CHAPTER 2

The Federal Budget and the Economy

CONTINUED GROWTH OF THE FEDERAL GOVERNMENT may be the most serious problem facing the American economy. The growth of Federal spending and the debt are the most visible manifestations of this problem. The first is a longstanding condition; Federal expenditure has generally increased relative to gross national product (GNP) for more than 50 years. The second condition is more recent; after declining for most of the postwar period, the outstanding Federal debt as a share of GNP has increased sharply in the past 5 years. These conditions are closely related. Reducing the growth of Federal spending would reduce both the spending and debt shares. Increasing taxes would not reduce the spending share and would reduce the debt share only if spending were also restrained relative to the tax increase.

Table 2–1 summarizes the long-term trends in the relationship of Federal expenditure, receipts, and borrowing to GNP. The Federal expenditure share of GNP has increased each decade since 1929 and, unless the near-term growth is reduced substantially, the expenditure share will also increase in this decade. Almost all the growth in the expenditure share since 1949 reflects the increase in Federal spending for nondefense programs. The receipts share increased rapidly through 1959 and has been roughly constant, except for cyclical variations, since that time. Federal borrowing as a share of GNP varied within a narrow range, except during World War II and recessions, until the past several years. The ratio of the outstanding debt to GNP increased sharply during the Great Depression and World War II, declined substantially through the 1970s, and has since increased sharply.

This chapter describes the primary relationships between the Federal budget and the U.S. economy. These relationships operate in both directions. Changes in economic conditions affect the budget for a given set of fiscal policies and they affect the policies selected. Changes in the budget also affect the economy, in ways that depend critically on the type of expenditure and the detailed characteristics of the tax code. For any meaningful evaluation of the effects of the Federal budget on the economy, fiscal policy should be defined in terms of the levels of government services, the eligibility conditions and payment rates for transfer programs, and the statutory tax rates on private activity. The first section of this chapter addresses the effects of Federal expenditure and the deficit. The second addresses the effects of the major types of Federal taxes. The concluding section discusses several proposals for change in budget concepts, the budget process, and the fiscal authority.

TABLE 2-1.—*Federal expenditures, receipts, and borrowing as a share of GNP, selected years, 1929-84*

[Percent of GNP]

Calendar year	Expenditures			Receipts	Borrowing	
	Total	Defense [1]	Other		Deficit	Debt [2]
1929	2.5	([3])	([3])	3.7	−1.2	16.1
1939	9.8	1.4	8.5	7.4	2.4	42.8
1949	16.0	5.1	10.9	15.0	1.0	75.5
1959	18.6	9.3	9.3	18.4	.2	42.8
1969	20.0	8.1	11.9	20.9	−.9	23.9
1979	21.1	4.6	16.5	20.4	.7	21.6
1984 [4]	24.0	6.0	18.0	19.2	4.8	30.2

[1] Purchases of goods and services.
[2] Federal debt held by private investors, end of June.
[3] Not available.
[4] Preliminary estimates.

Note.—Expenditures, receipts, and the deficit are on a national income and product accounts basis.

Sources: Department of Commerce (Bureau of Economic Analysis) and Department of the Treasury.

MAJOR CURRENT FISCAL ISSUES

The Federal Government, like all other institutions, faces two long-run constraints: Expenditure and the outstanding debt cannot grow indefinitely relative to potential receipts. The Federal Government differs from other institutions in two major ways. First, because of its size it has a major impact on private incentives and, therefore, the level and allocation of economic activity. Second, the Federal Government has a monopoly on the right to inflate its nominal receipts by creating money.

Federal expenditure must be financed by tax receipts. The substitution of borrowing for current tax receipts only defers the inevitable—additional taxation. An increase in the expenditure share, moreover, should face an increasingly stringent test, because the cost of additional Federal expenditure increases rapidly with the level and variance of marginal tax rates.

An increase in the debt share may be justified if Federal expenditure is temporarily high or receipts are temporarily low, in order to reduce the variation of tax rates over time. If Federal expenditure excluding interest payments grows proportionately with GNP, however, an increase in the debt share also requires an increase in future average tax rates to finance the increased future interest payments. An increase in the debt share, thus, must be financed by some combination of reducing the growth of noninterest expenditures below the growth of GNP, by higher future tax rates, or by inflation. Federal borrowing, in summary, is ultimately limited by the same conditions that limit Federal expenditure.

The current deficit is a crude measure of the present value of the amount by which future noninterest expenditures must be reduced or future tax receipts increased. The correct measure is the increase in the real market value of the net debt held by private investors. This requires adjusting the reported deficit for the differences between par and market value of the publicly held Federal debt, the loan portfolio, and other Federal financial assets. For many years, these adjustments substantially offset reported deficits, which is one reason why the reported deficit has provided little useful information about either Federal fiscal conditions or its effects on the economy. In recent years, however, these adjustments still leave a substantial increase in the real net debt.

In the absence of a change in fiscal policy, the prospective Federal deficits, however measured, are clearly too large. This conclusion is based less on the short-run effects of the deficit on the economy than on the effects of the deficit on the Federal budget. Many expected short-run effects of large Federal deficits on the economy have not occurred. Deficits were expected to increase inflation; in fact, inflation has been reduced by about two-thirds since 1980. Deficits were expected to increase interest rates; in fact, short-term interest rates are now less than one-half their peak levels in 1981. Deficits were expected to lead to weak investment and a weak recovery; in fact both real business investment and real GNP growth in the current recovery have been stronger than in any prior peacetime recovery. These developments do not indicate that the deficit had no effect, only that other conditions dominated. One important economic effect of fiscal policy in this period appears to have been the large increase in the trade deficit, but the magnitude of this effect was not widely anticipated. Given the longstanding concern about the Federal deficit, the short-run effects of the deficit on the economy have been surprisingly difficult to estimate.

Whatever the effects on the economy, the effects of the deficit on the Federal budget are clear: Federal borrowing increases future interest payments that must be financed by either reducing future noninterest expenditures or increasing taxes. The first priority of near-term fiscal policy should be to stabilize the ratio of outstanding Federal debt to GNP; the alternative is either a progressive reduction in the noninterest expenditure share of GNP or a progressive increase in tax rates. Only when this ratio is stabilized will the country have the luxury of addressing whether a further reduction in Federal borrowing would be desirable to increase net saving and investment.

This goal can be accomplished by either reduced growth of expenditure or by increased tax receipts. Reducing the growth of total Federal expenditure may require a substantial reduction in expenditure for some programs and the termination of others. Economic analysis does not provide a sufficient basis to make this choice. The decision to reduce expenditure or increase taxes is fundamentally a political choice. If the American people prefer that Federal expenditure be restrained to about 20 percent of GNP, no increase in taxes is necessary; if they prefer the current share of about 24 percent, a substantial increase in tax receipts is necessary at some time.

If constraining the growth of Federal expenditure is important, reducing Federal borrowing is urgent. The President has articulated a clear strategy to meet both of these objectives:

1. Maintain economic growth with declining inflation.
2. Reduce the growth of noninterest expenditure, to a rate below the growth of the economy, until a level is reached that is broadly supported by the American people.
3. Broaden the tax base to permit a further reduction in tax rates.
4. *Only as a last resort,* increase tax revenues if necessary to finance the level of government that is broadly supported.

This year will provide the critical test of whether the Congress prefers to restrain spending or increase taxes. The next election will provide the first test of whether that choice is supported by the American people.

EFFECTS OF THE ECONOMY ON THE FEDERAL BUDGET

The economy influences the Federal budget through two processes. Changes in real income, inflation, and interest rates affect both Federal spending and receipts without any change in current fiscal policy. Estimates of these effects are prepared as part of the budget process, and the current estimates are summarized below. Changes in economic conditions also affect the demand for Federal spending. For example, an increase in real income reduces government outlays, increases receipts, and reduces the deficit by the sum of these two effects. An increase in real income, however, may also increase the demand for new or current Federal services and transfers, so the net effect of higher real income may lead to higher Federal expenditure.

Economic cycles also affect the budget. Over the postwar period, business cycles have induced changes in expenditures and receipts that typically have a reinforcing effect on the change in the budget deficit. For example, the cyclical effect of the downturn that began in the third quarter of 1981 is estimated to have increased expenditures by about $12 billion at an annual rate and reduced receipts by about $54 billion at the trough in the fourth quarter of 1982. As a result of these estimated cyclical effects on expenditures and receipts, the deficit was increased by about $66 billion at an annual rate in the trough quarter. Of course, cyclical effects that increase deficits during contractions in economic activity can be expected to reduce deficits in the ensuing economic expansion.

Table 2-2 shows the estimated effects on outlays, receipts, and the deficit from changes in real GNP growth, inflation, the unemployment rate, and interest rates, assuming each change occurs beginning January 1986. The table shows the independent effect on the budget from a change in each variable; of course, a change in one would normally be associated with changes in the others.

TABLE 2-2.—*Sensitivity of the budget to changes in economic conditions, fiscal 1986 and 1987* [1]

[Billions of dollars]

Item	Fiscal year 1986	Fiscal year 1987
1 percentage point reduction in real GNP growth:		
Change in outlays	0.2	1.1
Change in receipts	−3.4	−13.6
Change in deficit	3.6	14.7
1 percentage point reduction in inflation:		
Change in outlays	0	−1.5
Change in receipts	−3.5	−13.3
Change in deficit	3.5	11.8
1 percentage point higher unemployment rate:		
Change in outlays	2.8	4.4
Change in receipts	0	0
Change in deficit	2.8	4.4
1 percentage point increase in interest rates:		
Change in outlays	3.3	9.7
Change in receipts	.5	1.1
Change in deficit	2.8	8.6

[1] Change assumed to begin in January 1986.

Source: Office of Management and Budget and Council of Economic Advisers.

Clearly, changes in real growth and inflation can have large effects on outlays, receipts, and the deficit without any change in policy. Policy can, however, affect the sensitivity of the budget to economic conditions. For example, the indexation of individual income tax brackets reduces the sensitivity of receipts to changes in the inflation rate. A greater proportion of outlays are also now indexed. As a result, the budget deficit is now much less sensitive to a change in the inflation rate.

Economic conditions also affect the choice of fiscal policies, and these effects may augment or offset the effect of these conditions on the budget, given current policies. A recent study of the major determinants of the Federal expenditure share of GNP in the years since World War II provides a basis for estimating these combined effects. Almost all the variation in the expenditure share during this period can be attributed to three conditions—the level of real GNP per capita, the unemployment rate, and the number of armed forces overseas. These conditions, of course, also reflect the effects of many other conditions with which they are related. Still other conditions affect the composition of Federal expenditure. The complex interaction of policy decisions and economic conditions that leads to total Federal expenditure, however, can be summarized by this simple relationship.

The major conclusion of this study is that, after controlling for cyclical conditions and the deployment of armed forces, the demand for Federal expenditures, *as revealed by the political processes,* has increased faster than the increase in GNP. This effect would lead to a continued increase in the Federal expenditure share of GNP unless there is a reduced popular demand for Federal services and transfers, a change in the political processes, or a constitutional restraint on Federal expenditure. It is not clear how much this relation reflects popular preferences or a bias in political processes. In any case, these preferences and processes are not inexorable.

Another recent study has estimated the major determinants of the tax receipt share of GNP. The major conclusion of this study is that the historical increase in the share is best explained by an independent increase in the amount of taxable activities, the most important of which are reflected by the increase in female labor force participation and the decline in the relative number of the self-employed. In the short run, the tax receipt share of GNP appears to be determined more by the supply of taxable activity than by the demand for governmental expenditure.

These studies suggest that the government expenditure and tax receipt share of GNP in the short run are determined by fundamentally different conditions; the deficit share is determined by the differences in these conditions. Over time, the present value of government expenditure is limited to the present value of tax receipts, but it is less clear what limits the level of the deficit in the short run.

EFFECTS OF THE FEDERAL BUDGET ON THE ECONOMY

For several decades, the Federal budget has been evaluated on the basis of its effects on total demand, the allocation of resources, and the distribution of benefits and taxes among income classes. Different criteria were usually applied to evaluate each effect. For several reasons, this approach is probably not as valuable as was once believed.

Changes in Federal expenditure, tax receipts, and the deficit appear to have little effect on total demand, as measured by nominal GNP, except in times of war. The primary effects of the Federal budget on the economy appear to operate through the "supply side" of the economy by affecting incentives to work, save, and invest, although this conclusion is controversial.

A distinction between the allocative and distributive effects of the Federal budget continues to be valuable, but it is not clear that these effects should be evaluated by different criteria. A good case can be made that changes in Federal services and transfer payments should be judged by the same standard, that is, whether the sum of the value to the direct beneficiaries plus the value to other taxpayers is higher or lower than the additional cost to the economy. Any other criterion for evaluating distributive effects seems inherently arbitrary.

The effects of the Federal budget on the economy operate through specific Federal expenditure programs and the detailed provisions of the tax code. These elements of fiscal policy affect the behavior of households, businesses, other private institutions, and State and local governments in varied ways. For this reason, changes in the budget totals provide little useful information about the effects of the budget on the economy.

Changing one component of the budget, in turn, has quite different effects depending on how other components are changed. An increase in government purchases, for example, must be offset by an equal reduction in other expenditures, an increase in tax receipts, or an increase in the deficit; the net effect on the economy depends on how much each of these other components is changed. An evaluation of the effects of changes in one part of the budget, thus, must specify the amounts by which other parts of the budget are also changed.

Cost of Government Spending

Government purchases of goods and services and transfers cost the economy a good bit more than the direct increase in the budget. The cost of additional government activities is the sum of the increase in expenditure, the additional cost of tax compliance, and the additional cost from the misallocation of private activities that accompanies the expenditure and the taxes needed to pay for it.

One study estimates that the average private compliance cost of Federal and State personal income taxes is 5 to 7 percent of the revenue they raise. Total compliance costs also include government enforcement and the private compliance cost of other types of taxes. The additional compliance cost attributable to an increase in tax receipts is likely to be lower than the average cost but is probably still substantial.

A change in government expenditure and tax rates also leads to a change in the allocation of private activity. For example, an increase in unemployment compensation appears to increase the unemployment rate, and an increase in social security benefits may lead to earlier retirement. Similarly, an increase in personal income tax rates appears to reduce employment, and an increase in the effective tax rate on the income from investment reduces new investment. The economic literature uses the term "marginal excess burden" to describe the additional costs of misallocation of resources per additional dollar of expenditure and tax receipts. This burden differs by the type of expenditure and tax and increases sharply as a function of marginal tax rates. Several recent studies provide similar estimates of the magnitude of this marginal excess burden as a function of the effective marginal tax rate and the responsiveness of the labor supply to after-tax wage rates.

Table 2–3 summarizes estimates of the allocative costs of different types of government expenditure. Most recent studies of labor supply are more consistent with a moderate response of the labor supply to after-tax wages. These estimates are based on the range of the combined Federal, State, and local marginal tax rates during the past decade. The implications of these estimates are:

- The cost of additional government services is probably around 1.43 times the additional budget cost, plus the additional cost of tax compliance.
- The cost of additional government transfer payments is probably around 1.57 times the additional budget cost, plus the additional cost of tax compliance. Transfer payments are more "expensive" than services because they reduce labor supply and saving.
- These estimates increase sharply with the responsiveness of the labor supply to after-tax wage rates and with the effective marginal tax rate.

The primary policy implication is that government services and transfer payments are desirable only if their value is substantially higher than their budget cost. Government activities that fail this test should be eliminated or scaled back.

What limits the relative size of government? As the above estimates indicate, the cost of government expenditure increases as the responsiveness of labor to its after-tax return increases. This suggests that the size of government may be constrained by the extent to which taxable activity is a function of tax rates; for example, income earners may change location to reduce their tax burden. A centralization of government finance, for example, such as from local govern-

TABLE 2-3.—*Allocative cost of government expenditure*

[Allocative cost per dollar]

Item	Responsiveness of labor supply	
	Zero	Moderate
Goods and services		
Marginal tax rate		
43 percent	$0.07	$0.43
46 percent	.09	.53
Transfer payments		
Marginal tax rate		
43 percent	.21	.57
46 percent	.24	.72

Source: Charles Stuart, *American Economic Review*, June 1984.

ments to the State or from States to the Federal Government, diminishes the opportunity to avoid taxation by moving, and therefore is likely to increase the combined size of the government sector.

The cost of government expenditure is also a function of the marginal tax rate. The relative size of government, in turn, may be a function of this cost. This suggests that a broad-base, low-rate tax system is more likely to lead to an increase in the size of government than would a narrower base, higher rate tax system. During the past 20 years, much of the growth in government spending has been financed by the value-added tax in Europe and by the social security tax in the United States—both of which are broad-based taxes. This illustrates an important dilemma in public finance. Lower tax rates would reduce the allocative costs of the tax system for a given level of government expenditure, but they may also lead to an increase in the size of government. If the size of government is already too large as a result of biases in the political process, then a tax reform that lowers tax rates should probably be accompanied by constitutional restraint on government expenditure.

Effects on Consumption and Investment

Government expenditure and receipts also affect the level and distribution of private expenditure. There is substantial agreement among the recent studies concerning the effects of government purchases of goods and services and of transfer payments. For a given level of government expenditure, there is considerable disagreement about the relative effects of tax receipts and borrowing.

For a given level of total output, government expenditure for goods and services must "crowd out" an equal amount of private expenditure. The amount by which an increase in government expenditure reduces a specific component of private expenditure depends on the degree of substitution between government services and that component. Transfer payments change the composition of private expenditure if the combined effect of transfers and taxes redistributes income among groups with different propensities to consume and save.

For a given level of total government expenditure, the effects of changing current tax receipts and the deficit by offsetting amounts are much less clear. A reduction in current tax receipts must be offset by an increase in future tax receipts, and the deficit is a crude measure of the present value of these future tax receipts. For several decades, conventional economic theory has assumed that people overlook the future tax receipts necessary to finance the debt service on current deficits; in this case, a reduction in current taxes and an offsetting increase in the deficit would increase consumption expenditure and reduce investment. Renewed attention is now being given to an older economic theory that assumes that people recognize the existence of the future liability and save for the future tax payments necessary to finance current deficits; in this case, different combinations of current tax receipts and deficits would have little effect on the level of current consumption and investment. For example, an individual taxpayer facing a reduction in taxes in one year and a certain increase in taxes the next year is most likely to save the current tax reduction to pay for the future liability. It is much less clear how a group of taxpayers would react to a current tax reduction if the timing and distribution of future tax increases, some of which might be borne by the next generation, were uncertain.

Several recent empirical studies of consumption and investment reflect the range of estimates of these effects. One study of the determinants of personal consumption expenditure found that government purchases of goods and services appear to reduce personal consumption expenditure by about 25 cents per dollar of additional government purchases. Transfer payments, however, appear to increase personal consumption expenditure by a substantial amount, implying a redistribution from households with a high propensity to save to those with a high propensity to consume. A reduction in tax receipts and a corresponding increase in real government debt appears to reduce personal consumption expenditure by a small amount; this result is consistent with the hypothesis that the future tax receipts necessary to finance current government borrowing are fully anticipated. The results of this study suggest that government expenditure, not government borrowing, is the primary fiscal effect leading to a "crowding out" of private investment. These results, however, are quite different from those of many prior studies.

A direct test of the effects of government expenditure and borrowing on private investment is also useful, both to estimate the several fiscal effects on the components of private investment and to provide an independent test of the estimates of the effects on personal consumption expenditure. One recent study, for example, estimated the effect of changes in the real Federal debt on the composition of GNP, without controlling for the level and composition of Federal expenditure. Over the period since World War II, this study estimated that a $1 increase in the real Federal debt increased private saving by about 45 cents, increased State and local saving by about 5 cents, and reduced total domestic investment by about 40 cents, including reduced business investment in plant and equipment of about 15 cents. During the recent period of floating exchange rates, a $1 increase in the real Federal debt appears to have increased net foreign investment in the United States by about 25 cents.

Another recent study estimated the effects of total Federal, State, and local expenditure for goods and services and transfers and of the total government deficit on the composition of GNP. Gross investment including consumer durables and net exports appears to be reduced by about 50 cents per dollar of government spending for goods and services and by about 50 cents per dollar of the combined government deficit. Business fixed investment also appears to have been substantially reduced by government spending for transfer payments, but most of the fiscal effects on the composition of investment have not been stable.

The combination of economic theory and the available evidence suggests the following general conclusions:

- An increase in government expenditure on goods and services, financed by an increase in taxes, reduces the sum of personal consumption expenditure and private investment by a nearly equal amount, with the larger impact on private investment.
- An increase in government transfer payments, financed by an increase in taxes, probably increases personal consumption expenditure and reduces private investment substantially.
- For the same level of total government expenditures, an increase in government borrowing probably reduces private investment by about 50 cents per dollar, but the distribution of these effects by type of investment has not been stable.

The general policy implication of these conclusions is that a reduction in government expenditure for either services or transfer payments would increase total private investment. A reduction of the deficit by increasing tax receipts may also increase private investment if the increased taxes are not levied on the income from saving and investment.

Effects of Intergovernmental Grants

The Federal budget includes about $100 billion of grants-in-aid to State and local governments. State budgets, in turn, also include about $100 billion of grants to local governments. Most of these grants are now limited dollar grants for broad purposes, such as education.

The effect of these grants on the economy depends on the response of the receiving governments. Many studies have found that limited-dollar, broad-purpose grants increase expenditure by the receiving government by about 43 cents per dollar of the grant, and by as much as 85 cents for education grants. The remainder of the grant appears to be used to reduce taxes or borrowing. In contrast, State and local government expenditure increases by only about 10 cents from an additional dollar of disposable income within their jurisdiction. The combination of grants and taxes by the higher level of government, therefore, has probably increased total government expenditure by 33 to 75 cents per dollar of the grants. Because the receiving government would not choose to finance this level of expenditure from its own tax base, the additional services financed by these grants are probably valued by taxpayers within the receiving jurisdiction at less than the cost of these services. This system of grants and taxes is desirable only if the sum of the value of these services within and outside the receiving government exceeds the cost of raising the additional taxes by the granting government. One other conclusion of these studies is that many of these grants are effectively fungible because they increase the total expenditure by the receiving government but have only a small effect on the composition of these expenditures.

The primary policy implication is that grants should be restricted to services that have substantial value to people outside the jurisdiction of the receiving government. In addition, the grants should be structured to assure that they lead to an increase in these specific services, rather than to a general increase in expenditure in the receiving jurisdiction.

Effects of Loans and Loan Guarantees

The Federal Government now makes net loans of about $15 billion a year, mostly at interest rates lower than necessary to recoup the sum of government borrowing and administrative costs. The intention of these loans is to reallocate capital from sectors with a high private rate of return to favored sectors with a lower private rate of return. These loans are desirable only if the sum of the return to the recipient and the taxpayer exceeds the interest rate on a private loan.

The Federal Government now makes net loan guarantees of about $20 billion a year. The cost appears on the budget only for loans that default. These loan guarantees also reallocate capital to favored sectors with a lower risk-adjusted private rate of return. Again, these loan guarantees are desirable only if the sum of the return to the recipient and the taxpayer exceeds the interest rate on a private loan. These loan guarantees are especially subject to abuse because no current appropriation is necessary to cover the loan origination or the guarantee.

THE FEDERAL TAX SYSTEM

The tax system affects the cost or return to engaging in most types of economic activity, and therefore it influences the allocation of resources. How tax revenue is collected also affects the distribution of after-tax income among various groups.

The principal sources of Federal revenue are the personal income tax, social insurance taxes, and the corporation income tax. These three taxes yielded about $641 billion in 1984, or 91 percent of total Federal receipts. Of this total, personal income taxes were $308 billion, social insurance taxes were $263 billion, and corporation income taxes were $70 billion. This section addresses only the individual and corporation income taxes; social insurance taxes and benefits are discussed in Chapters 4 and 5.

The Economic Impact of the Tax System

Any tax system that relates tax liability to measures of economic activity, such as income or expenditure, will cause some inefficiency in economic performance. This is because it encourages activities (such as leisure) that are untaxed or relatively undertaxed at the expense of taxed activities. The result is a misallocation of resources compared with their most efficient use.

The concept of a "pure" income tax provides a useful benchmark for assessing the current tax system and proposals for tax reform. A pure income tax would subject all income to tax, regardless of source. Furthermore, tax liability would be determined with reference to income, so that taxpayers with higher income would pay more tax and taxpayers with the same income would pay the same tax.

Even a pure income tax system would have important implications for the efficient operation of the economy. Because labor earnings are subject to tax at the margin, the total amount of hours worked is inefficiently low. This represents a cost to the economy to the extent that the productivity of the labor forgone due to taxation at the margin exceeds the value of time spent not working. Because the income from capital is subject to tax at the margin, some desirable saving and investment opportunities are also passed up. These forgone opportunities will in the short run lower the rate of growth of the economy and reduce the capital intensity of production. A lower capital intensity leads to a lower level of productivity and real wage rates.

Of course, the current income tax system is far from the pure system described above. Some sources of income are fully subject to tax, some are partially subject to tax, and others are completely exempt from tax. Deductions from income for tax purposes and special tax credits are allowed for a wide range of activities. Income from capital is not measured accurately, and the existence of a separate corporation income tax system adds an additional layer of taxation on capital income.

These divergences from a pure income tax system have arisen for a variety of reasons. In some cases they are the result of an explicit government decision to subsidize a particular activity through the tax system; the credit for residential energy conservation expenses is an example. In other cases, the tax feature is an attempt to maintain equity in the taxation of families or individuals in different situations, where income is not an adequate measure of the ability to pay taxes. The deductibility of extraordinary medical expenses and uninsured casualty losses are examples. Some features have been justified on the grounds that it is too complicated to implement the pure income tax treatment. In this category is the tax exemption of the income-in-kind provided by owner-occupied housing. Finally, many of the features of the tax law merely serve the interest of a particular group.

The result of all these special features is an extraordinarily complicated system that affects the return to labor supply, saving, investment, and myriad other activities. By altering the relative returns to various activities, the system diverts resources into less productive but more tax-favored activities. Consequently, the country wastes a substantial fraction of potential national income. Some of this waste is unavoidable under any income tax system; much of it, though, results because the system has strayed so far from a pure income tax concept.

Table 2-4 presents one set of estimates of the allocative costs of raising additional revenue from the major types of Federal and State taxes. These estimates assume a responsiveness of labor supply about midway between the two values used in Table 2-3 as well as about the same marginal tax rate.

The primary conclusions from these estimates are the following:

- The cost of additional government services and transfer payments substantially depends on the types of taxes that finance these expenditures.
- Among the major sources of tax revenue, the highest allocative costs are specific to the personal income tax and the major taxes

TABLE 2-4.—*Allocative cost by type of tax*

Type of tax	Allocative cost per dollar
Personal income tax	$0.55
Corporate and property taxes	.49
Social insurance taxes	.19
Retail sales tax	.35
Total	.48

Source: Ballard, Shoven, and Whalley, Working Paper No. 1043, National Bureau of Economic Research, December 1982.

on the income from capital. The lowest allocative costs are specific to social insurance taxes on labor income and the retail sales tax.

These estimates suggest that the cost of additional government services and transfer payments could be reduced substantially by replacing the present tax system with broader based, lower rate taxes on either income or consumption.

Special Problems of Taxing Income from Capital

One especially troublesome problem with the present tax system is the taxation of capital income. The present tax system, with some exceptions, taxes both saving and the income from savings, which increases the price of future consumption relative to current consumption. This reduces current saving and investment relative to the amount that would be saved and invested if taxes were levied only on consumption. Many of the changes in the Federal tax system during the past several decades represent selective measures to reduce the bias against saving and investment. Such changes include limited exclusions of retirement saving and measures to reduce effective tax rates on the income from new investment. The Economic Recovery Tax Act of 1981 further reduced the bias against saving and business investment, most importantly by extending the individual retirement accounts (IRAs) to employees and accelerating cost recovery on business investment. These measures have contributed to the rapid rate of domestic business investment, but they do not appear to have increased the personal saving rate. The substantial remaining bias against saving and investment should be a major focus of future changes in the tax structure.

The current tax system also distorts the pattern of investment spending, because the effective tax rate on new investment depends on the type of asset and the rate of inflation. These distortions have arisen partially because capital income is difficult to measure. For example, to calculate net income it is necessary to deduct the expenses incurred in earning that income, a critical component of which is the depreciation of the capital asset. Unfortunately, "economic depreciation," a concept that measures changes in value arising from both physical deterioration and obsolescence, is extremely difficult to measure accurately.

Another problem is that the tax system is not completely indexed for inflation. Although individual income tax brackets are being adjusted annually for inflation, taxation of capital income is still affected by the inflation rate. Depreciation allowances fall in real value as the price level rises, leading to an overstatement of the real income of businesses. Increases in the value of inventories solely because of inflation may also increase taxable income. Finally, increases in the value of capital assets that merely reflect the increased price level are subject to a capital gains tax upon sale.

This problem also applies to financial assets. In a period of inflation, part of the interest rate, the "inflation premium," compensates for the fact that the principal falls in real value over time. The tax system, however, considers the full nominal interest earned on taxable securities to be income to the lender and a deductible expense to the borrower. Taxable income is thus greater than true real income for the lender. Similarly, full deductibility of nominal interest payments leads to an understatement of the borrower's real income and reduces the tax liability.

Several of the changes in the tax law during the past decade have been advocated as offsets to the unintended effects of inflation on effective tax rates. These changes include the reduction in the taxation of capital gains in 1978 and the accelerated cost recovery system of the Economic Recovery Tax Act of 1981. Although these tax changes reduced the average rate of taxation on the income from new investment, they did not successfully deal with the problem that the effective tax rate varies widely depending on the type of investment and the financing method.

The effective tax rate measures the difference between the before-tax and after-tax real rate of return on an investment, expressed as a percentage of the before-tax real rate of return. Table 2–5 shows that the effective Federal corporate tax rate on the income from equity-financed investment is lower for equipment than for structures. The table also shows how the effective tax rate depends critically on the rate of inflation. Because different industries utilize different mixes of capital goods, differential taxation of assets results in differential taxation of capital income by industry. Table 2–6 indicates that the average effective Federal corporate tax rate on fixed investment varies widely by industry, and that the divergence in tax rates is higher at lower rates of inflation.

Nonuniform taxation of capital income causes misallocation of capital. One estimate of the cost of this misallocation of corporate cap-

TABLE 2-5.—*Effective Federal corporate tax rates on equity-financed investments in equipment and structures*

[Percent]

Asset class by depreciable life	Inflation rate	
	5 percent	10 percent
Equipment:		
3 years	−8	22
5 years	−3	19
10 years	20	32
Structures:		
15 years	35	45
18 years	40	45

Source: *Tax Reform for Fairness, Simplicity, and Economic Growth,* The Treasury Department Report to the President, Volume 1, p. 107.

ital is that it is equivalent to wasting 1½ percent of the present stock of capital, or more than $5 billion worth of output annually.

Another important feature of the present tax system is the presence of a separate tax on corporate income. There is no necessary role for a separate corporate income tax in a pure income tax system. The income generated by corporations could be directly attributed to stockholders and taxed under the individual income tax system in the way that partnership income is treated. The primary justification for a separate corporate tax is to ensure that retained corporate income is subject to tax. However, the corporate income tax achieves this end only at the cost of introducing a number of distortions to economic behavior. Corporate earnings distributed as dividends are taxed more heavily than other forms of capital income because they are subject first to the corporation income tax and then to the individual income tax. Earnings retained by the corporation may be overtaxed relative to noncorporate business income if the corporate tax rate is greater than the shareholder's marginal individual income tax rate. Thus, the present system can impose a higher effective tax rate on activities carried out by corporations compared with activities performed outside of the corporate sector.

Because interest payments are deductible while dividend payments to shareholders are not, the corporation income tax system provides an incentive to use debt rather than equity financing. This leads to more debt finance than the market would otherwise choose, increasing the vulnerability of corporations to bankruptcy. Because earnings paid out as dividends are taxed more heavily than earnings retained within the corporation, there is a tax incentive for corporations to retain earnings. This may lead to inefficient investment of retained earnings at rates of return lower than those available to the stockholder.

TABLE 2-6.—*Effective Federal corporate tax rates on equity-financed investments in equipment and structures for selected industries*

[Percent]

Industry	Inflation rate	
	5 percent	10 percent
Highest		
Service and trade	31	40
Leather	30	40
Agriculture	29	37
Apparel	28	38
Utilities	28	38
Lowest		
Mining	13	31
Pulp and paper	12	26
Petroleum refining	12	26
Transport services	9	26
Motor vehicles	8	26

Source: *Tax Reform for Fairness, Simplicity, and Economic Growth,* The Treasury Department Report to the President, Volume 1, p. 108.

PROPOSALS FOR REFORM OF THE FEDERAL TAX SYSTEM

Dissatisfaction with the tax system has recently generated interest in fundamental tax reform. Reform proposals can be grouped into two categories: those aimed at improving the current system and those that would substitute a new system. A common objective of the tax reform proposals of both types is to redress such problems as the erosion of the tax base, the overtaxation of capital income, and the undue complexity of the system.

A critical issue in the evaluation of tax reform options is the degree to which the income tax concept should be set aside in order to reduce the taxation of saving and investment. If the tax base were consumption rather than income, taxation of the return to saving and investment would be eliminated. The present income tax system has many special features, such as the treatment of pension contributions and earnings, that reduce the taxation of saving and investment. The tension between retaining the income tax concept, which does not differentiate between income from labor and income from capital, and the desire to reduce disincentives to saving and investment is a recurring theme in the discussion of tax reform options that follows.

Reforming the Income Tax

The Treasury Department proposal, introduced in late 1984, and other similar proposals rest on the belief that the income tax concept is sound, and that the deterioration in the performance of the current system is caused primarily by its departure from the framework of a pure income tax. The basic elements of these reform plans are simplification of the tax system, a broadened tax base, and lower marginal tax rates. In some cases, however, there is a conflict between simplification and base-broadening, as there is between adherence to a pure income tax ideal and other goals, such as reducing the disincentives to saving and investment.

Broadening the tax base would eliminate many sources of misallocation. In addition, because it also allows lower marginal tax rates for the same revenue raised, it would further reduce the inefficiencies arising from the tax system by reducing the differential between the return to taxed activities and the return to activities that are untaxed even under base-broadening. Exceptions to the principle of base-broadening should be justified either as incentive programs that promote the efficient use of resources or as measures to improve the equity of the system.

One element of base-broadening is the reduction of itemized deductions. The largest category of itemized deductions is interest expense. In an income tax system it is proper to deduct interest expenses incurred in order to earn income. Real interest payments should therefore be netted against real interest receipts. Arguments in favor of limiting or eliminating the interest paid deduction usually rely on the observation that many kinds of capital income are either partially or completely exempt from taxation. The primary example of this treatment is the deduction for mortgage interest, which is allowed even though the income-in-kind from owner-occupied housing is not regarded as taxable income. Currently, the law disallows the interest deduction on loans used to purchase tax-exempt bonds, and limits the total deduction of investment interest to net investment income plus $10,000. Although these rules are difficult to enforce, some such limitation is needed to maintain the integrity of the system.

The deduction for State and local taxes, the second largest category, has been defended on two grounds. First, it is argued that State and local taxes are involuntary payments that reduce an individual's ability to pay other taxes. According to this argument, income minus such involuntary payments is the proper base on which to calculate taxes. This argument is flawed to the extent that these taxes finance goods and services that are valued by individuals and that are determined through State and local political processes. The second argument is that Federal subsidization of State and local government spending is desirable. This subsidization is sensible only if, in its absence, State and local spending would be inefficiently low because of external benefits to residents of other jurisdictions. This argument, however, does not suggest the form that deductibility implies—a subsidy that applies only to those who have sufficient total deductions to make itemizing worthwhile, and at a rate equal to the marginal Federal tax rate. In any case, grants can be a more efficient means to address these external benefits.

The deduction for medical expenses in excess of 5 percent of adjusted gross income provides taxpayers with partial insurance against extraordinary medical expenses. The rationale is that large medical expenses reduce an individual's ability to pay, and thus the principle that taxpayers of equal means should pay equal taxes requires such a deduction. The choice of the appropriate floor for the deduction should reflect a balance between the reduced insurance value of a high floor and the substantial administrative and compliance cost of a low floor that would apply to a large fraction of the taxpaying population.

Another target for broadening the base of the income tax is employee benefits. These benefits would be regarded as taxable income under a pure income tax system, but are currently given favorable tax treatment. The major employee benefit programs are pensions; health, disability, and life insurance plans; and worker's compensation.

Under current law, employer contributions to qualifying private pension plans are deductible at the time of payment, and are not included as current income taxable to the employee. Furthermore, earnings on the pension fund's assets are not taxed as they accrue. Pension fund benefits in excess of employee contributions are taxable to the employee when paid out. If marginal tax rates are constant, this treatment of employer contributions is equivalent to taxing the contribution when made and imposing no further tax on either earnings or receipt of the fund. If the employee's marginal tax rate is lower when benefits are received compared with when contributions were made, the provisions provide the equivalent of a taxable contribution plus a subsidy to earnings of the fund. Under a pure income tax system, pension rights would be fully taxable at the time of accrual. The current treatment can be justified as a selective reduction of the bias against saving that is inherent in any tax on income. Similarly, the system of individual retirement accounts, which also represents a divergence from a pure income tax base, is designed to encourage saving. Effective saving incentives, though, should operate at the margin of new saving. At present, IRAs have an annual ceiling, and individuals can achieve the tax saving without doing any additional saving by transferring previous savings into the accounts.

Employer payments for group health insurance are not now taxable at the employee level, although they are deductible by the employer. This treatment provides a subsidy to health insurance that contributes to escalating medical care expenditures. These consequences are discussed in greater detail in Chapter 4 of this *Report.* A pure income tax plan would eliminate this subsidy by making employer payments for insurance taxable to the employee.

Under a pure income tax, all real capital gains would be subject to tax in the year they accrue, and all real losses would be fully deductible against other income. The current tax treatment of capital gains diverges from this in a number of ways. Gains are taxed only when income is realized (i.e., when the asset is sold), conferring the benefit of tax deferral, and are excused from taxation upon the death of the asset owner. Sixty percent of realized capital gains for assets held longer than 6 months are excluded from taxable income. However, the tax is based on nominal rather than real capital gains and only $3,000 of net capital losses for individuals can be offset against ordinary income in a tax year.

The 60 percent exclusion of long-term capital gains has been justified as an offset to the failure to tax only real capital gains. However, it is a highly imperfect offset, because an accurate measurement of real capital gain would not exclude a fixed fraction of gain, but rather a fraction that depends on the rate of appreciation and the amount of inflation that has occurred during the holding period. Adjusting the purchase price used in calculating taxable gain for inflation is preferable to the current percentage exclusion and the arbitrary holding-period distinction. Another reason for a lower tax rate on capital gains is to reduce the bias against saving and investment that is inherent in any income tax system.

Although under a pure income tax a separate corporation income tax need not exist, recent reform proposals have focused on redesigning rather than abolishing the corporation tax system. One approach is to lower the statutory corporate rate and reestablish the link between tax depreciation schedules and economic depreciation. This entails repealing the investment tax credit, lengthening the depreciation period, and indexing depreciation allowances for changes in the price level. The net effect of all three provisions would be to establish an approximately uniform effective tax rate, substantially lower than the present statutory corporation income tax rate, on all new investments. Because the effective tax rate would be uniform among types of assets, it would also be uniform among industries that use different mixes of capital goods.

The impact of such a reform on the effective tax rate on new investment cannot be determined from short-term corporate income tax payments. This is due to the extension of the period over which assets are depreciated and other credits against income are taken. To the prospective investor looking forward over the asset's useful life, the new tax system may be no less favorable than the current system. The timing of future tax payments with the same present value should not be relevant unless there is uncertainty with respect to tax rates in the future. For this reason, any conclusion drawn from a projected short-run increase in corporation tax revenues about whether the incentive to invest decreases, stays the same, or even increases must be tentative.

The principal advantage of this type of reform is to eliminate the variation in the effective tax rate on investment and the resulting inefficient allocation of capital. Other proposals view reducing the effective tax rate on new investment as more important than eliminating the variation. These proposals typically accelerate depreciation allowances relative to economic depreciation.

In evaluating these proposals, it is important to realize that two conceptually distinct issues are involved—the average effective tax rate on new investment and the variation in effective tax rates. A tax system that treats all types of investment uniformly, regardless of inflation, can be designed with any effective tax rate desired. For this reason, accelerated depreciation is not a necessary component of a system that features low taxation of new investment.

Either approach to corporation taxation can be supplemented with a plan to reduce the double taxation of dividends. This can be accomplished either by allowing taxpayers to deduct a percentage of their dividend receipts as a credit against their individual income tax burden, or by allowing corporations to deduct some or all of their dividend payments from taxable income.

A Consumption Tax

Proposals that emphasize taxation of consumption are based on the notion that the income tax concept itself is flawed, and that no amount of tinkering will substantially improve a system based on taxing income. Under a consumption tax, an individual's tax liability would be based on annual consumption rather than annual income. According to one proposal, it would operate similarly to the current income tax with a greatly expanded system of IRAs. A taxpayer with earned income can now establish an IRA and deduct from taxable income up to $2,000 per year. The funds earn income without taxation, but the entire balance is subject to full taxation at the time of withdrawal. A personal consumption tax based on the IRA model would allow the taxpayer to place an unlimited amount of deductible saving into a special account. The fund's earnings would not be taxed, and the fund's balances could be withdrawn at any time, whereupon they would be subject to taxation. Borrowing would be treated as a withdrawal, and therefore subject to tax. Consumer durables and housing could be treated in various ways; one method would be to disallow deductions for their purchase, and also to exempt from tax the imputed rental value of the services they provide. Under some plans, the individual could elect not to take a deduction for any financial asset purchased, in which case earnings and withdrawals of principal would be exempt from tax.

In this way, a consumption tax would not require direct accounting of annual expenditures, which would be impractical. Instead, an indirect determination of consumption would be made, based on defining consumption to be equal to income minus saving. The tax schedule applied to annual consumption could be graduated. As under a pure income tax, there is no necessary role for a separate corporation income tax under a consumption tax system. As income is no longer the basis for taxation, it is appropriate that tax liability not be incurred until funds are distributed to the owners of the corporations and used for consumption.

The return to saving is untaxed under a consumption tax. Thus, a consumption tax, unlike an income tax, creates no distortions with regard to saving and investment decisions. On the other hand, as with an income tax, it does distort incentives to work. Because it operates on a smaller tax base than the income tax, it must impose higher statutory tax rates to raise the same amount of revenue, potentially exacerbating any distortion in labor supply. Thus, the choice between an income and consumption tax system is a matter of the relative seriousness of the distortions under the two systems. This is an empirical question that cannot be answered on theoretical grounds. Although there has been a substantial body of literature on this subject, the question has by no means been resolved.

A pure consumption tax offers a solution to many of the structural problems of the current income tax. It would eliminate the nonuniformity in the taxation of various kinds of investment by setting a uniform effective tax rate of zero on the income from investment. Because the calculation of the tax base involves only current transactions, a consumption tax system would not require any explicit indexing provisions except to alleviate bracket creep if the rate structure were graduated. Furthermore, there is no need to measure economic depreciation or accrued capital gains, or to correct these measures for inflation. Because these difficulties in measuring capital income are avoided, a consumption tax represents a simplification compared with an income tax. However, a typical taxpayer's reporting requirements would be complicated by the need to add borrowing and account withdrawals to the tax base.

Many of the advantages of a consumption tax depend on the degree to which its "purity" could be maintained. A consumption tax system, though, could be burdened with special provisions favoring certain forms of investment or consumption just as the income tax system has been so encumbered. The allocative cost of such a system would most likely exceed the cost imposed by a pure consumption tax system.

Transition Issues

One unfortunate side effect of tax reform is that it alters the return to long-term commitments made on the basis of the former tax law. Consequently, assets that lose preferential tax treatment will likely experience capital losses, while assets with a reduced tax burden will likely experience capital gains. Individuals who have made long-term commitments, such as career choices, on the basis of previous tax law may be capriciously rewarded or penalized.

These gains and losses cannot be justified as recovery of tax benefits unfairly received or as compensation for excess tax payments unfairly paid. Once the current law has been in place for several years, the benefits of preferential tax treatment are reflected in the price of the asset or activity. For example, preferential tax treatment of the oil and gas industry undoubtedly generated capital gains for stockholders when the provisions were enacted. Subsequent purchasers of oil and gas stock have had to pay a higher price that reflected the tax advantages, and therefore are unlikely to have earned an extraordinary after-tax rate of return on their investment. Revoking the tax preferences would cause a capital loss to all stockholders, whether or not the current owners received a capital gain when the provisions were enacted.

One method to reduce, although not eliminate, the gains and losses that would accompany a tax reform is to phase in the changes or postpone the effective date of implementation. This would allow time for adjustment to the new rules and reduce the current value of the induced gains and losses. Another approach is to grandfather tax law changes, i.e., to apply them only to new commitments. Grandfathering can serve to minimize the capital losses on assets that are scheduled to lose preferential tax treatment, although it will not ensure that no such losses occur.

It has been argued that tax incentives designed to increase investment ought to apply only to new investment. This suggests that provisions such as the investment tax credit and accelerated depreciation that apply only to new investment provide a better set of incentives to capital formation than changes such as a reduction in the statutory corporate tax rate or dividend relief, which apply equally to new capital and capital already in place. The targeting of new investment induces capital losses on existing capital at the time such measures are introduced, because it essentially reduces the net purchase price of substitutable new capital. This policy will also tend to maximize the investment incentive per dollar of tax revenue lost, unless potential investors anticipate additional targeted investment incentives in the future.

There are also problems that would apply specifically to the transition from an income tax to a consumption tax. The critical issue is how to treat consumption out of the wealth that has been accumulated under the current tax system. One approach is to subject the wealth to tax when consumed by requiring existing wealth to be registered and considered to be in the IRA-type special account. This approach has been criticized as inequitable because it subjects individuals to tax on the consumption out of accumulated wealth on which income tax has already been paid; this inequity would fall most heavily on the retired population. The system would also create a tremendous incentive for individuals to hide existing assets from the qualified account at the time of transition, in order to deduct the value of the assets later as if it represented new saving. An alternative approach is to simply declare consumption out of old wealth to be exempt from tax. Even in this case, however, complicated accounting rules would be required to prevent wealthholders from reducing tax liability in the post-transition years by transferring assets to deductible qualified accounts.

The Treasury Tax Proposal

The tax reform plan proposed by the Treasury Department in 1984 embraces the principle that moving toward a pure income tax system would improve the operation of the economy by reducing the role of taxation in economic decisions. Toward this end the plan would eliminate scores of current provisions that are inimical to proper measurement of income.

The taxable base of the individual income tax would be expanded by adding currently untaxed sources of income to the base and by eliminating some deductions and limiting others. Prominent among the base-broadening measures are the repeal of the deductions for State and local taxes, limitation of charitable contribution deductions to those in excess of 2 percent of adjusted gross income, and the limitation of tax-free employee benefits (including a cap on excludable contributions for health insurance). A long list of other provisions are designed to restore uniform taxation of income.

The expanded tax base would allow individual income tax rates to be reduced significantly. The current schedule of 14 different tax brackets (15 for single taxpayers) with tax rates ranging from 11 to 50 percent would be condensed into 3 brackets with tax rates of 15, 25, and 35 percent. The personal exemption allowance would be approximately doubled, so that for a family of four filing a joint return no tax would be due on income of less than $11,800, compared with

$8,070 ($9,613 assuming full use of the earned income credit) in tax year 1986 under current law. The combination of base-broadening and rate reductions would reduce the expected revenue yield of the individual income tax by 8½ percent. This reduction is spread roughly proportionately among all income groups, with the exception of significantly greater percentage reductions in tax liabilities for the lowest income groups.

The Treasury Department also proposes major changes in the taxation of business income. The statutory corporation income tax rate would decline to 33 percent from its current level of 46 percent. The investment tax credit would be eliminated and the system of depreciation allowances would more closely replicate actual economic depreciation, with an adjustment for inflation. The tax treatment of inventories would be liberalized and include indexation. Finally, a deduction for one-half of dividends would be allowed to corporations, reducing the tax penalty for paying dividends out of the corporate sector. Certain special tax preferences that apply to particular sectors, primarily financial institutions and the oil and gas industry, would be repealed.

The provisions that generally apply to corporations would increase the average effective corporate tax rate on new equity-financed investment in equipment and reduce the effective rate on investment in structures and inventories. For any firm or industry, the change in the effective tax rate would depend on the mix of these assets. The reform appears to increase the average effective tax rate on new investment generally, but this issue is not yet resolved. The reform would also substantially reduce the misallocation caused by differential tax treatment by asset type, industry, and financial arrangements.

One summary measure of the effect of any tax proposal on investment incentives is the change in the rental rate on capital. The rental rate measures the annual cost of using capital, including taxes, expressed as a percentage of the capital good's price. The net effect of the Treasury Department proposal on the rental rate depends on the rate of inflation. Table 2–7 summarizes one study's estimates of the annual rental rate on capital, assuming a 4 percent real after-tax return on corporate equity, from the combined effect of the major provisions. These estimates also depend on the assumption that the dividend exclusion provision does not reduce the cost of capital.

At a 6 percent inflation rate, the Treasury Department proposal appears to increase the rental rate on producers' equipment by about 11 percent and reduce the rate on nonresidential structures by about 5 percent. The increase in rental rates would probably reduce the fixed investment share of total output, but other effects of the Treasury proposal might increase total output in the near term.

TABLE 2-7.—*Annual rental rate on corporate capital*

[Percent]

Asset type	Inflation rate		
	2 percent	6 percent	10 percent
Producers' equipment:			
Current code	14.6	15.2	15.6
Treasury proposal	17.0	16.8	16.7
Nonresidential structures:			
Current code	11.2	12.1	12.4
Treasury proposal	11.8	11.5	11.4

Source: Lawrence H. Meyer and Associates, Special Analysis, December 1984.

An innovative aspect of the proposal is its attempt, through comprehensive indexation, to insulate the tax system from the distorting effects of inflation. Interest receipts and interest payments (other than for mortgages on principal residences and up to $5,000 of other net interest expense) would be adjusted downward to approximate the portion that represents real income or expense. The taxation of capital gains would also be indexed. At the current inflation rate, most investors would be subject to about the same effective rate on real capital gains as now, but the effective tax rate on high return investments would be higher. Indexed inventory accounting and depreciation allowances are introduced in order to remove the undesirable link between the rate of inflation and the effective tax rate on real capital income.

In several important respects, the Treasury Department proposal does not meet the concept of a pure income tax. It does not tax the imputed income generated by owner-occupied housing. In fact, by exempting mortgage interest payments from the indexing provisions, it appears to increase the relative tax advantage enjoyed by owner-occupied housing. The Treasury Department proposal also represents a compromise with a consumption tax concept by retaining and, in some cases, expanding its saving incentives. The current treatment of pension contributions and earnings would be retained, as would be the treatment of retirement accounts for the self-employed (Keogh plans). Eligibility for IRAs would be extended on equal terms to spouses who are not employed, and the limit on tax-deferred contributions would be raised to $2,500 ($5,000 for a husband and wife).

In summary, the Treasury Department tax proposal represents a serious attempt to reduce the efficiency losses attributable to the current tax system. It directly addresses the major structural problems of the income tax system. On closer examination, some changes in the proposal may be desirable, but the Treasury Department proposal should be the starting point for serious consideration of tax reform.

BUDGET CONCEPTS, PROCESSES, AND FISCAL AUTHORITY

Almost no one is satisfied with the Federal budget process. Many are concerned about the outcomes of this process, which they believe do not reflect the preferences of the American people. Among the outcomes that are disturbing to many people are the following:

- Federal expenditure has continued to increase relative to GNP.
- The outstanding Federal debt has grown rapidly relative to GNP in recent years.
- Many Federal services and transfers serve only small components of the population.
- There is a general perception that there is a large amount of waste in the Federal budget.
- The Federal tax system leads to a large amount of misallocation, includes preferences for many small groups, and is unnecessarily complex.

It is not clear, however, that a change in the Federal budget process would change any of these conditions, as these conditions may result from the political processes.

Others are less concerned about outcomes than they are about the costs of the process. Their concerns include the following:

- The major appropriation bills have only rarely been approved prior to the beginning of the fiscal year.
- Many of the same issues are addressed in the budget resolution, the authorizing legislation, and the appropriation bills.
- Although the budget process consumes a large amount of the time of the Congress, it devotes only the most cursory attention to many budget elements.

Many people, of course, share both of these types of concerns. The one common view is that the present budget process is not working very well. There is much less consensus about what changes may be appropriate.

CHANGES IN BUDGET CONCEPTS

The Federal budget is a statement of expected cash outlays and cash receipts. The budget includes both operating and capital outlays and with some exceptions does not include accrued liabilities and receipts.

For many years, proposals have been made to separate the Federal budget into an operating budget and a capital budget. One argument for this concept is that it would provide a basis for determining the appropriate amount of the expected Federal deficit, based on a rule that the expected deficit in any year should not be higher than net capital outlays. Borrowing (and the necessary future taxes) to finance current government services and transfer payments, according to this rule, would not be allowed. Some borrowing to finance net capital outlays, however, would be permitted because the benefits accrue to the next generation of taxpayers. Most State budgets are subject to such a rule.

A change in the formal budget, however, is not necessary to make this determination. A special analysis published with the budget now summarizes the level and composition of investment-type outlays. In recent years, the total outlays for investment have been close to the level of the Federal deficit, but this is misleading. Outlays for physical structures and equipment are gross outlays, and thus do not reflect the depreciation of the current capital stock. Outlays for research and development and education may lead to future benefits, but do not directly generate future cash receipts to the Federal Government. The small amount of net loans is the only type of investment outlay that leads to significant future cash receipts. In summary, there does not appear to be a strong case for a formal capital budget. There is a better case for reporting the sum of investment-type outlays, net of depreciation, as a basis for determining the appropriate limit on the expected deficit.

Several proposals have been made to change the budget treatment of loans and loan guarantees. Under one proposal, new Federal loans would be sold to private investors. This would reduce current budget outlays from the net amount of these loans to the difference between the par value and market value of these loans. New loan guarantees could also be provided by purchasing loan insurance from private firms. This would increase current budget outlays by the amount that these firms would charge to accept these guarantees. Alternatively, the Federal Government could charge an origination fee on new loans and loan guarantees to cover the costs of administration and the expected defaults, as proposed in the fiscal 1986 budget. These proposals would lead to a more accurate budget accounting of the now implicit subsidy to the recipients of Federal loans and loan guarantees. Both of these proposals deserve serious consideration.

CHANGES IN THE BUDGET PROCESS

The congressional budget process does not ensure that approved outlays equal the total outlays established by the budget resolution. In addition, the process has seldom met its own deadlines.

One proposed reform would substitute a single annual budget bill for the current process of 13 general appropriation bills and the separate bills affecting taxes and transfers. The proposal involves the following steps: The budget resolution would clear the Budget Committee by April 15 and the Appropriations Committee and the Ways and Means Committee by May 15. A single budget bill, hopefully, would be approved by the July 4 recess. This proposal would be a radical change but it is probably feasible; about half of the State legislatures now adopt their budget in a single bill. This proposal would probably be acceptable to a President only if the appropriation bills were presented to the President by individual title or, preferably, if the President, like all but a few State Governors, had the authority for a line-item veto.

Several proposals for a biennial budget, approved in the first year of each Congress, are also being considered. Many States approve budgets on a 2-year cycle. The primary arguments for this change are to reduce the budget workload as well as the uncertainty about Federal financing. A biennial budget, however, would probably increase the number of supplemental appropriations to reflect unexpected changes in economic conditions and political preferences.

The Impoundment Control Act of 1974 authorized the President to defer specific expenditures unless overridden by a majority vote of either House. The President may rescind specific expenditures, however, only if approved by a majority of each House within 45 legislative days. Since a recent court decision, which overturned the provision for a legislative veto in this and other laws, both deferrals and rescissions must be approved by a new bill subject to the normal process. The current law severely restricts the President's authority to reduce expenditures for any purpose, including obvious waste and changed conditions. In effect, appropriations are now both a ceiling and a floor for allowed expenditures. Some consideration should be given to a rule and procedure that would provide broader authority for the President to reduce specific expenditures in order to meet the broader fiscal constraints established by the Congress.

For many years, additional outlays have often been financed by additional borrowing; decisions to increase outlays are not directly related to decisions affecting expected tax receipts. Votes to increase the debt limit have not been an effective restraint on this process. In 1983 the Senate debated a proposal to make the debt limit binding by authorizing the President to reduce outlays if the debt limit would otherwise be exceeded. In 1984 the House of Representatives approved the concept, but not the procedures, of a pay-as-you-go policy that would require an increase in expected receipts if any spending measure increased total outlays.

These proposals were not adequately developed, but they addressed a serious problem: The Congress can now vote to increase outlays for some purpose without any requirement to reduce other outlays or to vote for the increased taxes necessary to finance these outlays. The proposed reforms would permit the Congress to approve any expected deficit, but the expected deficit would be limited rather than open-ended. If the Congress is willing to finance additional outlays by reducing other outlays or by increasing current taxes rather than borrowing, this process would contribute to more effective restraint on both outlays and the deficit. Some development and consideration of these proposals deserves attention.

On net, one should probably not expect too much from changes in the budget process. After many years of observing this process, the former Director of the Congressional Budget Office concluded:

". . . our current problems are not primarily procedural. The budgeting process is complex and time consuming primarily because the Federal Government does so many different kinds of things, and because Congress is so reluctant to concentrate on major directions of policy while leaving the details to executive departments or State and local governments. We can simplify the budget process only by simplifying the government itself and changing the role of the Congress. We can make the budget process less time consuming only if we are willing to make decisions less often, or to give up some checks and balances. Moreover, the world is an unpredictable place, and, while we could perhaps handle unpredictability in the budget process better than we do, no procedural changes can eliminate it. . . . [T]he failure to make the hard decisions necessary to bring budget deficits down [does not] reflect biases built into our budget-making procedures."

CHANGES IN FISCAL AUTHORITY

The President has endorsed two measures that would change the authority of the President and the Congress on fiscal issues.

One proposal would authorize the President to veto individual line items in all appropriation bills, subject to the current provisions for overriding a veto of any bill. Governors in 43 States now have such authority. The Congress has approved such authority for the Governors of the Commonwealth of Puerto Rico and the Trust Territories and for the Mayor of the District of Columbia—but not for the President. Authority for a line-item veto has only once been withdrawn by a State, but was later reinstated.

For more than a century, the Congress has rejected presidential requests for this authority in order to maintain the opportunity to package spending proposals that the President would otherwise veto in broader appropriations that the President would approve. This practice did not represent a serious problem in the Nation's early history, because most appropriation bills covered a narrow range of activities and the President exercised broader impoundment authority. Now, however, appropriations are presented to the President in only 13 general appropriation bills, and the impoundment authority has been severely restricted.

Approval of a line-item veto may not have a substantial effect on total Federal expenditure. The experience of the States indicates that per capita spending is somewhat higher in States where the Governor has the authority for a line-item veto, even when corrected for the major conditions that affect the distribution of spending among States. In addition, less than one-half of the Federal budget would be subject to a line-item veto, and most of that would be for defense. A President committed to Federal spending restraint, however, could use this as an effective tool to reduce total spending.

Another argument for a line-item veto is to change the composition of Federal expenditure—from activities preferred by the Congress to activities preferred by the President. A Member of Congress is elected from a specific district or State—the President is elected by the Nation. As a consequence, a Member of Congress has stronger preferences for activities that benefit his or her regional constituency, and the President has stronger preferences for activities that benefit the Nation. The expected result of granting approval for a line-item veto would be an increase in the relative expenditures with national benefits and a reduction in the relative expenditures for pork barrel projects. That should be a sufficient basis for early approval of presidential authority for a line-item veto.

The President has endorsed a balanced budget/tax limitation amendment to the Constitution. This proposal was approved by more than two-thirds of the Senate and by more than a majority of the House of Representatives in 1982. The legislatures of 32 States have petitioned the Congress to approve a balanced budget amendment or to call a constitutional convention for this purpose.

The objective of this proposed amendment is to change the rules by which decisions are made to borrow or to increase the size of Federal outlays and receipts relative to national income. The proposed amendment provides for three rules:

- Actual outlays may not exceed projected outlays.
- Projected outlays may not exceed projected receipts, without the approval of 60 percent of the total membership of each House.
- Projected receipts may not increase faster than the growth of national income in the prior calendar year, without the approval of 50 percent of the total membership of each House plus the President.

Each of these rules could be suspended upon a declaration of war. In effect, these rules would require broader support for a decision to increase the Federal debt or for a decision to increase the relative level of Federal outlays and receipts than the support necessary for other legislation.

The case for the proposed amendment is based on a belief that present political and budget processes are biased in favor of increased debt and increased spending. Elected officials, because of their limited terms of office, may prefer current borrowing (and increased future taxes) to increased current taxes. Government officials may also prefer increased spending, because spending is more concentrated on vocal constituencies than are the diffuse effects of taxes. This perception is as old as the Republic. Alexander Hamilton's last report on the public finances expressed special concern about the accumulation of public debt in the following words:

"On the one hand, the exigencies of a nation, creating new causes of expenditure—as well from its own, as from the ambition, rapacity, injustice, intemperance, and folly, of other nations—proceed in increasing and rapid succession. On the other, there is a general propensity in those who administer the affairs of a government, founded in the constitution of man, to shift off the burden from the present to a future day—a propensity which may be expected to be strong in proportion as the form of a State is popular."

Approval of this proposed amendment would be a recognition that each generation may need to bind itself to responsible fiscal decisions in the interests of the current and future American community.

The necessary process of approving this proposed amendment would take several years, and the amendment would first be effective in the second fiscal year after approval. Thus, this amendment could not be binding prior to about fiscal 1990. This amendment cannot be a substitute for the hard choices necessary to reduce the growth of Federal expenditure and the Federal debt. Early approval of this proposed amendment, however, could force an earlier resolution of the choices necessary to resolve major near-term fiscal issues.

CONCLUSION

The primary conclusions of this chapter can be summarized in several simple sentences. The Federal deficit must be reduced. Reducing the growth of Federal expenditure is more likely to contribute to sustained economic growth than an increase in taxes. Some changes in the tax system that would permit lower marginal tax rates would also contribute to economic growth. None of these choices will be easy. A change in the budget process may be helpful. A change in the fiscal provisions of the Constitution may be necessary to achieve these goals.