole, the larger our government, the slower is the advance of our productivity. Government makes us poorer, on balance; we should avoid all of it that isn't essential for insuring that we can pursue our private interests as efficiently as possible, subject to the constraint that we do not prevent others from doing the same.

Accordingly, deficits should be avoided except in the face of dire emergencies. Government spending decisions should be made in conjunction with decisions about taxation, with the aggregate amount of the former constrained by the willingness of the public to assume an equal amount of tax burdens. For this purpose, it should be clear, we need quite different taxes from those we now rely on, as well as quite different processes for determining the amount and composition of government activity.

As the system now works, public policymakers have little incentive to limit, let alone cut government activities and spending and every incentive to expand them. What is needed is something in the policy-making process that will reverse this. Spending caps do not provide incentives for policymakers to limit spending; they provide incentives to find means for evading the caps. The same is substantially true of one or another of the proposed balanced-budget amendments to the Constitution. Instead of this approach, we need to establish a rule that limits spending increases to revenue increases and that imposes the need for spending reductions when revenue reductions are legislated. Moreover, to make sure that the tax-spending decision doesn't hide the fiscal burden, three other conditions must be met: 1) taxes are levied directly only on real people, not on creatures of the law, 2) the taxes should be imposed on the largest possible fraction of the population, and 3) taxes should be devised to maximize the awareness of taxpayers to their character and amount. Satisfying these conditions would establish a far closer nexus than now exists between the public and public policymakers, and make the latter much more responsive to the wishes of the mass of their constituents rather than merely to well-organized rent seekers.

A modest but significant first step in this direction is the Walker-Smith debt buy-down proposal. The proposal calls for allowing individual income taxpayers to designate up to 10 percent of their income tax liabilities to be allocated to a special trust fund, the resources of which could be used solely for the purpose of purchasing outstanding federal debt instruments in the hands of the public. Every dollar of debt repurchase would have to be matched by an equal reduction in federal outlays authorized for the fiscal year.

The true significance of this proposal is that it would open a line of communication between the public and their elected representatives concerning the size of the federal government. That communication would continue each year, not merely during election years. The Walker-Smith plan would not, in itself, satisfy all of the conditions required for reasonably efficient budget policy making, but it would certainly help to reverse the thrust of budget policy we have suffered for many years .

There are additional criteria that the taxes we rely on to finance government activities should be required to satisfy. These are the fundamental canons of taxation of long standing and wide acceptance. I have elsewhere discussed these at some length. One such discussion and an initial agenda of tax changes are included as addenda to this statement in the hope that they may prove to be useful when the Congress rejects the current tax proposals or determines to overcome the economic carnage the enactment of the Clinton program will leave behind.