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A TAX HIKE IS NO CURE FOR THE DEFICIT

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INTRODUCTION

Pressure to reduce federal budget deficits remains high, despite a District Court ruling invalidating a key section of the Gramm-Rudman-Hollings deficit reduction law. Also high is pressure to deal with such deficits by raising taxes, rather than cutting spending. In particular, an oil import fee appears to be gaining support as the price of oil slides downward.

Raising taxes will not cure the deficit, for the deficit is not caused by insufficient taxes, but by excessive spending. In the past ten years, in fact, federal tax revenues have almost tripled, despite the reduction in tax rates. The trouble is that federal spending has grown even faster than revenues. An oil import tax, however, would be a mistake; it would hamper America's international competitiveness, strike hard at the already depressed refining and petrochemical industries, further weaken the repayment capacity of several debtor nations, and raise U.S. unemployment.

Rather than giving consideration to tax gimmicks as a means of reducing the deficit, Congress should be pressing ahead with the only solution to the red ink--cutting federal spending.

WHY A TAX HIKE IS NOT THE ANSWER

Those who advocate tax increases to solve the deficit problem base their argument on a series of myths about the state of the economy.

Myth 1: The deficit derives from Americans being "undertaxed."

Many tax increase proponents claim that the deficit was caused by Ronald Reagan's tax "cuts" of 1981. But the fact is that revenues have remained relatively constant as a share of gross national product, despite the 1981 tax cut. Spending, however, has exploded. Figure 1 and Table 1 show this. Deficit reduction efforts, moreover, thus far have concentrated disproportionately on raising taxes, rather than cutting spending. Table 2 summarizes the revenue effects of five major tax increases already enacted during the Reagan Administration, and it indicates that over the next five years such increases will take over $469 billion out of the pockets of American taxpayers. Table 3 shows that these tax increases will take back over 39 percent of the tax reduction under the Economic Recovery Act of 1981, which is so often blamed for the deficits.

Myth 2: A tax increase will not affect economic growth.

Those who advocate tax increases to deal with deficits tend to assume that the economy can benefit from lower deficits without suffering from the tax hike itself. They assume that it is possible to have it both ways: higher growth and lower unemployment resulting from previous tax cuts, along with the alleged benefits from lower deficits, such as lower interest rates, resulting from a new tax increase.

A related error is to assume that taxes will be increased with the least possible economic damage. Yet, given the political makeup of Congress, it is more likely that new taxes would take the form of increased taxes on capital--hitting saving and investment rather than consumption. If taxes on capital were raised, saving could fall by as much or more than the amount of the tax. The result: rising interest rates, even as deficits fell.

Myth 3: Congress will use the new revenues to cut the deficit, not spend them.

It is wishful thinking to assume that new revenues, however raised, will be applied to deficit reduction, rather than fueling additional spending. More likely, any deficit reduction due to increased revenues simply will alleviate the pressure to control spending. If the deficit is ever brought under control by raising taxes, spending is almost certain to take off again--unless checked by a balanced budget/spending limitation amendment to the Constitution.

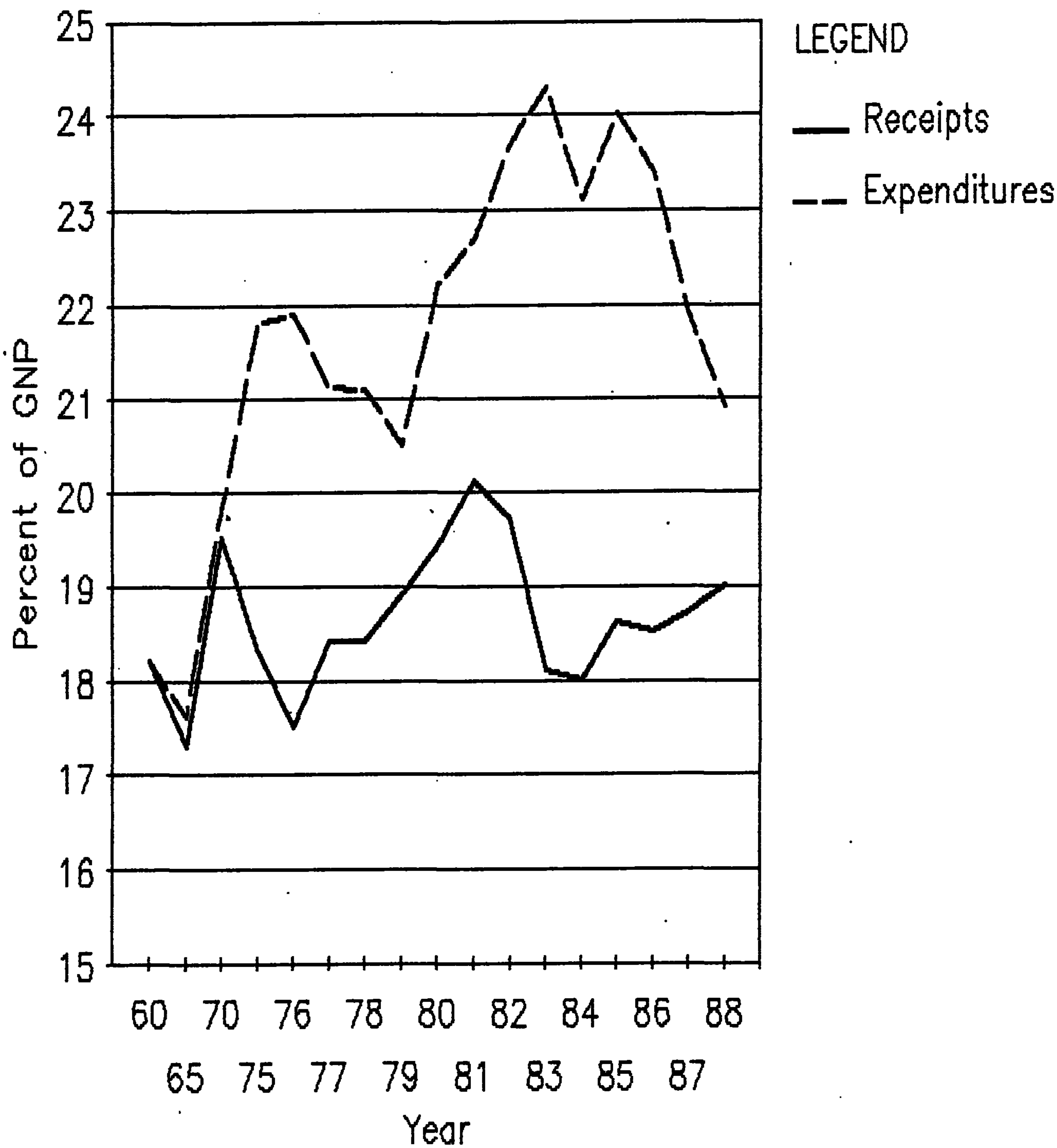
Table 1
Receipts, Expenditures, and Deficits
(percent of GNP)

Year	Receipts	Expenditures	Deficits
1988*	19.0	20.9	-1.9
1987*	18.7	21.9	-3.2
1986*	18.5	23.4	-4.8
1985	18.6	24.0	-5.4
1984	18.0	23.1	-5.0
1983	18.1	24.3	-6.3
1982	19.7	23.7	-4.1
1981	20.1	22.7	-2.6
1980	19.4	22.2	-2.8
1979	18.9	20.5	-1.6
1978	18.4	21.1	-2.7
1977	18.4	21.1	-2.8
1976	17.5	21.9	-4.3
1975	18.3	21.8	-3.5
1970	19.5	19.8	-0.3
1965	17.3	17.6	-0.2
1960	18.2	18.2	+0.1

*Estimate

Source: Office of Management and Budget

Figure 1
Federal Receipts and Expenditures



Source: OMB

Table 2
Effect of Major Tax Increases
(billions of dollars)

Legislation	1985	1986	1987	1988	1989	1985-89
Tax Equity and Fiscal Responsibility Act of 1982	39.2	49.2	59.2	61.6	61.7	270.8
Highway Revenue Act of 1982	4.2	4.5	4.7	4.8	5.0	23.2
Social Security Amendments of 1983	8.7	8.0	9.2	20.0	24.9	70.9
Railroad Retirement Revenue Act of 1983	0.7	1.1	1.1	1.1	1.1	5.1
Deficit Reduction Act of 1984	9.3	16.0	21.8	24.9	27.2	99.2
Total	62.1	78.8	96.0	112.4	119.9	469.2

Table 3
Tax Increases Compared to 1981 Tax Cut
(billions of dollars)

	1985	1986	1987	1988	1989	1985-89
1981 Tax Cut	170.3	207.5	244.8	274.0	303.7	1,200.3
Tax Increases	62.1	78.8	96.0	112.4	119.9	469.2
Increases as a % of 1981 Cut	36.5	38.0	39.2	41.0	39.5	39.1

Source: Office of Management and Budget

IS DEFICIT REDUCTION WORTH A TAX HIKE?

Because the U.S. economy is extremely complex, actions dealing with one problem may create others. High interest rates are still an irritant, but have declined sharply despite large budget deficits. Interest rates on three-month Treasury bills, for example, have fallen by half since 1981, from 14 percent to a current level of about 7 percent. How much further do advocates of tax increases think rates would fall if the budget were balanced? In 1969, the last year the U.S. had a balanced budget, Treasury bill rates averaged 6.7 percent--only slightly lower than they are today.

If it is unlikely that lower deficits will push interest rates down further, what benefits can be expected? Some argue that the deficit raises the exchange value of the dollar and thereby penalizes exports. But if interest rates are now about what they were when the budget was balanced--and lower than in many competing countries--what continues to draw foreign funds into dollar-dominated assets? If foreign investment in dollar assets is a problem, and it almost surely is not, balancing the budget is not going to solve it.

It has also been argued that the federal deficit causes inflation. But this is an argument with little evidence. In the past four years, in fact, inflation has subsided as the deficit has mounted.

It is even questionable whether any action is needed to curb the deficits. They appear to be coming under control under current policies. If the Administration estimates are correct, the budget deficit will fall to 1.9 percent of gross national product by fiscal 1988; this would be the lowest level since 1979. Independent projections reach similar conclusions.[1] The Congressional Budget Office's (CBO) most recent forecast, for example, shows the the deficit falling by $20 billion a year without congressional action.

The case for tax increases to balance the budget thus is extremely weak. It becomes weaker still when the specific tax proposed is an oil import fee.

OIL IMPORT FEE

In recent months there has been considerable discussion of an oil import fee as a revenue-raising device, either for deficit reduction or for financing tax rate reductions as part of tax reform. Such a fee would be a particularly bad way of raising revenue for economic and political reasons alike. It would hurt American industry, American consumers, some of the nation's most important allies, and many of its heaviest debtors.

A frequently discussed option is imposing a $5 per barrel tariff on imported oil. Since oil prices are falling, it is said, this would

1. William G. Dewald, "CBO and OMB Projections, Adjusted for Inflation, Show Federal Budget Deficit Under Control," Federal Reserve Bank of Richmond Economic Review, November/December 1985, pp. 15-22.

be a painless tax hike, barely noticed by the consumer. Yet a CBO study of this idea concluded that a tariff would reduce real economic growth by 0.5 percent the first year. The result of this: a jump of 100,000 in the unemployed and a 0.4 percent hike in the consumer price index.

The CBO also noted that the fee's impact on the federal deficit may be surprisingly limited. In calculating the revenues raised by the fee, it is misleading simply to multiply U.S. oil imports by $5 per barrel. The relative increase in the cost of oil caused by the fee would reduce demand for oil, slow economic growth, and spur higher federal expenditures for mounting unemployment and for indexed entitlements boosted by higher inflation. Thus while an oil import fee would yield new revenues, it also would trigger higher federal outlays. And although Washington might take in more revenue from corporate income taxes and windfall profits taxes, assuming that domestic oil prices rose by the amount of the tariff, it is noted by the CBO that there would be lower revenues due to offsetting effects elsewhere in the economy resulting from higher energy prices.[2]

The amount of revenue might also be affected by pressures to make exemptions in the tariff's coverage. For example, the U.S. imports a substantial amount of oil from some of its closest allies and from nations with serious debt problems. Imposing a tariff on Mexican oil, for example, could exacerbate that country's serious foreign debt problems.

The seven countries in Table 4 provide over 66 percent of U.S. oil imports. The U.K and Canada are two of America's closest allies, and Canada is also America's largest trading partner. There undoubtedly would be strong political pressure to exempt these two countries from an import tariff. Mexico, Venezuela, Ecuador, Nigeria, and Indonesia, meanwhile, are heavily in debt and owe large sums to U.S. banks. Again, there would likely be heavy political pressure to exempt such nations from an import tariff. By contrast, the U.S. imports just $3.8 billion in oil per year from Saudi Arabia and just $678 million per year from the United Arab Emirates, which together account for just 12 percent of total U.S. oil imports.

2. The study is reprinted in the Congressional Record, April 26, 1982, pp. S 3982-91, (daily edition).

Table 4
U.S. Oil Imports from Selected Countries, 1984

Country	Imports*	Percent of Total Imports
Mexico	6.8	17.9
Canada	3.5	9.2
United Kingdom	4.1	10.8
Venezuela	3.7	9.8
Ecuador	1.0	2.6
Nigeria	2.4	6.3
Indonesia	3.7	9.8

*Billions of dollars

Source: Department of Commerce

If certain nations were exempted from the tariff, its revenue yield would be sharply reduced. There also would be serious enforcement problems, as it would be difficult to prevent an exempted nation from obtaining oil from a nonexempted nation and transshipping it to avoid the tariff. It would be practically impossible to determine whether a given barrel of oil came from a nation that was covered by the tariff or from one that was not.

Another problem with an oil import fee involves the treatment of such petroleum products as gasoline, heating oil, and petrochemicals. If the tariff applied only to crude oil, an obvious way to evade it would be to refine the oil or manufacture the petrochemicals outside the U.S. and then ship in the products free of tariff. This would penalize the U.S. refineries, which are already operating at historically low capacity rates, and the petrochemical industry, which is suffering from slow growth.

Rising imports are already a serious problem in both industries. Petrochemical imports, for example, doubled from $3.3 billion in 1981 to $6.5 billion in 1985. Imports of gasoline rose 38 percent in 1985, while the number of operating refineries fell to 199 from 315 in 1981, and capacity utilization remained at the very low level of 76 percent.[3]

Negative effects also can be expected in the other U.S. industries for which the price of oil is an important factor. Such industries would be at an international disadvantage compared with their competitors in nations that paid no oil import fee. Says Du Pont chairman Edward Jefferson: "While appealing at first glance, a tax on imported oil would seriously impair the worldwide cost competitiveness of many domestic industries by forcing them to use energy and petroleum-based raw materials at prices above world levels."[4] The result could be an increase in the U.S. trade deficit, even as oil imports declined.

The economic effects of an oil import fee would extend beyond the American firms using imported oil. The price of all oil would rise by an equivalent amount, as would oil substitutes, such as natural gas. As the Washington Post puts it: "The price of the imports sets the price for the domestic product. Currently this country imports about a third of its oil. It means that for every dollar collected by the federal government in the tax, $2 will go to the domestic oil industry in higher prices."[5]

It is unfair, in short, to establish a tariff, which is advertised as benefiting all Americans through lower deficits, yet will primarily benefit domestic oil companies--especially when no similar import relief has been granted to other industries, such as textiles or shoes. Protectionism is a bad idea.

It also makes little sense to favor oil companies emphasizing domestic production at the expense of those dependent on imported oil. If Washington tried to address these inequities, it would have to create a new entitlements system, similar to that which existed prior to full oil decontrol in 1981. Such a system would be complex and expensive to administer. It would require domestic producers, in effect, to subsidize imports. And it would tend to increase oil imports.

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3. See 1986 U.S. Industrial Outlook (Washington, D.C.: U.S. Department of Commerce, International Trade Administration, 1986).

4. Quoted in John M. Berry, "Impact of Oil Import Fee Disputed," The Washington Post, July 26, 1985, p. B2. See also Charles Kadlec and Arthur Laffer, "Oil Levies Were a Bad Idea, Anyway," The Wall Street Journal, July 30, 1985.

5. "Taxing Oil," editorial, The Washington Post, December 29, 1985.

Congress already has considered an oil import fee and wisely rejected it. Just last November, the Senate voted decisively 78 to 18 against an amendment by Senator Gary Hart, the Colorado Democrat, to impose a $10 per barrel tariff on imported oil.[6] There is little reason to believe that the political conditions have changed much between then and now. And President Reagan remains adamant in his opposition to an oil import fee.

CONCLUSION

The oil import fee idea is unlikely to go away as long as there are those who believe that with oil prices falling such a fee would be a kind of "free lunch." The New York Times joined this chorus recently, claiming an oil import fee would merely "have the effect of paying ourselves what we have been paying to foreign oil producers."[7] This argument makes no sense. Its advocates apparently ignore or dismiss the overall economic impact of such a fee. An oil import fee would be a bad idea.

Equally senseless, and for most of the same reasons, would be any other kind of tax hike imposed to reduce the federal budget deficit.

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6. Congressional Record, November 14, 1985, pp. S 15599-15606.

7. "In the Name of Sanity, Tax Oil," editorial, The New York Times, December 24, 1985.