

TAXATION AND CURRENT ECONOMIC POLICY

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Executive Summary

Recent projections of Federal budget surpluses have stimulated discussion about the role of tax policy in the current macroeconomic policy mix. This paper first highlights several key premises underlying pro-growth tax policy:

- The current tax structure imposes an excessive burden or welfare cost on the economy.
- Tax rate changes can impact economic incentives in a wide range of ways.
- Tax policy should focus on long-term economic growth rather than on short-term aggregate spending or business cycle stabilization.
- Tax rates should be distinguished from tax revenues.
- Tax relief can work to constrain government spending growth in a number of ways.

Given these premises, the paper highlights a number of considerations supporting tax relief policies at the present time:

- Marginal tax rates have increased for many taxpayers in recent years.
- Federal tax revenue as a percent of GDP has increased to historic highs in recent years.
- Tax rate reduction could contribute to sustaining essential economic growth.
- Tax relief could help constrain current pressure for more government spending.
- Tax rate reduction can help to restore a more rational tax policy.
- Proportional income tax relief to those paying income taxes is fair and equitable.

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INTRODUCTION

The recent projection of Federal budget surpluses by both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) has stimulated discussion about the role of tax policy in the current macroeconomic policy mix. After highlighting some key premises underlying pro-growth tax policy, the paper reviews current circumstances, explains why tax distortions have increased in recent years, and makes the case for tax rate reduction. Reduction in tax rates can take several forms including uniform across-the-board rate reduction, liberalized IRA deductions, and other measures to reduce the current multiple layers of taxation on saving or investment.

PREMISES

Pro-growth macroeconomic tax policy should be premised on a number of key considerations:

- ! ***The current tax structure imposes an excessive burden or “welfare cost” on the economy:*** Our current tax code is economically counterproductive in that the cost of taxation involves not only the direct, obvious revenue costs, but additional costs of lost income and output. Estimates suggest that every additional dollar of tax revenue costs the economy significantly more than one dollar; substantial deadweight losses are evident. For example, Martin Feldstein estimates that an additional increase in tax revenue “achieved by a proportional rise in all personal income tax rates involves a deadweight loss of two dollars per incremental dollar of revenue.”¹ In short, deadweight losses of our current tax code are considerable. This suggests that additional public spending should occur only if the benefits it produces exceeds the full costs of those benefits, including the deadweight loss of collecting the revenue. This also suggests that tax reduction would reduce some of these excessive costs. Feldstein provides estimates of a substantial reduction of deadweight losses of the existing tax system brought about by a reduction in tax rates.² In short, current levels of taxation impose heavy costs or excessive burdens on the economy together with related costs of compliance and complexity. These costs have important negative consequences for long-term economic growth. This is one of the reasons that reductions in the levels of tax burdens would improve long-term macroeconomic performance.

- ! ***Tax rate changes can impact economic incentives:*** Changing marginal tax rates can impact a number of relative prices and consequently affect behavioral choice, resource allocation, and real economic activity. In particular, tax-induced relative

¹ See, for example, Martin Feldstein, “Tax Avoidance and the Deadweight Loss of the Income Tax,” NBER Working Paper No. W5055, March 1995, p.37.

² Feldstein, pp.32-3.

price changes can affect choices between work and leisure, consumption and future consumption, and taxable and non-taxable activity. Similarly, qualities that are difficult to measure such as ambition, motivation, the intensity of work effort, as well as other activities such as innovation, managerial skills, and entrepreneurial activity can also be affected by tax rate changes. In short, a full range of behavioral responses of taxpayers to changes in tax rates is possible. Changes in marginal tax rates, therefore, can simultaneously impact the supply of various factors of production such as labor, capital, and entrepreneurship, and consequently can affect productive capacity, aggregate supply, and long-term economic growth. Pro-growth tax policy should be designed to maximize these potentially favorable growth effects. The implication is that marginal tax rate cuts are preferred to various tax credits that have little impact on these important growth incentives.

- ! **Tax policy should focus on long-term economic growth rather than on short-term aggregate spending or stabilization:** By focusing on expanding various factors of production and thereby fostering aggregate supply rather than on managing aggregate demand or spending, tax policy can promote long-term economic growth. Aggregate spending, after all, is and will continue to be largely determined by monetary policy. In short, in order to raise living standards in the long run, tax policy should emphasize the primacy of production and aggregate supply.

Similarly, tax policy's long-run growth orientation should preclude attempts to actively use tax changes to "fine tune" or stabilize the economy over the business cycle. Pro-growth tax policy improves efficiency and incentives, and removes distortions and deadweight losses, thereby impacting aggregate supply rather than manipulating aggregate demand.

- ! **Tax rates should be distinguished from tax revenues:** Tax rates and tax revenues are distinctly different variables. Changes in marginal tax rates should be thought of as changes in relative prices affecting choice, resource allocation and real economic activity rather than as revenue or income changes. In short, these rate changes impact incentives and behavior and therefore are of utmost importance to growth advocates.

Tax revenue, on the other hand, is the product of the tax rate multiplied by the tax base. As such, changes in tax revenues are correctly interpreted as changes in spending or purchasing power. Understandably, changes in tax revenues are of utmost interest not so much to growth-incentivist advocates, but to those interested in the budget process and the financing of government purchasing or spending powers.

When the incentive effects of particular tax rate changes are correctly measured and properly taken into account (as in dynamic scoring models), changes

in tax revenues and tax rates may not be highly correlated and may possibly move in opposite directions. Accordingly, accounting for potent incentive effects of well-designed pro-growth tax rate cuts can result in substantially less revenue loss than static revenue scoring methods would suggest.

! ***Tax cuts can work to constrain government spending growth:*** Tax cuts can help to constrain the growth of government spending, thereby both limiting the size of government and encouraging economic growth. Government spending together with the financing it necessarily entails, after all, is the fundamental public sector burden on the overall economy. Actions limiting the size of government not only minimize financing burdens, but enable a larger share of economic resources to be more usefully employed in the more efficient private sector, thereby enabling the economy to grow more rapidly than would otherwise be the case.³ Tax cuts can help to accomplish this limitation of government spending in a number of ways:

- ***By constraining the key financing source for government spending:*** Government normally has incentives to spend all available tax revenue (and then some). By constraining funding, tax cuts limit government's primary input or its key source for spending.
- ***By lessening the budget surplus and thereby removing the temptation for more government spending.*** Limiting spending can work directly by constraining tax revenue as described above, or indirectly by reducing the existing pool of unclaimed revenue. Because government has incentives to spend existing unclaimed revenues, reduced surpluses lessen the incentive to spend. Thus, by lessening budget surpluses, tax cuts can reduce the temptation for additional government spending.
- ***By garnering the support of citizens necessary for the backing of spending restriction.*** Given the presence of special interests with a strong appetite for additional public spending, tax cuts can serve as a counterweight to the influence of these special interests in the political process. Without such counterweight, political pressures would weigh in the direction of more public spending. Thus, tax cuts can be used to muster the support of citizens necessary to support spending restraint.

³ For a discussion of the relationship between government spending and economic growth, see James Gwartney, Robert Lawson, and Randall Holcombe, "The Size and Functions of Government and Economic Growth," Joint Economic Committee, April 1998.

- ***By bolstering economic growth and thereby lessening the need for certain categories of government spending*** (such as unemployment insurance or income support programs).

CURRENT REASONS TO REDUCE TAX RATES

Given these key premises of pro-growth tax policy, there are several reasons, including the following, that support tax relief at this time :

- ! ***Marginal tax rates have increased for many taxpayers in recent years:*** While major elements of the income tax code are indexed for inflation, as real incomes rise, each year more and more taxpayers continue to be pushed into higher tax brackets. The result of this “real bracket creep” is to place larger and larger proportions of taxpayers in higher tax brackets, thereby broadening the disincentive effects of higher marginal tax rates.⁴ Additionally, marginal rate increases for some tax brackets were legislated in the budget bills of both 1990 and 1993. Furthermore, marginal rates on other forms of federal taxation (such as the payroll tax) have gradually increased over time, buttressing a higher overall marginal rate structure of federal taxation. While these considerations have not resulted in uniform marginal tax increases for each taxpayer, all taxpayers would still benefit from across-the-board tax rate reduction. Moreover, marginal income rate reduction is essential now to reverse the backsliding that has occurred both because of real bracket creep and legislated marginal tax increases. Because of the structure of the tax code, it is essential for Congress to periodically cut taxes to restore those rates that promote incentives and foster growth.

- ! ***Federal tax revenue as a percent of GDP (or the federal tax burden) has increased to historic highs in recent years:*** During the current expansion, federal tax revenues have grown significantly faster than the macroeconomy, placing ever-higher burdens on many of those paying taxes. Higher and higher shares of national income are being devoted to paying federal taxes. Not only is the proportion of federal tax revenue to GDP at the highest levels since World War II, but the President’s budget projects this tax revenue-to-GDP ratio to remain at or near record levels throughout the entire budget forecast horizon.⁵ In short, tax policy is growing more restrictive and burdensome on the overall economy from both the average and marginal rate

⁴ Currently referred to as “real bracket creep,” the phenomenon of economic expansion generating rapid revenue growth resulting in sizable budget surpluses at full employment was earlier called “fiscal drag” and was part of the rationale used to justify the Kennedy tax cut in the 1960s.

⁵ Similarly, federal income taxes as a percentage of GDP are also at record post-war levels and are projected to remain at or near these record levels throughout the President’s budget forecast horizon. Similar statements apply to federal payroll taxes.

perspectives as well as from the perspective of welfare costs. Accordingly, a tax rate reduction to relieve some of this increased excess burden and thereby promote efficiency and growth is most appropriate at this time.

- ! **Tax rate reduction would help to sustain essential economic growth:** Marginal income tax rate cuts would enhance incentives to work, save, invest, and innovate, thereby encouraging continued economic expansion. Efforts to sustain economic growth are critically important at this juncture for several reasons. In addition to a number of well-known domestic benefits, continued U.S. economic growth is particularly important to the vitality of the global economy. As the world's largest economy and a major export market for many countries, protracted U.S. growth is essential for the global expansion to continue, particularly given the persistent weakness in Japan and in many of the world's emerging markets. An uninterrupted U.S. expansion could provide the stable backdrop needed to allow many of these countries to make necessary long-term structural adjustments.

Furthermore, continued U.S. economic growth provides the best foundation for policies to save and/or reform social security and medicare. Such growth will lend the time essential to carefully prepare appropriate responses to these important problems. An interruption in the expansion could create obstacles to needed bipartisan solutions to these problems. For these reasons, tax policy involving tax cuts to nurture and sustain our economic expansion is most appropriate.

- ! **Tax cuts could help constrain the current pressure for more federal government spending, thereby both limiting the size of government and helping to sustain the U.S. economic expansion:** Tax cuts can work to limit government spending growth in coming years by constraining such spendings' key source of finance. Tax cuts can also work to limit spending growth by lessening budget surpluses, thereby reducing the temptation of government to spend such monies. Additionally, tax cuts can act as an incentive to taxpayers to restrain their demands for more government spending. Such tax-induced spending restraint helps to promote continued economic expansion in part by reducing the excess burden of taxes and government spending.
- ! **Tax cuts can help to restore rationality to tax policy:** By the mid-1980s, a consensus had emerged among most economists and tax experts that proper reform of the U.S. tax code should entail lowering marginal tax rates and broadening the tax base. They recognized that tax loopholes and tax code complications spawned by years of special interest tax lobbying should be minimized or removed in favor of a cleaner, simpler code with fewer brackets and lower rates. Conservative economists as well as liberal economists from the Brookings Institute largely agreed on these principles which were partially incorporated into the tax code by the *Tax Reform Act of 1986*. After exhaustively reviewing recent literature surrounding the *Tax Reform Act of 1986*, Auerbach and Slemrod concluded that "the theoretical case remains valid for a tax

system with a broad and clean base which minimizes the reward to tax-driven economic activity.”⁶

Recently, however, tax policy has lost its moorings. Specifically, tax policy during the 1990s has moved in a direction opposite to the concept of a broader base and lower rates; it has increasingly been characterized by targeted tax relief or tax credits that necessarily and inevitably imply a narrower tax base. As former Federal Reserve Governor Lindsey has ably pointed out in recent testimony before the Senate Budget Committee:

Targeted tax relief means, by definition, a narrower tax base. Some economic activity becomes tax favored while, to compensate, other forms of economic activity must carry higher marginal rates to make up the difference.⁷

In short, as the tax base is chipped away, over time marginal rates will be raised to compensate for revenue losses.

A reversal of this unfortunate trend is essential to restore a rational tax policy. An across-the-board marginal income tax rate cut would be a move in this direction and could help to revitalize support for the earlier view.

! ***Returning tax monies to their rightful owners (the taxpayer) is appropriate:*** A budget surplus signifies a tax overpayment (for goods or services not rendered). Such monies do not belong to the government, but to the taxpayer; tax money is the people’s money rather than the government’s. In short, there is a moral dimension to tax policy deliberations that merits consideration when weighing tax options in an era of budget surpluses. Returning tax monies to their rightful owners is an appropriate option.

! ***A proportional income tax rate reduction to those paying income taxes is fair and equitable:*** The current income tax code is progressive with a very high proportion of tax revenues being paid by taxpayers in the upper-income brackets. Such progressiveness means that upper-income taxpayers not only pay significantly more taxes in absolute terms, but they also pay higher percentages or shares of their incomes in taxes as well. Lowering tax rates proportionately across the board reduces the tax burden by equal percentages on all those paying taxes. Since all taxpayers are

⁶ Alan J. Auerbach and Joel Slemrod, “Economic Effects of the Tax Reform Act of 1986,” Journal of Economic Literature, Volume XXXV, Number 2, June 1997.

⁷ Lawrence B. Lindsey, “Federal Tax Policy in the New Millennium,” statement before the Senate Budget Committee, January 20, 1999, p.18.

treated alike, such change is fair and equitable. But such action does retain the progressive structure of the tax code.

SUMMARY AND CONCLUSION

Pro-growth tax policy should be premised on a number of key considerations. A host of reasons highlight the appropriateness of tax rate reduction at this time. The current tax structure imposes an excessive burden or welfare cost on the economy which would be reduced by lowering tax rates. Marginal and average tax rates have increased in recent years with the average tax burden reaching and persisting at historically record levels. Reducing tax rates is currently one of the few viable public policy options available to sustain economic growth. Uninterrupted economic growth is particularly important given global economic weakness and during periods when solutions to the social security crises are being formulated. Broad-based tax cuts can help restrain the spending of government and are fair, equitable, and appropriate in a period of budget surplus.

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