March 26, 1984

DANGERS OF THE DEFICIT REDUCTION PLAN

INTRODUCTION

Ronald Reagan and Senate Republican leaders are lobbying intensively for a three-year projected $150 billion Deficit Reduction Plan that could be brought to the Senate floor early this week. The plan is to be introduced as an amended and expanded version of S.2062, the Senate Finance Committee's Budget Reconciliation Bill. Proponents claim it represents a fair compromise because it cuts $40 billion from defense, and $43 billion from non-defense spending, raises $48 billion by hiking taxes and closing tax "loopholes," and reduces interest outlays by an estimated $18 billion.

Despite the backing given to the plan by the President and Senate leaders Robert Dole (R-KS) and Pete Domenici (R-NM), a number of Republican senators are balking. Charles Grassley (R-IA) and Nancy Kassebaum (R-KS), for instance, are pressing for defense cuts below the 5 to 8 percent real growth in FY 1985 allowed by the plan. Robert Kasten (R-WI) and others hesitate to accept tax hikes and argue, using the President's previous statements, that this would damage the economy. A great many conservatives loyal to the President fear that this new plan will only be a replay of 1982's TEFRA "compromise" disaster--in which the President signed the largest tax increase in history on the promise that he soon would receive $3 in spending cuts for every $1 in tax increases. Congress broke its word and instead of cutting spending, actually increased non-defense outlays 4 cents for every $1 of new taxes.

Deficit hysteria is blinding legislators to the reality of the economic recovery and to the facts of 1982's "deficit reducing" package. Congress agonizes that current fiscal policy will push up interest rates and impede economic growth. Congress embraces a tax increase as a spur to economic growth or reduced deficits, yet can cite no historical evidence of any link between deficits

and interest rates. Has Congress forgotten that despite TEFRA's $100 billion in tax increases in 1982, projected deficits were doubled less than a month after the bill was passed?[1] How can Congress be so certain that this time a tax boost would cut the deficit? Why have the Senate leadership and the President's advisors overlooked the unpleasant fact that just four months after TEFRA was passed interest rates ended what had been a rapid decline and have been rising ever since?

The logic that a tax increase somehow increases investment is fundamentally flawed.[2] Though high deficits, say the tax-hikers, would stifle business investment and halt the economic recovery, gross private domestic investment (GPDI) increased over 35 percent between the fourth quarters of 1982 and 1983. This far exceeds the average of 26 percent for post-war recoveries, and indicates that this recovery was led by investors, not consumers.[3] Those now supporting this tax package are baffled by this and say it cannot happen because of "high" interest rates purportedly due to the deficit. Yet capital spending plans are projected to increase a thumping 17 percent this year.[4]

Businesses are investing because real rates of return on investment have increased more than the real interest rate for loanable funds--thanks in large part to prospects for economic recovery and the lower cost of investment resulting from 1981 tax reductions. TEFRA and some elements of the proposed tax increase bill erode seriously the after-tax rate of return. Most disturbing, the new package takes the illogical step of taxing investment, its proponents argue, to improve the climate for investment.

The proposed deficit plan has been forced on the President by legislators who have an extremely poor track record of economic forecasting since Reagan took office. They ridiculed Reagonomics; they said unemployment would not drop sharply (it has); they said the recovery would be weak (it hasn't been); and they warned that the recovery would sputter out (it isn't). At the least, responsible members of Congress, no matter what their views of the deficit issue, should demand that the package must not pass without ironclad provisions ensuring that spending will be cut if taxes are raised. The last thing the nation needs is a rerun of TEFRA.

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1 See Paul Craig Roberts, "Taxes and Deficits," Wall Street Journal, January 14, 1984.

2 John Palffy, "The Hatch-Gramm Balanced Budget Spending Freeze Proposal," Heritage Foundation Issue Bulletin No. 91, May 5, 1983.

3 See Norman Ture, "The Anatomy of This Recovery: No Case for Tax Hikes," Institute for Research on the Economics of Taxation, March 2, 1984.

4 Business Week, March 12, 1984, p. 12.

DEFICITS AND INTEREST RATES

Most members of Congress are not really worried about deficits as such. What actually concerns them are the prospects of high interest rates and reduced business investment due to an alleged "crowding out" of private borrowers by the government. They mistakenly see a tax hike as a means of avoiding this. But this reasoning is based on the myth that deficits lead to high interest rates. It ignores the economic reality that federal spending, not deficit size, is the real drain on the economy. Discussions of taxes and deficits distract attention from the fundamental truth--all government expense must be financed by the nation's wage earners either through higher taxes, higher inflation, or higher interest rates or a combination of them. Each damages the economy and destroys jobs.[5]

Tax increase proponents overstate the correlation between government deficits and interest rates. In fact, most empirical analysis and historical evidence confirms that, if anything, there is a slight negative relationship between interest rates and deficits. Deficits skyrocketed in 1982, for instance, while interest rates plummeted. Other countries, such as Japan, have managed for years to run much larger deficits than the United States as a percentage of gross national product, while maintaining low interest rates. And the Wall Street Journal recently noted that despite an unexpected 12 percent decrease in the federal deficit in January, due to the strength of the supply-side recovery, Treasury bills and the prime rate both increased.[6] A recent survey of the data and studies on the matter by Treasury Department experts also confirmed that there is no conclusive theory available linking large deficits to high interest rates.

The case that tax increases reduce deficits or increase economic growth is equally unproven. Weeks after TEFRA was enacted on the promise that a tax increase would reduce federal budget deficits, the Congressional Budget office (CBO) raised its projections of future deficits. On the other hand, the Kennedy tax cut of the early 1960s demonstrates that tax reductions can bring down deficits by encouraging growth. Tax receipts rose $10 billion in 1964 and 1965, and GNP increased by $25 billion despite the $12 billion tax cut.[7]

When taxes are raised, deficits are rarely cut because the new revenues remove the pressure for making deep spending cuts. Legislators soon begin edging away from their politically unpleasant agreements to reduce outlays. Notes Nobel Laureate economist Milton Friedman:

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5 See Thomas Humbert, "Understanding the Federal Deficit, Part 3: The Unproven Impact," Heritage Foundation Backgrounder No. 330, January 27, 1984; and John Palffy, op. cit.

6 "The Prime Movement," Wall Street Journal, March 21, 1984.

7 See Paul Craig Roberts, The Supply-Side Revolution: An Insider's Account to Policy Making in Washington (Cambridge, Massachusetts: Harvard University Press, 1984), pp. 76-81.

> You cannot reduce the deficit by raising taxes. Increasing taxes only results in more spending. Political Rule No. 1 is: Government spends what government receives plus as much as it can get away with.

The record of TEFRA proves Friedman's dictum. Congress raised spending to more than offset the projected tax increase.

Not only do tax increases lead to more spending, they rarely yield the revenue promised, just as tax cuts rarely cut revenues as much as opponents fear. Most tax increases hit productive economic activity, such as work, saving and investment. This damages the economy and thus cuts future tax revenues. Even closing non-productive tax "loopholes" invariably fails to raise the promised amount of revenue because a portion of the money merely finds its way into other loopholes. Taxpayers will seek loopholes so long as it is less costly to pay accountants than to pay taxes on normal investments. The way to eliminate loopholes, as the Japanese have found, is to reduce or eliminate taxes on savings and risk-taking--thus making productive investment attractive to taxpayers. When a loophole is closed, thus making that particular investment inefficient or unavailable, the creative taxpayer merely moves to the next most efficient loophole or deduction.

HOW THE TAX BILL WILL HURT INVESTMENT

The folly of trying to cut deficits and improve investment by raising taxes should be evident to Congress. But even those legislators who honestly believe that higher taxes will lead to lower deficits and a better business climate should note that several provisions in the package, carried over from the Senate Finance Reconciliation Bill (S.2062), would reduce savings and economic growth directly--and thus undermine the deficit reduction plan.

The most damaging are:

(a) Repeal of the 15 percent net interest exclusion

This provision is projected to raise $7 billion in revenue. But it could reduce the return on savings by as much as 18 percent, thus reducing the incentive to save. The effect of this smaller pool of private savings would offset the advantages from the anticipated reduction in government borrowing. Extensive tax exemptions have encouraged Japanese taxpayers to save at rates more than three times those of Americans.[8] This large pool of savings allows the Japanese government to finance significantly higher deficits with lower interest rates than does Washington. Rather

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[8] Calculated by Evans Economics, Inc., Washington, D.C.

than reducing interest deductions, Congress should learn from Japan and increase interest deductions to foster risk-taking and saving.

(b) Delaying the expensing of business personal property for four years

Noted business economist Peter Drucker recently explained that in the past decade the American economy has created 20 million new jobs--mostly by small businesses financed on a shoestring. This "entrepreneurial revolution" is the foundation of the next generation of U.S. companies.[9] Delaying expensing would increase the cost of investment to small businesses, directly offsetting any such advantages from possible reductions in interest rates. The provision is projected to raise $1.4 billion.

(c) Delaying the reduction in the windfall profits tax

This provision would discourage new oil exploration, increase the future cost of oil, and thus add a further boost to general business costs.

(d) Lengthening depreciation on structures from 15 to 20 years

This recovery has been led by an explosion in capital spending--well above the average for post-war recoveries. While this capital surge has powered the recovery, business investment has been characterized so far by spending on new equipment, not new factories.[10] Only now are expenditures on new plants beginning to match the pace of other spending. A recent survey indicates that firms plan to boost plant spending by 17 percent this year.[11] Lengthening the depreciation schedule for structures could nip this acceleration in the bud. And hardest hit would be those industries that most need to replace obsolete factories--such as steel and textiles. This provision, which would raise an estimated $1.3 billion, could dampen seriously a key stage of the recovery.

(e) Raising corporate taxes

Corporate income taxes hit investors twice, since both dividends and profits are taxed. They also distort investment decisions and reduce corporate profits. Economist Kenneth T. Mayland, of First Pennsylvania Bank, has noted that existing depreciation write-offs, generating corporate retained earnings should allow private companies to generate $350 billion in internal funds in

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9 "How New Entrepreneurs Are Changing U.S. Business," U.S. News and World Report, March 26, 1984, p. 68.

10 Norman Ture, op. cit.

11 "A Hot Economy Starts Smoking--Capital Spending Surges," Business Week, March 12, 1984, p. 19.

1984. These retained earnings, he says, will be more than enough to self-finance projected capital expenditures.[12] Higher corporate taxes, however, will mean less retained earnings. This, in turn, means that corporations would be forced to borrow more in the credit markets to finance planned investment. So pressure on the credit markets, which the tax hikes are intended to reduce, would be increased directly by this provision.

If these tax provisions were not damaging enough, Democrats in both the House of Representatives and the Senate threaten to add $20 billion more in tax increases.

Among their possible targets are:

(a) Repeal of the third year of the tax cut

New gasoline and Social Security taxes, and inflation, have all but wiped out the original Reagan tax cuts. Raising marginal tax rates now would only destroy and reverse the recovery that got underway only when the full impact of the three-year tax plan was felt.

(b) Repeal or delay of the indexing of income tax brackets

This provision, advocated in the recently unveiled Senate Democratic plan, could raise revenues, but it would hurt the poor and middle income classes most--hardly a welcome side-effect of a reduction in the deficit.[13]

(c) Imposing a surcharge on high incomes

According to the Grace Commission, even if the government were to tax away all the income of those earning over $60,000, the government would only collect an additional $33 billion. The budget thus cannot be balanced just by over-taxing the wealthy. Moreover, much of this money would come straight from savings (thus raising interest rates) since high income households save most earnings over $50,000. It would also make remaining tax shelters even more attractive.

In fact, recent IRS data confirm the supply-side hypothesis that lowering marginal rates on the rich results in increased revenue collections from the wealthy. Despite reductions in the top marginal rate from 70 to 50 percent, tax receipts from individuals earning over $100,000 in 1982 increased over 13 percent, compared with 1981.[14]

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12 "The 'Crowding Out' Scenario Looks Less Likely This Year," Business Week, January 30, 1984, p. 12.

13 Thomas Humbert, "Tax Indexing: At Last a Break for the Little Guy," Heritage Backgrounder No. 225, March 22, 1983.

14 Statistics of Income, (S.O.I. Bulletin, IRS), vol. 3, no. 3, Winter 1983-1984.

ANOTHER TEFRA FIASCO IN THE MAKING?

The present tax package threatens to repeat the sorry history of TEFRA. This would be the heaviest tax bill in history--1,000 pages long and hardly a simplification of the tax code. Moreover, while it is a tax bill intended to reduce deficits and encourage investment, it could actually have the opposite effect, as did its 1982 predecessor. As former Assistant Secretary of the Treasury Paul Craig Roberts has noted,

> TEFRA was supposed to help investment by raising revenues, thereby lowering budget deficits and interest rates. Instead it reduced the cash flow of the business sector by the amount of the tax hike, thereby making business more dependent on borrowing to finance investment. Since firms have lower credit ratings than the U.S. Treasury, the substitution of business borrowing for Treasury borrowing has the effect of raising the interest rate. In addition, TEFRA directly reduced the return on investment by raising the after-tax cost of plant and equipment. The only way TEFRA could have contributed to lower interest rates is by reducing private investment and thereby lower demand for credit.[15].

The current deficit reduction plan could repeat the same mistakes.

Some Republicans share Roberts' concerns, but reluctantly see tax increases as the painful price they must pay for obtaining spending cuts. But is it a good deal? Again the TEFRA experience suggests they are being conned. The First Concurrent Resolution on the Budget for FY 1983 (S. Con. Res. 92), passed in April of 1982, recommended $100 billion in tax increases and $280 billion in budget cuts. President Reagan cited the Resolution's budget cuts as the condition for his support of TEFRA. Indeed, on August 9, 1982, he noted that:

> the budget resolution passed this year (1982), if Congress sticks to its targets, will decrease the red ink in the budget by almost $400 billion through 1985. The tax bill's new revenues are only one-quarter of that total. The remaining three-fourths--$280 billion in deficit reductions--is to come from lower outlays. We worked with Congress on this resolution and that was the price of my support--$3 saved in outlays for every $1 in increased revenues.

The critical passage in the President's statement was "if Congress sticks to its targets." In truth the nation was burdened with 4 cents in non-defense spending increases for every

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[15] Roberts, _op. cit_, pp. 301-302.

dollar of TEFRA taxes. As such, Congress still owes the President over $150 billion of non-defense spending cuts from their last deal.

MAKING THE DEAL STICK

The Problem

Nobody is now demanding that Congress make good on its past promises. That may be too much to expect in Washington. Yet the President and his congressional allies at least should learn from their past mistakes. Senate and White House backers of the new package, however, are taking some precautions to make sure that they are not bamboozled again. Unfortunately, the tax increases are all specified and can be passed in one timely bill. Many of the specific spending cuts, on the other hand, still have to be agreed upon and passed through several appropriations bills much later this year. In order for the spending and defense cuts and tax increases to be included in S.2062--the Senate Finance Reconciliation bill--the Senate would have muster a majority to waive its germaneness rule.

As planned, the bill would state that the spending cuts must be made in particular budget functions. But such a statement does not guarantee that the spending cuts actually will be delivered. Some House and Senate authorizing committees already have begun writing budget-busting authorizations. As these authorizations filter through the appropriations process and onto the floor they easily could violate the ceilings mandated in the bill.

Even if a senator or congressman raised a point of order against the appropriation, a majority of 51 senators or 218 representatives could pass the bill--thus reneging on the spending side of the deficit package. The President would then be forced to sign into law spending that violates the budget compromise, or veto entire appropriations bills.

The Options

(1) Conservatives could try to hold tax increases hostage to spending cuts by voting down the Reconciliation Bill--that is, the entire deficit reduction plan--on the floor of the Senate. They could opt to link specific tax increases to specific spending cuts when they are voted on by the appropriations committees. Unfortunately, including tax legislation with appropriations bills in this way would take some highly creative procedural footwork. It is unlikely that Congress would go along with this--it would require unprecedented cooperation between the Finance committees and the Appropriations committees, and between the House and Senate.

(2) Legislators would be better advised to call the bluff of those who solemnly promise spending cuts by attaching an amendment to the Reconciliation bill, allowing the President to "line item veto" any spending that violates the prescribed limits in

the next three years. This restricted veto would require two-thirds of Congress for an override--effectively guaranteeing that the cuts would be made.

This second option is the only plausible method of ensuring that Congress keeps both sides of its bargain with the White House.

ARE THERE REALLY ANY SPENDING CUTS IN THE PROGRAM?

No sooner had the Deficit Reduction Plan been made public than critics began to cast doubt on its numbers. A CBO statement on March 19 claimed that the plan reduced outlays only $52 billion--not the $101 billion the Administration claimed. Moreover, rumors abounded that some entitlement cuts were already being stricken from the agreement. And who could forget the disappearing act of TEFRA's spending cuts?

Depending on the base figures used for the purposes of calculation, the package either reduces defense spending $40 billion or increases it $4 billion. The $40 billion cut in defense spending constitutes a cut from the President's proposed FY 1985 increase of 13 percent, leaving a real increase of approximately 8 percent over FY 1984.

The Senate also assumes that $18 billion will be saved from reduced interest expenditures, but the Congressional Budget Office claims the saving will be only $12 billion. Moreover, if the tax increases do not yield the anticipated revenues, or if some of the spending cuts are not made or are cancelled out by other increases, these spurious interest reductions will never materialize at all.

Some members contend that since some of the Finance Committee's entitlement cuts already have been approved they hardly can be considered as part of the compromise. Moreover, many of the proposed spending cuts would result from a broad freeze on non-defense discretionary spending. Specific cuts have not yet been agreed to, however. These would be determined in the appropriations cycle this summer. Under election year pressures Congress could ignore limits placed on it in the proposed reconciliation bill.

CONCLUSION

The Republican Deficit Reduction Plan is the most attractive option currently under serious consideration. Yet it contains potentially fatal pitfalls. The investment tax provisions of the deficit reduction plan should be resisted strongly. Only as a last resort should they be viewed as a distasteful, possibly dangerous cost of obtaining spending cuts. Closing non-productive loopholes will do little to reduce the deficit. Closing other loopholes will increase the cost of saving and investment. It is a curious logic which argues that the deficit must be bridged with taxes on investment in order to raise savings and investment.

The Deficit Reduction Plan is supposed to cut $52 billion from CBO basline spending over the next three years. If the plan can achieve this modest goal without counterproductive taxes on savings and investment it would constitute a small step in the right direction. However, the economy needs more than a 2 percent cut in federal spending. It needs the scope of cuts proposed in the Grace Commission report and detailed in a proposed budget by the House Republican Study Committee.[16] Congress should take the opportunity it now has to demand such cuts be part of any compromise. As many of these spending cuts as possible should be specified in the bill rather than left to the vagaries of the appropriations process.

In addition, if the Senate leadership is to obtain the budget cuts it wants, it should amend the bill to grant the President a line item veto to enforce the proposed spending reductions over the next three years.

Only if the President receives assurance that all the proposed spending cuts will be enforced and that Congress will return to the tables for more cuts should the President sign any bill that includes even $1 of tax increases.

The booming economic recovery refutes the dire predictions of those in and out of Congress who claimed first that a recovery could not take place because of the deficit; then that it would fizzle out in 1983 because of high interest rates; then that consumers, not investment, would power the upturn. Now the doomsayers are saying that billions of dollars of new taxes on business are necessary to provide the incentive for continued investment. Not only do those pulling for such tax increases systematically ignore all the evidence before them but they use arguments that defy logic. Congress would do much better if it were to devote more time to devising a method of ensuring that spending cuts would stick, and less time inventing new ways of taxing the recovery to death.

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[16] The Grace Commission Budget Alternative, Republican Study Committee, February 28, 1984.