

# **The National Economic Commission Should “Just Say No” to New Taxes**

**by Thomas M. Humbert**

**T**hroughout his campaign for President, George Bush made the “No Tax-Increase Pledge” a central issue, and it was a major reason for his victory. Now, less than one week after that victory, Washington’s pro-tax advocates are maneuvering to use the National Economic Commission (NEC) as a Trojan horse to reverse the President-elect’s mandate and force him to endorse tax increases he neither ran on nor desires.

The American people must not be denied the economic policy they overwhelmingly supported in November’s national election. Ignoring that popular mandate not only would be undemocratic, it would also be bad economics. The NEC’s own legislative charter establishes the Commission for the purpose of recommending “methods to reduce the federal budget deficit while promoting economic growth and encouraging saving and capital formation.”

Yet, the NEC cannot fulfill the intent of this qualifying charge — to promote growth — by raising taxes. There are at least seven reasons why the NEC should “Just Say No” to tax increases:

- 1) Taxes increases hurt economic growth and discourage capital formation.**
- 2) Tax increases undermine tax equity.**
- 3) Tax increases result in higher government spending.**
- 4) Tax increases endanger international competitiveness.**
- 5) The budget deficit has already fallen significantly.**
- 6) A balanced budget can be achieved without tax increases.**
- 7) Tax increases would invite chaos in the financial markets.**

Only a solution to the budget that maintains a healthy, growing economy with lower interest rates and higher employment at least over the next four years will produce a lasting increase in real government revenues and balanced budgets. Progress on the deficit will be made only if the NEC pays attention to the factors that affect interest rates and employment, while ruling out counterproductive tax increases.

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Does this mean that the NEC can pack up and go home? If it simply lives up to its public reputation as “the tax-increase Commission,” that would not be a bad idea. But if the NEC decides to live within the no-tax increase bounds set by the American people, it could yet perform a valuable contribution by considering ways to enhance growth, create free trade areas, and assure stable monetary policy.

That agenda could yet earn the NEC its place in history and help keep the budget and economy on a steady course for the next decade and beyond.

## **WHY NO TAX INCREASES?**

The public desire for no new taxes is confirmed by solid economic analysis. Sound logic suggests that raising taxes would be bad economic policy for seven major reasons.

**First, tax hikes hurt economic growth and undermine the climate for savings and investment.** Every new tax imposes its own pattern of disincentives; every tax drains money from the private marketplace to government programs; every tax wraps the private sector with complex regulations and greater paperwork; every tax is largely drawn from capital formation.

Some taxes, of course, are less harmful than others — but no tax is economically benign. At least five professional economic studies published over recent years — including ones from the World Bank, Harris Trust and Savings Bank, Purdue University, and the Hoover Institution — indicate that tax increases are the cause of decreased rates of growth, lower rates of investment, and fewer jobs.

**Superficially Benign.** This year’s candidate for the most popular tax increase is the consumption tax, in particular the value-added tax (VAT), which is a tax levied on the difference between a firm’s sales and its purchases. While big spenders like the tax because it is a powerful revenue raiser (a 5 percent VAT could raise up to \$100 billion), even some business leaders are fond of the consumption tax because it may exempt capital purchases from taxation. Superficially, the VAT seems to be economically benign toward saving and investment.

Yet, this mistakes the incidence of a tax with its burden. The VAT’s incidence may well be on consumption expenditures, but it is probable that a VAT would be shifted back to production, workers, or — most likely — savings. Here’s how. Saving is simply future consumption. Taxing consumption expenditures therefore reduces the reward for saving — both past and future. As such the VAT would cause cutbacks in savings, very possibly by nearly the amount of the tax. This would especially be true of working people who have very little discretionary consumption.

The consumption tax also discourages work effort, channels transactions into the untaxed underground economy, and creates mindboggling complexity and burdensome paperwork as more and more exemptions are inevitably shot through the consumption tax base to make the tax less burdensome to the poor. The European experiences with the VAT should

be instructive. In every country where a consumption tax has been tried, it has been associated with low economic and job growth.

**Disguising a Tax Increase.** Other tax increase proposals also have been floated. The excise tax is often suggested as a relatively harmless tax. But there is no economic justification to discriminate among different types of consumption unless a particular consumption expenditure is associated with well-defined externalities. A higher gasoline or energy tax would be an example of a general tax increase disguised as an excise tax, and a particularly harmful one. Because the transportation industry is a backbone of our economy, higher energy taxes would ripple throughout the economy in higher costs.

A higher rate of tax on upper-income taxpayers is often supported on equity grounds as a means to "soak the rich." In reality, an income tax hike would make the tax code less progressive by driving upper-bracket taxpayers into loopholes and tax shelters; it would also further exacerbate the double taxation of saving and likely destroy the 1986 tax reform, which was forged on the bargain of lower tax rates in return for fewer loopholes.

Worse still, any of these taxes would have to be set at a relatively high level to eliminate the deficit. Erasing a \$150 billion deficit with a tax increase would require a 24 percent increase in general fund revenues or, including payroll taxes, a 19 percent tax revenue increase. This enormous increase in revenues would seriously risk current economic vitality.

**Second, tax increases undermine tax equity.** The American public's strong opposition to tax increases stems from a keenly felt certainty that they are not undertaxed. Even without new taxes, tax revenues are scheduled to increase by \$70 billion to \$80 billion per year. These federal revenues will rise to over \$1 trillion for the first time in history in 1990. Taxes will consumer 19.6 percent of GNP in 1990 — only four times in this century have tax burdens been this heavy.

It is impossible to make the case that average Americans have not been paying their fair share. In reality, most have very little capacity to bear an additional tax burden. The median income family of four did not pay a cent of income taxes in 1948; today their tax bill is nearly \$2,700. Yet higher taxes would sabotage the already precarious financial stability of the family, and thereby make it more dependent on government services and programs for such basic needs as health care, retirement savings, education, and child care.

Far from increasing tax fairness, higher marginal tax rates on upper income groups could reduce progressivity and increase the tax burden on the working families of America. The 1981 tax rate reductions have actually enhanced tax progressivity, increasing tax payments of the wealthiest 15 percent by three times more in 1985 than they would have paid under the old tax code, according to Harvard economist Lawrence Lindsey. Higher marginal tax rates would reverse this progress.

**Third, increasing tax revenues relieve the pressure for budget cuts and usually result in higher spending.** The Tax Equity and Fiscal Responsibility Act (TEFRA) was supposed to cut spending by \$3 for every \$1 dollar of tax increases, but while the \$100 billion tax increase became law, the budget cuts were never enacted. Not surprisingly, one study of tax

increases conducted for the Joint Economic Committee estimates that every dollar of tax increases in post-war American history raised spending by \$1.52.

Despite Congress's "iron-clad" pledges to cut spending in return for tax increases, no one has yet devised any means of assuring that tax increases will be used for deficit reduction. We are often reassured that a special trust fund could be set up for tax increases or that tax revenues could be "fenced off" in the budget for deficit reduction. But such efforts are useless. Government funds are fungible. With one hand, Congress can retire debt with the new taxes, while with the other increase spending programs and issue new debt. The result: higher spending, higher taxes, and the same government deficit.

**Fourth, raising tax rates would endanger U.S. international competitiveness.** The revolution to reduce tax rates is now a world-wide phenomenon. The *Economist* in August 1986 predicted that "a tax revolution is about to stalk through the West" and warned that those with too high top rates would suffer a "brain drain" and "the more serious drain away of some of the large number of modern industries." Since then, Canada, France, Germany, Japan, the United Kingdom, and Australia among the major industrial nations have followed in the U.S. lead in lowering marginal tax rates.

With the lowest top tax rate of any industrial nation, the U.S. has a major advantage over its industrial competitors. If our taxes, especially tax rates, begin to increase, we will erode that advantage and suffer from an investment and capital drain.

**Fifth, the budget deficit has already fallen significantly.** The Congressional Budget Office reports that the budget deficit dropped from \$220 billion in 1986 to \$150 billion in 1988, and fell from 6.3 percent of the total economy to 3.2 percent — about one-half its previous burden.

But it is not the budget red ink in any one year that matters, but the accumulative size of the government debt. This represents the true financial commitment of the taxpayers to future generations and helps determine the government's credit rating.

In 1946, the national debt amounted to 120 percent of GNP, and almost 50 percent in 1959. Today the debt is 43 percent of GNP and is estimated to drop to 40 percent by 1994 — even if the annual deficits remain well above \$100 billion — according to Polyconomics Vice President Alan Reynolds. Today's debt burden is clearly not out of line with past levels — and even those heavier debt burdens of the past did not prevent expansion in the 1950s and 1960s.

**Sixth, a balanced budget can be achieved without tax increases.** A 4 percent growth in federal expenditures and continued economic expansion would balance the budget by 1993. Allowing for 4.5 percent growth in spending a year — which would permit a 0.5 percent real growth in spending and 4 percent inflation — would balance the budget by 1994, according to Reynolds. The latter path allows significantly higher real government spending, but both point to the same conclusion: government deficits can be put on a declining path over the next four or five years with moderate and achievable budget restraint.

The real objective however should not be insistence on an arbitrary growth rate in spending, but rather real government spending below the growth rate of the economy. This will assure that the private sector grows faster than the government, and allow more resources to be used for capital investment, consumption, and the future tax base.

**Seventh, tax increases would invite chaos in the financial markets.** A tax increase would send a signal to the financial markets that American policy makers are once again returning to the higher taxes-looser money days of the 1970s, when capital formation and investment were almost destroyed by the twin forces of inflation and tax-induced stagnation. Clearly, a return to tax-flation would be disastrous for Wall Street, despite the highly-publicized calls of some prominent Wall Street gurus asking for just such policies.

Last year's stock market crash as well as the recent jitters in the stock and bond markets are not a signal that Wall Street wants new taxes to stem the deficit. It is mindboggling to believe that somehow Wall Street just discovered budget deficits seven years into the expansion and only now is spooked by the deficit, though it has dropped in half since 1983 as a percentage of GNP. It is also hard to believe that Wall Street wants another tax on capital formation on top of the double taxation of interest and dividend income.

Yet, it is obvious that something is bothering the financial markets. A more likely explanation of market jitters is the concern that the Federal Reserve Board will allow the U.S. dollar to plunge in international markets and permit inflation to restart. When one former Chairman of the Council of Economic Advisers and close Bush advisor, for example, suggests that the dollar will have to fall another 20 percent to reduce the trade deficit, one can understand why foreign investors would get the jitters about holding U.S. bonds and stocks.

**Unhelpful Fed.** It also does not help when Fed Chairmen act as if they will hold monetary policy hostage to tax increases. Former Chairman Paul Volcker used to tell congressional committees he would be able to reduce interest rates only after Congress cut the deficit — by raising taxes if necessary even though budget cuts were preferable. This sent a clear message to Wall Street that lower interest rates were tied to the uncertain fiscal action of Congress in reducing the deficit. When virtually the entire media and political community insists that a tax increase is a foregone conclusion, one can further understand a lack of confidence among investors in the fate of our economy.

Rather than point blame at the budget deficit, the Fed clearly needs to send a signal that it will separate monetary policy and its goal — stabilization of the dollar — from fiscal action of Congress and its goal — achieving stronger economic growth. Only a separation of the two levers of economic policy will produce both stable prices and a pro-growth fiscal policy. A firm stance against taxes is a *sine qua non* to confidence in the financial markets. But the conduct of monetary policy independent from progress on the deficit is also vital.

## **THE "TWIN TOWERS OF DEBT" MYTH**

The major reasons cited for raising taxes is centered around the so-called twin towers of debt, which advocates say threaten to wreck the U.S. and world economy. Yet, those who

see a connection between the budget and trade deficits must explain, argues Polyconomics Vice President Reynolds, why the U.K., Denmark, Australia, and Switzerland all have budget surpluses and large trade deficits, and why Germany has a budget deficit just as large as the U.S. (2.1 percent of GNP, including local government) and yet a huge trade surplus.

Frankly, the credibility of those making these arguments is put in question by their record of error concerning previous purported effects of deficits. In 1981 and 1982, these same people warned direly that the 1981 tax cuts would wreck the recovery, cause inflation, raise interest rates, and create a high dollar.

When inflation collapsed, interest rates plummeted, the dollar dropped, and the economy entered its longest peacetime recovery in history, they still refused to admit the wisdom of lower tax rates, but instead shifted ground to another crop of imminent economic catastrophes. These, too, have little validity:

**1) The budget deficit is enormous and growing.** The budget deficit is not out of control; in fact, it is coming down dramatically. The Congressional Budget Office reports that the budget red ink dropped from \$220 billion in 1986 to \$150 billion in 1988. More important, as a share of total economic output — the best measure of the economic impact of federal borrowing — the deficit has fallen to 3.2 percent of gross national product in 1988 — about one half of its peak in 1983 of 6.3%. In FY 1989, OMB projects that the deficit will decline further to 2.8 percent of GNP.

When state and local surpluses (\$50 billion in 1988) are added to the federal deficit, the ratio of general government deficits to GNP is lower in the U.S. than in the U.K., France, Germany, Italy, and Canada. Only Japan has a notably lower ratio of debt to GNP, and that has been only true since 1985.

It is also instructive to look at the deficit in real terms, corrected for the effects of inflation. This reduction in the real value of outstanding public debt, however, is not shown in the U.S. budget — a case of single-entry bookkeeping. Former Treasury official Steve Entin estimates that the budget deficit would fall by about \$70 billion to \$75 billion each year, if this inflation adjustment were made. As Entin points out, the \$70 billion-\$75 billion inflation component of the debt does not crowd out private saving or investment because bond holders, suffering a real loss of wealth, reduce their consumption accordingly:

**2) The Consumption-Binge Charge.** The tax-hike advocates also believe that a tax increase is necessary to dampen consumer demand for foreign products and services that have made the U.S. a net debtor nation to the world.

Yet, the trade deficit cannot be explained as a product of overconsumption: today, imports from abroad are about the same percentage of U.S. GNP as in 1980 (see Chart). It is exports that are down, largely because Europe and especially Latin America are not growing as fast as the U.S., and therefore not consuming American exports. If anything, the trade deficit is a sign that much of the Third World and Europe are not enjoying the same healthy economic growth of the U.S. because they have not reduced their own very high tax rates.

**U.S. IMPORTS AND EXPORTS**  
(% OF GNP)

YEAR	EXPORTS	IMPORTS
1980	8.2	9.1
1982	6.7	7.8
1984	5.8	8.8
1986	5.3	8.7
1987	5.6	9.1

Source: U.S. Department of Commerce.

The supposed dangers of the trade deficit are also an illusion. Most every nation that has cut tax rates has experienced strong economic growth and capital inflows. To invest in the strong U.S. economy, foreigners must sell us their goods and services to earn dollars. Indeed, for most of our history until 1915, some of the fastest periods of economic growth, the U.S. was a net importer of capital, and therefore ran an almost continuous trade deficit.

**Creating Jobs.** As then, foreign investments today expand the productive capacity of American factories, create jobs, and even generate the profits to pay back the debt — or, more likely, the debt will never be paid back but instead will be rolled over to finance yet more business expansion. In the meantime, the debt burden will easily be paid from the increased capacity of the economy.

The cost of servicing the foreign debt in 1987 amounted to less than 0.5 percent of GNP (including offsetting earnings from U.S. assets abroad 0.1 percent), according to the Council of Economic Advisers. Servicing the debt will remain insignificant for decades to come. Even if investment flows continued at current pace, by the end of the century U.S. indebtedness would be only slightly larger than Canada's has been in recent years.

The scare about Japan buying up America has as little basis in reality as the 1960s hullabaloo that America was buying up Europe. Japanese direct investment abroad actually amounts to about one-fifth of America's, and while Japan's foreign investment is growing by 60 percent a year, America's outflows have been higher, up by 110 percent since 1983, according to a study by the Royal Institute of International Affairs in London. In fact, Japan's total direct foreign investment in the U.S. is only 25 percent of Europe's and three-quarters of Canada's.

The major point, however, is that investment — whether from Americans or from abroad — is not a sign of overconsumption, nor is it something harmful to the U.S. economy. And foreign investment dollars will stay here, creating wealth, as long as we don't inflate it away or create a punitive tax environment.

**3) The Crowding Out Argument.** The most popular argument of tax increase proponents is that tax increases — while not harmless — would be clearly preferable to government deficits and the overconsumption, reduced net savings, and decreased investment those

deficits create. It is true that savings and investment would be higher in the absence of the deficit, all other things being equal.

But all other things are not equal. A study by the Office of Economic Policy at the Department of Treasury, among others, shows that when taxes are increased, government saving is offset by a decline in private savings. This is because taxes, unlike deficits, not only impair incentives for future savings, but actually reduce the real value of all past savings.

**Placing the Deficit in Context.** The crowding out argument must also be examined in the context of the total size of financial and real assets available to finance the deficit. A \$150 billion deficit, in reality, is relatively small compared to the financial assets of the U.S. personal sector, totaling about \$8 trillion. Non-financial assets, like real estate, housing, and businesses, are also available to help finance the deficit. And finally, with world capital markets, the deficit can also be financed from asset markets worldwide.

In this context, the government debt — at least at current levels — is tiny compared with these sources of financing. No wonder, then, that there is little sign that the deficit has impeded expansion or capital formation. Even a relatively small change in the Treasury bill interest rates could attract a flood of funds from the total stock of financial and real assets and not crowd out investment, impede the expansion, or reduce saving. Consider the facts which tend to support this conclusion:

- ◆ ◆ Manufacturing productivity has grown 4.5 percent yearly since 1981, even higher than in Japan and Germany; overall productivity in the 1980s has doubled the pace of the 1970s, though still below the brisk pace of the 1960s.

- ◆ ◆ Business and personal savings are up by \$200 billion since 1980, while gross private domestic investment has soared from \$437 billion in 1980 to an annual rate of over \$700 billion in 1988. As a percentage of GNP, fixed investment is close to historical levels.

- ◆ ◆ The U.S. saving rate may not be much different than Japan's, adjusted for cultural and measurement differences. While personal saving is down, the more relevant measure of savings should probably be the stock of U.S. personal financial assets, up some \$500 billion annually, compared with only \$176 billion in Japan during the 1981-1985 period, according to Kenichi Ohmae, managing director of McKinsey & Co. Had savings rates been measured on this financial asset base, says Ohmae in a recent *Wall Street Journal* article, the American savings rates would be 14.7 percent and the Japanese would be 16.7 percent.

In fact, the best measure of crowding out is not the deficit at all, but total government spending. Whether that spending is financed through debt or taxes is an important but secondary concern to the overall burden of government spending.

Frankly, economists disagree profoundly about the effects of deficits — some believe they are harmful, some don't, others only under certain conditions. A recent survey of the academic literature by the Congressional Budget Office, for example, found a few articles concluding that deficits raised interest rates to some degree, but well over half the articles found no statistically significant connection between deficits and interest rates, and some articles even measured a negative correlation.



What we do know, however, is that the deficit is coming down substantially, that it did not prevent a vigorous expansion when it was twice the burden, and that — above all — “solutions” to the deficit that would harm the expansion should be rejected. I would put a VAT, corporate, or income tax increase in that category.

Instead of taking the risk of a tax increase, I would hope that the NEC would recommend growth-enhancing ideas such as reductions in the capital gains tax rate to increase entrepreneurship and risk-taking, privatization of government programs better run in the private sector, free trade areas, and monetary reforms. On that last point, if the value of money could be better stabilized between countries, perhaps by anchoring the dollar to an objective, market-based standard of value, I believe interest expense on the debt could fall dramatically. Even a two percentage point decline in interest rates would cut the 1994 deficit by \$50 billion.

## CONCLUSION

America’s economy has become the wonder of the world. Most other nations are modeling their economies after what the Europeans have called the American economic miracle. And no wonder. The U.S has produced 89 percent of all jobs created in the Western world since 1980. Over the past eight years, 16 million new jobs have been created, manufacturing productivity has increased faster than our major trading partners, real personal income has increased over 15 percent, and the economy is now into its seventy-second month of expansion.

**Winning Economic Strategy.** The secret of the American success: tax rate reductions that encourage risk-taking for entrepreneurs, small business people, and innovators — the people who generate the most jobs in our economy. This is clearly no time to reverse this winning economic strategy and enact new tax increases that could erase our economic gains and even sacrifice further expansion. The brisk economic recovery since 1982 has generated record real revenues, and will continue to bring in a revenue windfall if new taxes don’t spoil the economy. Indeed, we should be moving forward with further tax cuts, not tax increases.

In an important sense, the 1988 presidential election represents the triumph of these economic views. This message is neither unique nor transitory. Over the last eight years, the American people have vetoed tax increase candidates in three separate elections. The American people know that continued economic expansion is the only sure way to reduce the deficit. These victories, fought and won in the forum of public opinion, must not be ignored by the National Economic Commission.

