

CHAPTER 2

Fiscal Policy and Economic Expansion

SOON AFTER WORLD WAR II ended, the United States started to put its economic house in order. The Federal Government committed itself in the Employment Act of 1946 to achieve for the Nation maximum levels of income, employment, and purchasing power. During the 1970s, however, the goals of the Employment Act eluded the Nation. Reduced real income, widespread and persistent unemployment, and the dollar's eroded purchasing power plagued the country. During the 1960s and 1970s attempts were made to use discretionary change in fiscal policy to stabilize the economy over short periods. By concentrating on the incentives created by Federal tax policy, this Administration redefined fiscal policy. The subsequent revitalization of the U.S. economy not only advanced the Nation toward meeting the goals of the 1946 commitment, but also led to a worldwide revolution in fiscal policy.

This Administration has pursued fiscal policy as part of a comprehensive program to reduce the role of the Federal Government in the economy and expand the role of the private sector in economic decisionmaking. The Federal tax system has been restructured by reducing marginal tax rates, indexing personal income tax brackets, and strengthening incentives for private capital formation. Federal Government expenditures have been subject to new controls to reduce both their rate of growth and the Federal budget deficit.

These policies have contributed to the longest peacetime expansion on record. During this expansion real gross national product (GNP) has increased 27 percent, and real per capita disposable income has increased 17 percent. Since November 1982 the economy has expanded, creating almost 19 million new nonfarm jobs and improving employment opportunities. Furthermore, inflation has been reduced to nearly one-third of its 1980 level. During the past 8 years the goals of the Employment Act of 1946 have been pursued through policies that have encouraged sustained economic growth, job creation, and reduced inflation.

For much of the postwar era fiscal policy emphasized discretionary changes in tax rates and Federal expenditures designed to regulate aggregate demand in ways that compensate for fluctuations in private

spending. It is now widely recognized, however, that the ability of the government to design and implement successful countercyclical fiscal policies is limited even though changes in tax and expenditure policies do have the potential to influence aggregate demand and real GNP. Government expenditure and tax policies are determined through the political process, which inevitably means that attempts to adjust aggregate demand to stabilize the economy are constrained. As Chapter 1 explains, variable and sometimes long delays occur in implementing discretionary changes in fiscal policy that limit their effectiveness in achieving timely adjustments in aggregate demand. Increased understanding of the effects of anticipations, such as expectations of changes in tax rates, on the timing of responses to fiscal policy has further increased doubts about the stabilizing properties of countercyclical fiscal policy.

The Federal budget has been in deficit throughout most of the postwar era and consistently since 1970. Since 1946 Federal revenues have rarely exceeded 20 percent of GNP. However, since 1970 the trend in the rate of growth of Federal Government expenditures has exceeded the trend in the rate of growth of tax revenues. While the political process has kept Federal Government revenues within a narrow range, fluctuating around 20 percent of GNP, the same process has also allowed Federal expenditures to expand as Federal entitlement programs grew. Persistent budget deficits are the result.

Since fiscal 1985 this Administration has been able to reduce Federal outlays and the Federal deficit as a percent of GNP. However, further controls on Federal Government spending are necessary to reduce the deficit and redress imbalances between investment and domestic saving. Unfortunately, the growth in spending has not been used for government nondefense investment, which has stagnated since 1970 as a percent of GNP. The Federal Government has increasingly been borrowing to finance transfer programs and other programs that fund consumption. The growth of Federal borrowing, combined with a lower net private saving rate in the United States since 1980, has given greater impetus to reduce government spending on consumption. Over the long run, fiscal policies can encourage private capital formation through low marginal tax rates. The tax incentives of the 1980s have encouraged private investment. Foreign saving has financed much of that investment. Further reductions in the growth of Federal spending are necessary to encourage increased national saving and to reduce U.S. reliance on foreign saving to finance domestic investment.

This chapter examines the evolution of fiscal policy in the postwar era and recent changes in Federal tax and expenditure policies. It discusses the rationale for moving away from countercyclical fiscal

policies to a fiscal policy that is primarily focused on the long-term goals of improving incentives and increasing capital formation. The chapter examines postwar changes in the structure of Federal Government spending and their effect on institutions, incentives, and capital formation, and reviews tax policy over the past 8 years and its influence on the economy. Finally, the chapter explores the Federal budget deficit within the context of an overall fiscal policy designed to encourage sustained economic growth over the long term.

THE EVOLUTION OF FISCAL POLICY IN THE POSTWAR ERA

Throughout much of the postwar era successive Administrations have attempted to stabilize the economy through temporary changes in Federal Government expenditure and tax policies. Yet great uncertainty has attended the timing and magnitude of the effects of discretionary fiscal policy on the performance of the economy. Forecasting the fluctuations of the economy is difficult and imprecise. It is rarely possible to know in advance when a recession will occur or when the economy will be subject to increased inflationary pressures. The information necessary to prevent a recession or control an expansion through fiscal policy may be impossible to obtain. Because of the uncertainties involved, attempts to use fiscal policy to fine-tune the economy can be procyclical rather than countercyclical.

Discretionary changes in fiscal policy during the postwar era have often taken place at the same time as changes in monetary policy. Most major fiscal policy initiatives were announced well before their actual implementation, virtually inviting anticipations of their eventual passage. Both the simultaneity of monetary and fiscal changes and the effect of fiscal policy proposals on expectations complicate the problem of measuring the timing and magnitude of their effects.

Lags between the proposal of a discretionary change in fiscal policy and its enactment vary considerably. For example, a 13-month lag occurred between the initial proposal of the tax cut of 1964 and its passage. The Tax Reduction Act of 1975, however, was enacted after only a 2-month lag. The success of fiscal policy in stabilizing the economy can be sheer luck. Major tax cuts that result from broad political pressures for tax relief have sometimes been fortuitously timed and have helped to speed an economic recovery. For example, the Congress imposed a major tax cut in the Revenue Act of 1948 over President Truman's veto; the cut moderated the recession of 1948-49, which began 7 months after the act became law.

Even if changes in fiscal policy are correctly timed, they can be ineffective in stabilizing the economy. For example, the temporary income tax surcharge enacted in June 1968 failed to dampen con-

sumer spending. Consumers responded by reducing personal saving, rendering negligible the impact of the tax surcharge in reducing inflationary pressures in the economy.

Some economists argue that tax cuts designed to increase aggregate demand with an unchanged level of Federal Government expenditures can result in an equal increase in saving. Empirical evidence indicates that much of a tax cut can end up as increased saving, although consumption is generally increased also. Changes in personal income tax rates in 1964 were largely offset by increased private saving although lower tax rates did provide improved incentives. Similarly, in 1975 a tax rebate of up to \$200 per family appears to have gone initially into private saving rather than consumption. In addition, stimulative fiscal policies are often said to put upward pressure on real interest rates and adversely affect private investment.

The effect of countercyclical fiscal policies combined with monetary policy on the price level is also a matter of concern. From 1960 to 1982, as described in Chapter 1, a higher price level and a higher rate of inflation followed after each trough of the business cycle. Fiscal and monetary policies should encourage steady economic expansion without contributing to inflationary expectations.

To a large degree Federal expenditures and receipts automatically adjust to cyclical fluctuations in real GNP. Built into the Federal budget are automatic stabilizers (such as unemployment insurance benefits and payroll tax collections that vary with the rate of unemployment and a progressive rate schedule for income taxation) that act to maintain aggregate demand when national income falls. Similarly, reductions in some components of government expenditure and increases in tax collections under the Federal income tax system act to restrain aggregate demand when it is increasing. These automatic stabilizers cushion the effects of cyclical fluctuations in the economy and make an important contribution to moderating recessions and controlling upward pressure on the price level.

The success of a countercyclical discretionary Federal fiscal policy designed to fine-tune the economy is difficult to measure. Because changes in fiscal policy frequently occur at the same time as changes in monetary policy and other changes in the economy, it is difficult to isolate the separate influence of fiscal changes on the economy. Uncertainties, difficulties in forecasting, and variable lags in implementing discretionary fiscal policies complicate the measurement of the price and output effects of fiscal policy.

During the postwar period the Federal Reserve System and some administrations have attempted to coordinate monetary and fiscal policies to stabilize the economy. Despite the good intentions of policymakers, sometimes monetary policy has acted to frustrate the goals

of discretionary fiscal policy, and the combination of the two policies has destabilized the economy. For example, the Revenue and Expenditure Control Act of 1968, enacted 11 months after it had been proposed, was designed as an anti-inflationary tax surcharge. Yet saving fell and the surcharge failed to reduce consumption. Given the uncertainty of the macroeconomic situation at the time, however, the tax surcharge, and the accompanying Federal expenditure ceiling raised concerns about a recession. To reduce that likelihood, the Federal Reserve allowed the money stock to expand rapidly. In this case, monetary action proved more powerful than the fiscal restraints. The economy continued to boom and later to inflate. The expansion in the money supply fueled inflation and inflationary expectations. In 1969 the Federal Reserve reversed course abruptly, reducing the rate of monetary expansion. The reduction in the rate of monetary expansion contributed to the recession of 1970.

In the 1970s fiscal policies designed to trade inflation for employment contributed to increasing inflation without decreasing unemployment. Monetary growth in the 1970s set the economy on an inflationary course. Inflation contributed to higher effective marginal tax rates on real personal and corporate income in the 1970s, thus offsetting the effects of tax cuts and investment tax credits enacted at the time. Expansionary fiscal policies embodied in the Tax Reduction and Simplification Act of 1977 and the Revenue Act of 1978 were designed to increase employment, but they probably added upward pressure to the price level.

Excessive fiscal and monetary expansion during the period 1977–78 contributed to a further increase in the rate of inflation during the period 1979–81 without producing a lasting decline in the unemployment rate. The unemployment rate was over 7 percent in 1981 while inflation exceeded 9 percent, measured by the annual percent change in the GNP implicit price deflator.

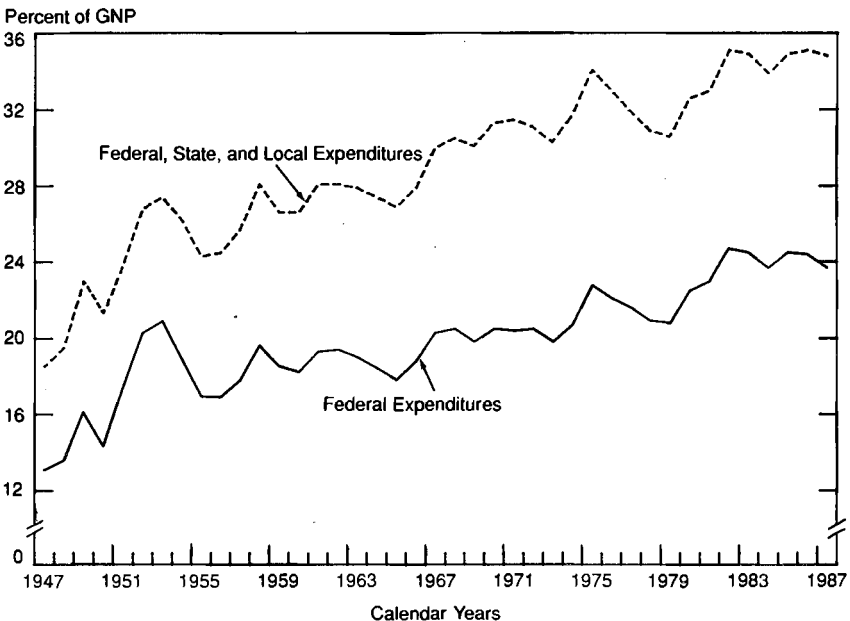
Discretionary fiscal policies designed to stabilize the economy in the postwar era have as often destabilized the economy as contributed to stabilization. Recognizing its limitations, this Administration has used fiscal policy as a long-term tool for achieving sustained economic growth. Fiscal policy can stimulate growth by controlling Federal spending and redirecting it toward government investment programs, and can encourage capital formation and labor force participation by lowering marginal tax rates to improve incentives for work and investment. A cornerstone of such a policy is tax incentives to increase net private investment. Reduction of effective tax rates on capital income stimulates investment. Tax policies have encouraged investment and have been effective in increasing net investment in the United States since 1981.

THE GROWTH OF GOVERNMENT EXPENDITURES AND REVENUES

An appropriate long-term fiscal policy concentrates on adjusting the path of government expenditures and the tax structure to achieve efficient use of resources and the goals of the Employment Act of 1946. The constraints on such a policy can be best understood through examining the postwar growth of government and how Federal revenues have varied as a percent of GNP since 1947. The postwar era has experienced growth in spending at all levels of government. Chart 2-1 shows the upward trend in both total and Federal Government spending as a percent of GNP.

Chart 2-1

All Government and Federal Expenditures as Percent of GNP



Note.—Data are on a national income and product accounts basis.
Source: Department of Commerce.

The postwar growth of government reflects increased demands for government goods and services and increased Federal commitment to provide income support and subsidized services for such groups as the elderly, farmers, veterans, and the poor. Transfers to individuals increased from 25.8 percent of government expenditures at all levels in 1947 to a peak of 35.9 percent of expenditures in 1983.

Federal Government expenditures nearly doubled from 13.1 percent of GNP in 1947 to a peak of 24.7 percent of GNP in 1982. Since 1982 the share of GNP devoted to Federal expenditure has declined, falling to 23.7 percent of GNP in 1987.

State and local government spending, excluding Federal grants-in-aid, has grown more rapidly than Federal spending in the postwar period. The percent of GNP absorbed by State and local expenditure of nongrant funds has increased more than twofold. Government expenditures at all levels have increased from 18.5 percent of GNP in 1947 to a peak of 35.1 percent of GNP in 1982.

Chart 2-2 shows how Federal expenditures and receipts have varied as a percent of GNP on a fiscal year basis from 1947 to the present. From 1947 to 1969 Federal Government expenditures fluctuated from a low of 12.8 percent of GNP to a high of 20.9 percent. From 1970 to 1983 Federal expenditures rose from 20.1 percent of GNP to 25.1 percent. The same period was associated with increased Federal commitment to programs that involved direct benefit payments to individuals that mainly finance consumption.

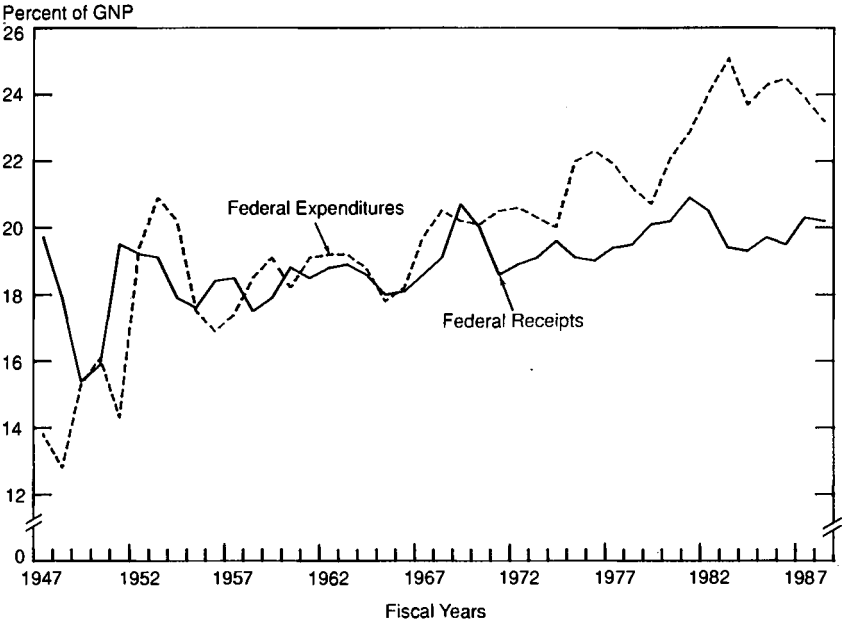
Federal receipts have fluctuated between 17.5 percent and 20.9 percent of GNP since 1951. Over the entire postwar period Federal receipts have averaged 18.9 percent of GNP.

In practice the upper bound to Federal receipts in the postwar era has been about 20 percent of GNP. In many instances in the postwar era, tax relief legislation has followed when Federal revenues, as a percent of GNP, have been at the upper bound of 20 percent. For example, in 1947 Federal receipts were 19.7 percent of GNP. The Revenue Act of 1948 became law in April 1948. When combined with the fiscal effects of the 1948-49 recession, the Revenue Act of 1948 contributed to reduce Federal receipts to only 15.4 percent of GNP in 1949. This was the postwar low. The Congress passed the Tax Reduction and Revenue Adjustment Acts of 1975 after Federal receipts again rose near 20 percent of GNP in 1974. It reduced taxes in 1977 (Tax Reduction and Simplification Act of 1977) and again in 1978 (Revenue Act of 1978), when Federal receipts were 19.5 percent of GNP. While reducing average tax rates, however, these tax reductions of the 1970s failed to reduce personal statutory marginal tax rates.

In 1979, Federal receipts as a percent of GNP rose above 20 percent of GNP. The Economic Recovery Tax Act of 1981 (ERTA) provided a major tax cut designed to encourage long-term economic expansion. Federal tax revenues fell from 20.9 percent of GNP in 1981 to 19.3 percent of GNP in 1984. By 1987, growth in the economy raised Federal revenues to 20.3 percent of GNP. Federal revenues are expected to be 20.2 percent of GNP in 1988.

Chart 2-2

Federal Receipts and Expenditures as Percent of GNP



Note.—Data are on a national income and product accounts basis.
Source: Department of Commerce.

The discrepancy between the growth in receipts and the growth in expenditures has implied a growing trend toward Federal budget deficits since 1970, which has made the Federal Government a net dissaver. The deficit has resulted from a political system that failed to contain Federal outlays but kept Federal tax collections below 21 percent of GNP. Administration fiscal policy in the 1980s has sought to reduce Federal spending as a percent of GNP, while at the same time reforming the tax system to improve efficiency and encourage capital formation.

THE STRUCTURE OF GOVERNMENT SPENDING

Government expenditures can influence the rate of capital formation and future living standards by affecting both incentives and economic institutions. Subsidy programs that distort incentives can adversely influence economic performance by affecting labor force participation, work effort, and resource use. Similarly, a shift of govern-

ment spending away from investment can also reduce the future capital stock and living standards. Other things being equal, government spending can influence consumption and investment in any given year. If government expenditure displaces investment purchases, it can lower future living standards. Government spending also affects resource demands and influences relative prices of goods and services. It is therefore important to examine the structure of government spending to see how such spending affects both capital formation and incentives to use resources efficiently in the private sector.

Federal investment expenditures include purchases of both defense and nondefense equipment and structures and outlays for research and development activities. The Federal Government also finances education and training that could be classified as investment in human capital. From 1963 to 1975, Federal outlays for physical investment, including Federal grants to help State and local governments to finance capital investment and grants for research and development fell from one-third of Federal expenditures to less than 16 percent. Chart 2-3 shows the trend in Federal investment as a percent of GNP. From 1968 to 1974, Federal investment outlays fell sharply both as a percent of Federal outlays and as a percent of GNP.

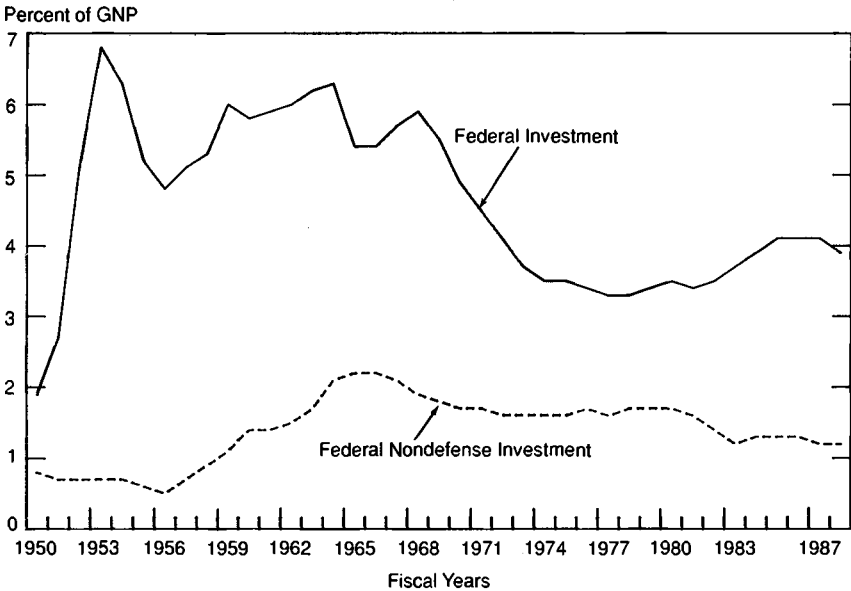
During the 1950s and early 1960s the Federal Government increased nondefense investment and spending for research and development as a percent of GNP. The government sector constructed highways, including the Federal Interstate Highway System, and invested heavily in educational structures and urban infrastructure. The Federal Government invested heavily in military weapons systems such as B-52 bombers. Although essential for national security, investment in defense does not directly contribute to improved future living standards in the same way as nondefense investment.

From the late 1960s to the early 1970s, Federal Government outlays for capital investment and for research and development plummeted both as a percent of total outlays and as a percent of GNP. By 1982 Federal outlays for investment as a percent of GNP were 60 percent of what they had been in the 1960s. The fall in the investment share of Federal spending is a matter for concern because it can adversely affect the productivity of inputs in the private sector as discussed in Chapter 1.

Federal nondefense physical investment and outlays for research and development account for close to one-third of Federal investment outlays. Federal nondefense investment as a percent of GNP grew from 1956 to 1966. After 1966 it first fell and then stagnated through much of the 1970s and early 1980s. The decline after 1980 reflects in part a shift of responsibility for such expenditures to State and local governments as real Federal grants were reduced. Federal

Chart 2-3

Federal Investment Outlays as Percent of GNP



Note.—Investment includes research and development, physical capital, and the investment component of grants-in-aid to State and local governments.

Sources: Department of Commerce and Office of Management and Budget.

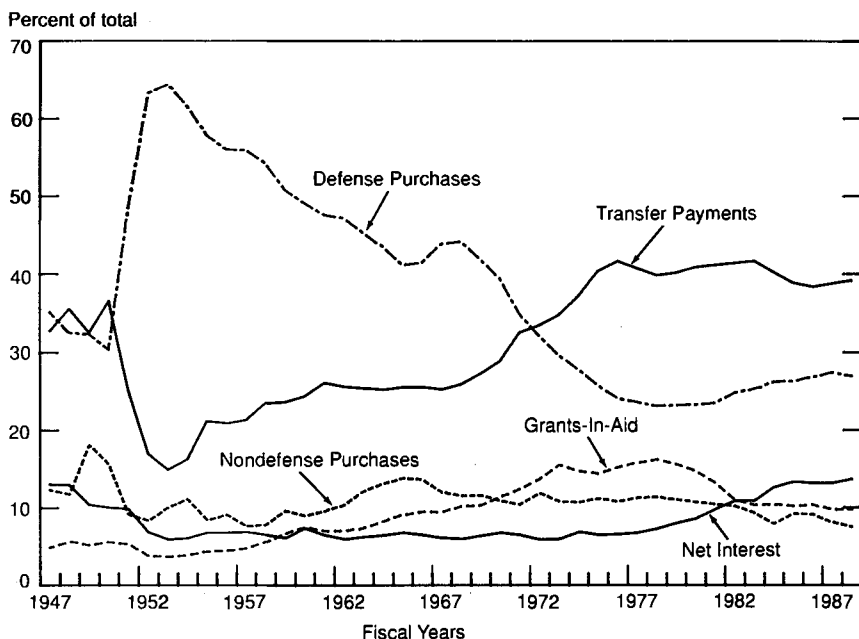
nondefense investment rose modestly from 1983 to 1986 but declined thereafter.

The postwar decline in the relative importance of Federal investment outlays parallels an increase in Federal direct benefit payments to individuals. By and large, these benefits constitute transfer payments that finance consumption by recipients.

Chart 2-4 shows trends in five major categories of postwar Federal Government spending as a percent of total Federal outlays. The rise in transfer payments from a postwar low of less than 15 percent of Federal expenditures in 1953 to a peak of 41.7 percent in 1983 represents a major redirection of Federal spending toward consumption. The relatively high level of transfer payments in the early postwar period largely reflected the GI bill much of which went to investment in human capital. Since 1950 the Federal Government has expanded the level of support under old-age survivors and disability insurance to increase cash transfers to the elderly and others on social security pensions. In 1965 the Congress enacted the medicaid and medicare programs to assist the indigent and the elderly in obtaining health care. Various government subsidy programs including

Chart 2-4

Federal Expenditures by Type



Note.—Data are on a national income and product accounts basis. Total expenditures includes subsidies less current surplus of Government enterprises and wage accruals less disbursements, not shown separately.

Source: Department of Commerce.

food stamps and housing assistance also grew in the 1960s as did expenditures under the means-tested Aid to Families with Dependent Children (AFDC) program. These direct-benefit programs provided assistance to the aged, disabled, indigent, and disadvantaged, but also distorted choices of recipients and reduced work incentives. The subsidy programs encouraged consumption of medical care by reducing the price to recipients of such services below the costs of providing the services. The increase in social security pensions induced many elderly to leave the labor force at an earlier date than they would have otherwise. Expenditures for means-tested assistance under AFDC and in-kind transfer programs may have discouraged the poor from seeking employment and job skills, thus contributing to welfare dependency. Under this Administration the growth rate of means-tested subsidies and transfers has slowed, while the share of payments going to the most needy has increased.

Chart 2-4 shows that defense spending as a percent of total Federal expenditures experienced a sharp downward trend between fiscal years 1953 and 1978. By 1978 Federal defense purchases fell to a postwar low of less than 24 percent of total expenditures. Since 1980, defense expenditures have risen somewhat as this Administration has undertaken a program of investment to improve the Nation's military preparedness and to maintain the U.S. role in ensuring international political stability.

One achievement of this Administration has been to reverse the trend toward a declining share of GNP allocated to national defense. From the mid-1950s to 1979, defense expenditures fell as a percent of GNP. By fiscal 1978, defense expenditures were less than 5 percent of GNP for the first time since 1950. Since 1981 the Administration has emphasized investing in new defense capabilities to enable the Nation to provide better for defense and to meet international commitments. Defense spending has increased from 5.4 percent of GNP in 1981 to 6.5 percent of GNP in 1987. Defense spending as a percent of GNP is, however, still below the levels that prevailed from 1955 to 1965.

The most significant change in the composition of defense outlays since fiscal 1981 has been a sharp increase in the ratio of investment to noninvestment outlays. Defense investment consists of weapons systems procurement, military research and development, and military construction. The ratio of investment to noninvestment defense outlays had declined from around 0.75 in the early 1960s to below 0.43 in 1976, but has risen sharply since 1981 to more than 0.70 in 1987. The modernization of the Armed Forces has resulted in only a modest increase in defense purchases as a percent of total Federal outlays.

In summary, the postwar composition of government spending has indisputably moved from defense and investment purchases to programs that transfer income and services to individuals. The effects of these programs on incentives to work and to use resources efficiently must continue to be scrutinized so that social objectives are achieved in ways that minimize efficiency losses in resource use and consequent loss of output.

The decline in Federal nondefense investment could reduce future living standards. Future administrations should consider expanding programs of nondefense investment, including investment in infrastructure and education, to improve future productivity.

THE LONG-RUN VIEW OF FISCAL POLICY

Fiscal policy over the past 8 years has sought to establish an environment for continued expansion of the economy's long-run potential to produce goods and services. Reducing marginal tax rates, eliminating tax preferences that distort incentives, and controlling growth of government outlays can free up resources to be used more efficiently to improve living standards in the United States. Chapter 1 showed that most economic groups have shared improvements in living standards.

Fiscal policy over the past 8 years improved incentives to use resources efficiently in the private sector. Since 1982 real GNP has increased at an average annual rate of 4.2 percent. The expansion has contributed to rising employment as a percent of the population and has reduced the civilian unemployment rate below 5.5 percent. This record of expansion has occurred even as inflation has dropped to nearly one-third of its 1980 rate and as interest rates have fallen substantially since the beginning of the decade. In contrast with earlier efforts to trade off inflation for employment, the use of fiscal policy for long-term growth has succeeded in realizing high employment with low inflation.

Productivity in manufacturing, measured from the business cycle peak in 1981, has risen at a faster rate than the postwar average and 2.6 times the rate of increase achieved between the business cycle peaks in 1973 and 1981. Tax policies designed to stimulate private investment have helped modernize the capital stock in the manufacturing sector and have probably contributed to this impressive record of productivity growth.

Taxation affects national well-being through its indirect effects on private incentives. Taxes result in a reallocation of purchasing power, but they can reduce incentives to use resources in the private sector efficiently. A tax system that weighs heavily on income from capital can adversely affect investment and the future level of income and standard of living. Similarly, taxes can also distort the work-leisure choice and impair work incentives, thereby causing losses in efficiency in labor markets.

A Federal budget that imposes high taxes on capital income to finance government consumption and private consumption through transfer payments to individuals is likely to adversely affect capital formation. Because taxes on capital income reduce the return to investment, they discourage private investment. The low economic growth in the United States from 1973 to 1982 was in part a result of fiscal policies that distorted the efficient use of resources and impaired incentives to save and work. Changes in tax policy since 1981

have improved incentives to use resources efficiently in the private sector through lower statutory marginal tax rates on both personal and corporate income and curbs on tax preferences that distort investment choices.

If the 1980 tax law were still in place today, Americans would probably be paying considerably more than 20 percent of GNP in taxes. Reduction in marginal tax rates and indexing of personal income tax brackets for inflation have prevented the moderate inflation of the past 6 years from pushing taxpayers into higher tax brackets and paying larger shares of their real income in taxes.

Despite the reductions in personal and corporate income tax rates, average Federal receipts as a percent of GNP have been higher in the last 8 years than the average for the 1970s. In the 1970s Federal receipts averaged 19.3 percent of GNP, while from 1981 to 1988 Federal receipts averaged 20.0 percent. Much of the growth in Federal receipts has resulted from economic expansion. Increased payroll tax collections have also increased Federal revenue. This is the result of higher payroll tax rates and increases in maximum wages subject to payroll taxes.

Federal outlays still remain above Federal tax revenue. This difference requires that the Federal Government continue borrowing to cover its budget deficit. Further controls on Federal outlays to reduce the Federal budget deficit are required.

TAX POLICY AND ITS IMPACT ON THE ECONOMY IN THE 1980s

The Congress has enacted two tax acts of historic significance since 1981: The Economic Recovery Tax Act of 1981 (ERTA) and the Tax Reform Act of 1986 (TRA). These acts have resulted in a fundamental restructuring of income taxation in the United States to improve incentives to produce, save, and invest and to encourage more efficient use of resources in the private sector.

The Economic Recovery Tax Act of 1981 reduced the top marginal tax rate for individual income from 70 to 50 percent. It reduced marginal tax rates on given levels of nominal income for all tax brackets while indexing personal exemptions, the standard deduction, and tax brackets in 1985 to prevent bracket creep. The indexation of tax brackets was designed to prevent future inflation from pushing individuals with no change in real income into higher tax brackets.

The act significantly reduced the average burden of taxation for American families compared with what it would have been without a change in the tax law. The tax reduction resulted primarily from a 23 percent across-the-board cut in marginal tax rates. Another provision

of ERTA was a special deduction for married couples designed to encourage labor force participation of both spouses by lowering the marginal tax rate on earnings of the lower earning spouse. These cuts in marginal tax rates acted to increase the incentives to work and to invest. The act also encouraged household saving through special deductions for retirement saving.

ERTA significantly changed the treatment of capital expenditures to encourage private investment and research and development. The accelerated cost recovery system and an increase in the investment tax credit for some types of equipment allowed an increase in the real after-tax rate of return for many types of investment. The provision to allow expensing of up to \$5,000 worth of equipment in 1982 and 1983 is likely to have increased the return to all types of small business investment. The Tax Reform Act of 1986 increased expensing of capital to \$10,000 worth of equipment. Expensing allows businesses to deduct capital outlays as a current cost when calculating taxable income.

Changes in the tax treatment of investment goods increased the real rate of return to investment in the United States relative to that in foreign nations and partially offset the distortions resulting from the high inflation of the 1970s. ERTA significantly reduced the effective tax rates on all new depreciable assets, but was relatively more favorable to investment in equipment and vehicles than to other types of investment goods.

The Economic Recovery Tax Act sought to improve future living standards by reducing the tax rates on capital income and encouraging investment. This historic change in tax policy sought to increase the Nation's capital stock.

Unlike many of the tax cuts of the postwar era, ERTA was designed as a fundamental restructuring of the tax system rather than as a temporary stimulus to aggregate demand. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) scaled back some of the investment incentives of ERTA by adjusting the accelerated cost recovery system in order to prevent cost recovery benefits from actually exceeding those of expensing. Nevertheless, the ERTA-TEFRA reforms significantly reduced the effective tax rate on most investments. One estimate shows that ERTA sharply reduced tax rates on capital by more than 50 percent, on average, compared with effective tax rates prevailing in 1980. Despite the TEFRA changes that increased effective tax rates on capital (which in some cases was zero or negative), these tax rates were still estimated in 1982 to be considerably below the levels that prevailed in the 1970s.

The Tax Reform Act of 1986 represented a broad overhaul, probably the most extensive in U.S. history, of the structure of both the

personal and corporate income tax. This act further lowered marginal tax rates on personal income and reduced the number of tax brackets while broadening the tax base to prevent significant loss of tax revenue. The act eliminated many tax preferences that distort choices so as to improve efficiency of resource use. The revenues obtained from reducing wasteful tax preferences have allowed a reduction in statutory marginal tax rates for taxpayers so as to encourage work effort and capital formation. The top personal marginal tax rate effective in 1988 is 33 percent for taxpayers subject to phase-out provisions affecting the personal exemptions and the 15 percent bracket. However, the top marginal tax rate for those in the highest taxable income class is limited to 28 percent.

The Tax Reform Act of 1986 also resulted in a somewhat higher effective marginal tax rate on capital income because it changed depreciation rules, the tax treatment of long-term capital gains, and repealed the investment tax credit. However, more uniform tax rates on alternative types of investments also resulted from a change in depreciation rules designed to improve the allocation of investment. Phasing out tax preferences such as the deduction of nonmortgage consumer interest on personal income tax returns was designed to change the allocation of private spending away from consumer durables toward business investment.

By reducing personal and corporate marginal tax rates, it has been possible to reduce the Federal Government's drag on both growth in the private sector and incentives. Reduction in personal and corporate income tax rates has not, however, resulted in a decline in Federal revenues as a percent of GNP because the tax base has been broadened, the economic expansion has increased income, payroll taxes have been increased, and wasteful tax preferences have been eliminated. Nevertheless, the reduction in tax rates has served to make disposable income greater than it would otherwise have been, thereby allowing more private consumption and saving while encouraging private investment.

Research on the effects of U.S. personal tax rate reductions under ERTA indicates that changes in taxpayer behavior that increased taxable income recouped as much as 40 percent of the revenue loss that would have resulted from the tax rate cuts. Some evidence on the effects of the ERTA tax cuts indicates that the response to the reduction in marginal tax rates has been greatest for taxpayers in the highest tax brackets: as a result the share of income tax paid by the highest income groups actually increased. Annual taxes paid by taxpayers with nominal taxable incomes of \$200,000 or more increased by nearly \$10 billion in 1985 relative to what they would have paid had

no change in tax rates and no macroeconomic response to the changes in tax rates occurred.

REDUCTION IN TYPICAL FAMILY TAX BURDENS

The tax reforms of the 1980s have prevented the Federal income tax burden from increasing sharply for virtually all families. For example, had there been no tax changes during the 1980s, a married couple with two dependent children with a single earner earning a median income of \$29,654 in 1987 and taking average itemized deductions would have paid \$3,840 in Federal income tax. With the reduced tax rates this family's Federal income tax liability in 1987 was actually \$2,389. Such a family pays 38 percent less in personal taxes than it would have were the 1980 tax law still in effect. The average Federal tax rate for this family in 1987 was 8.1 percent. Were the 1980's law still in effect, this family would pay an average tax rate of 12.9 percent.

Two-earner families have enjoyed even greater savings. A family consisting of a married couple and two dependent children, taking average itemized deductions and earning the median income of \$38,022 for two-earner families of four in 1987, enjoyed a 51 percent Federal tax cut. Such a family would have paid \$5,009 in income taxes were the 1980 law still in effect in 1987. The actual tax bill was only \$2,456, a tax cut of \$2,553. The average tax rate for such a family would have been 13.2 percent without tax changes since 1980. With the tax changes of the 1980s this family paid only 6.5 percent of its income in taxes. Table 2-1 shows how tax changes have affected one- and two-earner families with median income under assumptions about their average tax deductions. Estimates for 1988 show similar tax savings after the provisions of TRA were fully in effect.

TABLE 2-1.—*Income Tax Reductions: Current Law Versus 1980 Law, Median Income One-Earner and Two-Earner Families of Four*

Year	Median income one-earner family of four				Median income two-earner family of four			
	Income	Taxes under		Reductions under current law ¹	Income	Taxes under		Reductions under current law ¹
		Current tax law ¹	1980 tax law			Current tax law ¹	1980 tax law	
1980.....	\$20,429	\$2,081	\$2,081	\$0	\$25,669	\$2,227	\$2,227	\$0
1981.....	21,690	2,266	2,295	29	27,803	2,605	2,648	43
1982.....	22,777	2,217	2,487	270	29,316	2,333	2,970	637
1983.....	23,885	2,183	2,691	508	30,581	2,150	3,236	1,086
1984.....	25,561	2,295	3,003	708	32,549	2,313	3,670	1,357
1985.....	25,849	2,284	3,087	803	34,469	2,541	4,129	1,588
1986.....	28,388	2,591	3,574	983	35,336	2,598	4,353	1,755
1987.....	29,654	2,389	3,840	1,451	38,022	2,456	5,009	2,553
1988 ²	30,863	2,626	4,106	1,480	39,572	2,737	5,393	2,656

¹ "Current tax law" refers to the law in effect in year shown.

² Estimated.

Sources: Department of Labor (median income data) and Office of Management and Budget.

The reductions in the marginal tax on labor income encourage labor force participation particularly of second earners. Because TRA reduced the difference between gross wages and net wages at the margin, it provides workers with an incentive to increase their work effort.

The act cut the average Federal tax rate paid by families with an annual income of less than \$10,000 by more than one-half, and it is estimated that tax reform will reduce the number of low-income families paying Federal income tax in 1988 by more than 4 million.

TAX REFORM AND CAPITAL FORMATION

Under ERTA, capital formation was encouraged through measures to increase both saving and investment. Stimulus to saving came from reductions in marginal tax rates and from availability of individual retirement accounts for a broad spectrum of taxpayers. Stimulus to investment came from reduction in tax rates, accelerated depreciation, and investment tax credits. As shown in Table 2-2, ERTA was followed by an improvement in the annual average growth rate of U.S. gross domestic investment. Real gross domestic investment grew at an average annual rate of 5.6 percent from 1980 to 1986 compared with an average annual rate of only 2.1 percent from 1965 to 1980. Compared with other major industrial market economies the U.S. improvement in investment is impressive. Over the same period gross domestic investment in Japan grew by only 3.2 percent per year on average. As shown in Chapter 1, however, net investment in the United States grew more slowly than gross investment because of a shift to shorter lived assets during this period.

TABLE 2-2.—*Growth of Real Gross Domestic Investment in the Seven Summit Countries, 1965-86*
(Average annual percent change)

Country	1965 to 1980	1980 to 1986
United States	2.1	5.6
Japan	6.7	3.2
West Germany	1.7	-.1
France.....	3.8	-.2
United Kingdom.....	1.2	4.7
Italy	2.5	-1.1
Canada.....	4.7	1.6

Source: The World Bank, *World Development Report 1988*.

The Economic Recovery Tax Act contributed to a reduction in effective rates of taxation of capital compared with levels existing in the 1970s. Taxes directly influence the cost of capital, which is the pretax return on a new investment required to cover the marginal

cost of the investment given the market rate of interest, the rate of inflation, and the taxes levied on the income from the investment. The cost of capital has been estimated in one study to be higher in the United States than in several foreign nations. Although some controversy surrounds these data, some estimates based on the 1985 Tax Code suggest that the cost of capital in the United States has been about twice the cost of capital in Japan. The cost of capital in the United States also exceeded the cost of capital in the United Kingdom, but the estimated differential was not as great as that for Japan.

The average difference between the gross and net rate of return after taxes in the United States has been estimated to be more than 3 percentage points. Because corporate investments financed with equity in the United States receive less favorable tax treatment than do investments financed with debt, the taxes on equity-financed investments are higher than average. High taxes on capital income do contribute to the differential in the cost of capital between the United States and some foreign nations. Both the United Kingdom and Japan, for example, have taxed capital lightly. West Germany, however, has taxed capital income relatively heavily. The tax burden on corporate equity capital in the United States has also been estimated to be relatively high, with the difference between gross return and the net return after taxes running at 5 percentage points. According to one estimate, an investment financed with equity that cost 7 percent yielded only 2 percent after taxes in the United States in the mid-1980s.

The United States taxes capital income through the personal and corporate income taxes. In addition it now taxes realized capital gains and generally taxes all such gains (except for those on principal residences in most cases) as ordinary income. Reducing the tax burden on capital income would contribute to attracting funds into domestic capital formation in the United States.

Despite adjustment in the original ERTA rules in 1982, the act represented a powerful incentive for investment. Its tax reforms contributed to a substantial increase in net fixed nonresidential investment in the first half of the 1980s. ERTA also contributed to an increase in the real after-tax net return on capital in the nonfinancial corporate sector. Estimates indicate that ERTA also contributed to an increase in the investment-to-GNP ratio. Further, lower inflation resulting from this Administration's economic policies also has stimulated investment. The ERTA tax changes along with reduced inflation are likely to have been a major reason for increased productivity growth in the 1980s and the improving competitiveness of U.S. manufacturing industries in international markets.

Under TRA the average effective tax rate on capital increased. This increase arises mainly because TRA was designed to finance the cut in the personal income tax burden with a rise in the corporate tax burden. Despite its reduction in the top statutory corporate tax rate from 46 to 34 percent, TRA's other provisions—such as elimination of the investment tax credit and changes in depreciation rules—offset the reduction in the tax rate and raised the cost of capital on average. Other things equal, the increase in the marginal effective tax rate on capital resulting from the new Tax Code will act to reduce investment. The act's other changes will even out the effective tax rates on alternative investments, however, and thus moderate this effect. The evening out of tax rates on alternative investments, combined with elimination of tax deductibility of consumer nonmortgage interest, will provide incentives to allocate investment funds more efficiently. The economic effect of reduced investment due to the increase in the effective tax rate will therefore be offset at least in part by improved efficiency in investment choices as distortions in the pattern of investment choices are reduced.

Overall, the tax reform is likely to increase net national product after a period of adjustment. The new tax law will contribute to more efficient investment patterns by eliminating tax shelters that have encouraged the purchase of assets for resale so that new owners can redepreciate them.

Table 2-3 provides estimates of how TRA has influenced effective tax rates on corporate and noncorporate capital investments compared with prior law. The average tax rate on investment has increased from 33.3 to 36.5 percent. The increase in the tax rate on investment has been greater in the corporate sector than in the noncorporate sector. The new law has reduced the variance of effective tax rates on alternative investments by more sharply increasing the effective tax rates on investment in equipment relative to the increase in the effective tax rates on structures, including owner-occupied housing. The effective tax rates on land and inventories have fallen.

Despite the increase in the effective tax rate on capital investment resulting from TRA, tax reform remains consistent with a fiscal policy that encourages capital formation. Problems in the taxation of capital income remain, however, because depreciation allowances, capital gains, and interest income and expenses have not been indexed for inflation. Higher inflation would raise the effective tax rate on capital, as it did in the 1970s. Some concern also remains about the effects of the increase in the statutory tax rate on capital gains on incentives to invest and to realize capital gains.

Lack of indexation of depreciation allowances, capital gains, and interest will distort decisions by taxing nominal as opposed to real

TABLE 2-3.—Estimated Average Effective Tax Rate on Investment

(Percent)

Type of asset	Prior to TRA ¹	Under TRA ¹	Prior to TRA ¹	Under TRA ¹
OVERALL TAX RATE ON INVESTMENT	33.3	36.5		
Owner-occupied housing	22.5	23.7		
	Corporate		Noncorporate	
Equipment.....	10.0	39.6	-11.9	25.4
Structures:				
Nonresidential	34.4	43.1	27.8	31.4
Residential.....	49.5	52.5	38.2	40.6
Public utility.....	32.6	44.5	22.1	33.6
Inventories.....	48.8	45.8	33.0	30.5
Land:				
Nonresidential	50.6	47.8	36.1	33.8
Residential.....	53.9	51.4	41.4	39.5
OVERALL WITHIN SECTOR	38.7	44.4	33.2	33.9

¹ Tax Reduction Act of 1986.

Source: Department of the Treasury, Office of Tax Analysis.

capital income. In an inflationary environment, the effective tax rate on real capital gains and investment purchases will increase, thereby increasing the cost of capital. In an inflationary environment with no indexation of nominal capital gains or depreciation allowances based on historical cost, inflation biases an income tax toward consumption. To ensure continuing incentives for capital formation, therefore, inflation must continue to be reduced or depreciation allowances and capital gains and other inflation-sensitive income and deductions should be indexed.

In view of the positive response by upper income groups in realizing more capital gains after the ERTA tax reductions, some concern arises about the effects of the increase in the capital gains tax rate under TRA on tax revenue and investment incentives. The tax rate increase is the largest applied to capital gains in the postwar era. Some evidence now indicates that capital gains realizations are highly sensitive to tax rate changes and to anticipation of such changes. High tax rates on capital gains tend to lock investors into their portfolios because unrealized capital gains are not subject to taxation.

High tax rates on capital gains may also have long-term implications for capital formation and entrepreneurial activity. The capital value of a new business typically rises as the business succeeds. Owners of the business can receive income in the form of capital gains through sale of equities in the business. Higher capital gains taxation can, therefore, adversely affect the return to entrepreneurial activity over the long run and further reduce incentives for capital formation.

U.S. TAX STRUCTURE AND THE NEED FOR STABLE TAX RATES

The tax reform movement has spread worldwide. Spurred on by the success of tax reform in the United States, many nations are reducing marginal tax rates and adjusting their tax systems to encourage capital formation and increase incentives to work. Following the lead of the United States, most nations in the Organization for Economic Cooperation and Development have reduced marginal income tax rates.

Other nations raise substantial revenue with national value-added taxes on a base that explicitly excludes investment purchases. The heavy use of payroll taxes, which are not levied on capital income, along with consumption-based value-added taxes has contributed to reduced tax burdens on capital per dollar of tax revenue in many of those nations relative to the United States. Dividends in the United States remain subject to double taxation—taxed as income to corporations and again as personal income to the stockholders. Most of the European Community members have policies to relieve some of the double taxation of corporate income. On the other hand, most of these nations impose higher taxes on the use of labor.

The U.S. tax system still encourages investment in owner-occupied housing. The effect of TRA on investment in homeownership is difficult to forecast. The reduction of marginal tax rates and reduction of the number of itemizers will reduce incentives for homeownership. Other provisions in the Tax Code, however, encourage homeownership. For example, in most cases capital gains from the sale of a home still receive preferential treatment as does debt incurred to buy a home relative to debt incurred to purchase other consumer durables. Interest on mortgage debt is largely tax deductible while interest on other household loans is not. In addition, imputed rent on owner-occupied homes is not taxed. Some countries restrict the interest deduction for homeownership and some actually tax imputed rent from homeownership. The United States still has a tax system that distorts investment choices in favor of homeownership relative to other investment opportunities.

In sum, the tax policies of the past 8 years have improved incentives for capital formation and efficient resource use. A consistent long-term fiscal policy is necessary for the incentive effects of tax reform to bear fruit. Stability in the tax structure is needed to maintain long-term incentives for capital formation and to improve efficiency in resource allocation. Future fiscal policy must avoid raising marginal tax rates, which would reduce incentives for capital formation and lower future standards of living.

CONTROLLING FEDERAL OUTLAYS AND THE FEDERAL BUDGET DEFICIT

During the past 8 years Federal taxes as a percent of GNP have actually increased compared with average levels during the 1970s, while marginal and average tax rates declined. In view of the harmful effects of high marginal tax rates on private capital formation, a goal of this Administration has been to reduce the Federal deficit by reducing the growth of Federal outlays. In fiscal 1987, Federal outlays adjusted for inflation declined for the first time in 14 years. The budget process must be reformed and Federal spending must be restrained to reduce the budget deficit further.

The Balanced Budget and Emergency Deficit Control Act of 1985, as amended in 1987 (the Gramm-Rudman-Hollings Act) calls for a balanced Federal budget by 1993. The Gramm-Rudman-Hollings Act provides a framework for reducing the budget deficit through sequestration of funds when the budget deficit reaches specified trigger levels. A sequester would involve permanent cancellation of budget authority for a broad category of defense and nondefense programs. Except for 1993, when the target is a zero deficit, the sequester triggers are \$10 billion over the target deficits for each year. Table 2-4 shows the target deficits and sequester triggers for 1990 to 1993. In the event of a recession, however, the Congress can suspend Gramm-Rudman-Hollings for the remainder of a fiscal year or for the following fiscal year, or both, upon passage of a joint resolution.

TABLE 2-4.—*Deficit Targets Under the Gramm-Rudman-Hollings Act, 1990-93*

[Billions of dollars]

Fiscal year	Target deficit	Sequester trigger
1990	100	110
1991	64	74
1992	28	38
1993	0	0

Source: Gramm-Rudman-Hollings Act.

The “budget summit” in the fall of 1987 resulted in a 2-year, \$76-billion budget reduction package that for fiscal 1988 and 1989 complied with Gramm-Rudman-Hollings. Further reduction of the deficit will require cutting inefficient programs to eliminate waste and perhaps relying more on user fees to shift the cost of particular services from taxpayers to those who benefit from the service. Programs of purely local benefit should be transferred to State and local governments. Gramm-Rudman-Hollings increases incentives for the Con-

gress to control spending, and as such represents an important contribution to reducing the deficit without raising taxes.

THE FEDERAL DEBT AND DEFICIT IN PERSPECTIVE

The deficit and U.S. national debt must be put in perspective. The current government sector's net debt burden as a percent of GNP is well below historical highs and is also well below the levels for several other industrial nations. The United States and other developed nations have in the past prospered with government debt levels significantly higher than U.S. current levels without significant reductions in standards of living or growth.

Progress has been made in reducing the Federal budget deficit. The Federal deficit has declined from 5.4 percent of GNP in fiscal 1985 to 3.2 percent of GNP in fiscal 1988 and is projected to decline still further as a percentage of GNP.

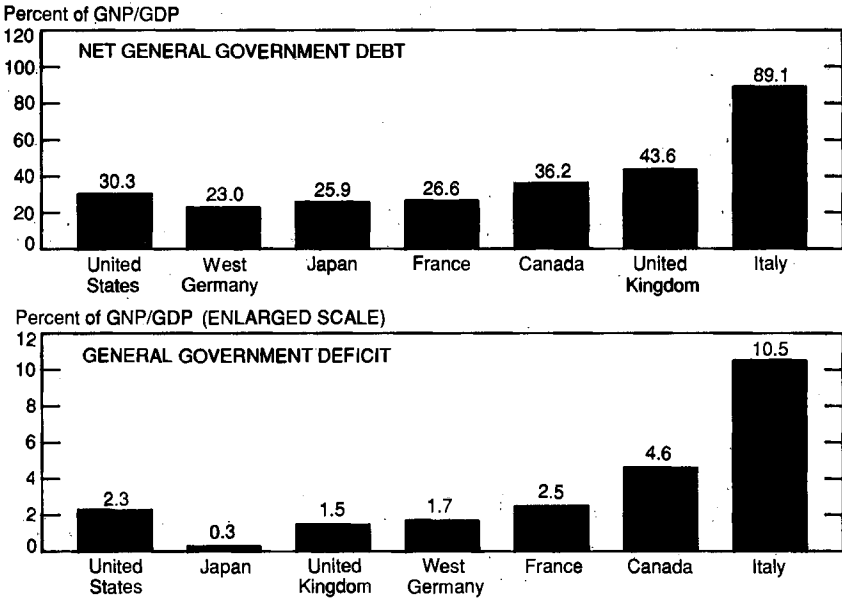
The general government deficit in the United States is less than the Federal Government deficit because State and local governments in the aggregate have run budget surpluses in recent years. For example, in 1987 State and local governments in the aggregate in the United States ran a \$52.9 billion budget surplus; the nominal Federal Government budget deficit that year was \$157.8 billion. The net dissaving by governments at all levels that year therefore amounted to \$104.9 billion which was the combined government deficit on a national income and product accounts basis. This net dissaving by the government sector amounted to 2.3 percent of GNP in 1987.

Chart 2-5 shows the 1987 net public debt of the government sector and the general government deficit in seven major industrial nations (the G-7) as a percent of the value of national production. The U.S. net public debt is a smaller percent of the value of national production than the net public debt of Canada, the United Kingdom, and Italy and is not much higher than that of Japan and France. The 1987 general government deficit as a percent of the value of national production in the United States was less than that for France, Canada, and Italy in that year.

How to measure the Federal budget deficit is controversial. For example, inflation results in overstating Federal Government net interest payments. Assuming 5 percent inflation, a 7 percent nominal interest rate on the net Federal debt results in \$70 of Federal outlays for each \$1,000 of net Federal debt. But \$50 of the \$70 represents receipts to the Federal Government in the form of an "inflation tax" on the holders of the net Federal debt. Government accounts treat the payment of interest—the entire \$70—as an expenditure but do not record the inflation tax as a receipt. Adjusting the nominal deficit for the inflation component of interest rates results in a real deficit

Chart 2-5

Debt and Deficit in the Seven Summit Countries in 1987



Source: Organization for Economic Cooperation and Development.

much smaller than the nominal deficit. This outcome occurs because interest payments now constitute a substantial portion (about 14 percent) of Federal expenditures.

While lack of adjustment for inflation tends to overstate the deficit, other omissions act to understate its real value. For example, Federal Government loan and loan guarantee programs and insurance programs involve spending commitments that are not valued in the current budget. The cash deficit could increase substantially in a given year if loan guarantees were to become due. Similarly, the recent experience of the Federal Savings and Loan Insurance Corporation illustrates how underfunded Federal insurance programs can possibly require increased Federal outlays. A reserve or contingency fund accurately covering the value of expected losses under loan guarantees and other unfunded liabilities of Federal Government agencies would increase, and more accurately reflect, Federal Government spending commitments.

The economic effects of government deficits are highly controversial. In any given year, the Federal budget deficit is a measure of the

nominal amount of Federal dissaving. The deficit is a concern of fiscal policy because it could result in pressure to increase the money supply, which would increase the price level. The deficit can also contribute to a misallocation of resources through its effect on capital markets and private incentives.

A deficit absorbs saving but actually affects the total saving in the economy in a complex manner. Because the Federal deficit, interest rates, output, and prices are parts of an interdependent system, it is incorrect to assume that a dollar reduction in the budget deficit would add an equal amount to gross saving. For example, in 1987, despite a large decline in the Federal budget deficit, there was little change in the balance of trade deficit, as real gross private domestic investment rose and the personal saving rate fell, increasing aggregate demand and thus import demand. The balance of trade deficits of recent years and consequent flow of foreign saving into the United States constitute a combined result of forces influencing both the government budget deficit and private incentives to save and invest. The budget deficit cannot be singled out as the single cause of the balance of trade deficit. Nonetheless, reduction in the Federal budget deficit through spending restraint remains an essential component of a strategy to reduce the balance of trade deficit.

A government deficit implies borrowing to pay for current government goods and services. Such borrowing can be justified if governments use the borrowed funds to provide investment goods that will generate a stream of future benefits to offset the future taxes that must be raised to pay interest on the borrowed funds. A deficit that finances an increase in public or private investment outlays, as opposed to consumption outlays, can actually improve future living standards. A complicated issue in analyzing the Federal deficit over the long run involves determining how the deficit and the composition of government outlays, along with tax structure, influence capital formation, resource use, and incentives to produce, save, and invest.

This discussion is not meant to minimize the negative influence of the current budget deficit on capital formation. Although there are disputes about estimated effects, studies indicate that the overall effect of deficits in the postwar era has been to reduce U.S. capital formation. These studies imply that future fiscal policy would improve future living standards by continuing to reduce the rate of government dissaving by controlling Federal Government expenditures.

THE SOCIAL SECURITY TRUST FUNDS' BUILDUP AND THE BUDGET DEFICIT

One of the more significant fiscal changes in the postwar era has been the growth of social security and medicare benefits, their indexation for inflation, and the consequent increase in payroll taxes to fi-

nance these benefits. Legislation enacted in 1977 and in 1983 increased payroll tax collections and mandated future increases. Annual payroll tax collections have begun to exceed annual payouts for social security benefits. The social security trust funds have increased and are forecast to continue to do so until the second quarter of the next century. For a time the social security trust funds buildup will increase Federal Government saving and contribute to a decline in the Federal budget deficit.

Awareness of large projected old-age survivors and disability insurance (OASDI) trust funds' surpluses has resulted in some concern about how the trust funds' surpluses might be used. Some observers fear that the trust funds' surpluses will be used to finance other government spending or will offer a solution to reduce the deficit that avoids the basic issues of cutting wasteful programs and improving resource use in the economy. Although these concerns are valid, it must be emphasized that the magnitude of the social security trust funds' buildup has been overstated.

The OASDI trust funds constitute budget accounts, not cash. When the trust funds are drawn upon to pay benefits, the Treasury must raise cash. When spending for social security benefits in a given year is less than receipts earmarked for those benefits, the excess receipts are loaned to the Treasury. The Treasury credits a special issue Treasury bond to the OASDI trust funds and credits interest on the bond at a rate equal to the average rate for marketable Treasury securities of 4 years or more to maturity.

Payment of interest on the special issue bonds held by the OASDI trust funds is merely an intragovernmental transfer. The interest credited to the trust funds is a general fund liability of the Treasury. In effect the Treasury issues a promise to pay the interest by making a note in its books. Much of the buildup of the trust funds over the next 30 years will constitute interest that the Treasury credits to the funds in this way.

A proper view of future trust funds' surpluses requires adjustments for inflation, for interest transfers to the funds that do not constitute net income to the Federal Government, and for the forecast deficits in the social security hospital and health insurance funds (HI). After these adjustments, the surpluses are much smaller relative to the Federal unified budget than unadjusted surpluses. Table 2-5 shows projections of OASDI and HI surpluses and deficits, excluding interest credited to the trust funds, in both current dollars and 1988 dollars. The annual projected OASDI surpluses never exceed \$75 billion in 1988 dollars. The maximum OASDI surplus in the year 2005, after adjustments, constitutes less than 7 percent of 1988 Federal spending. Adjusting for the forecast deficit of the HI fund shows that the

maximum surplus of the combined OASDI and HI trust funds in 2005 will amount to only \$50 billion in 1988 dollars. This amount equals less than 5 percent of current Federal spending.

TABLE 2-5.—Unified Budget Impact of Projected OASDI and HI Surpluses (Excluding Interest), Selected Years, 1988–2065

(Billions of dollars)

Year	Current dollars			1988 dollars		
	Total	OASDI	HI	Total	OASDI	HI
1988.....	40	32	8	40	32	8
2005.....	98	145	-47	50	74	-24
2025.....	-804	-329	-475	-187	-76	-110
2045.....	-3,544	-1,544	-2,000	-375	-163	-212
2065.....	-11,328	-5,218	-6,110	-547	-252	-295

Source: Department of the Treasury, based on Alternative II-B series in the 1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds and data from the Social Security Administration.

These projections suggest that the windfall of funding coming from the social security trust funds' buildup will not constitute a significant increase in purchasing power to finance other government programs. In addition, as Table 2-5 shows, the surpluses in the trust funds are projected to give way to large deficits later in the 21st century, as the population ages and payments for social security beneficiaries grow rapidly. By the year 2065 the deficit in the OASDI and HI trust funds is projected to be \$547 billion in 1988 dollars, an amount representing one-half of total 1988 Federal spending.

As the number of retirees grows through the 21st century, the social security trust funds will move into deficit and the Treasury will have to raise cash to pay out the interest on the trust funds' securities. As the proportion of retirees to workers increases, larger portions of both GNP and Federal revenues will have to be allocated to pay social security pension and health benefits. Taxable resources will be needed to finance those benefits; fiscal policies must encourage real increases in capital formation that will create those resources in the future.

A fiscal policy that encourages both private saving and private investment complemented by a reduction of the Federal deficit through elimination of wasteful expenditures will act to increase capital formation. The prospect of the buildup of the social security trust funds should therefore involve no significant change in fiscal policy. The buildup itself will decrease government dissaving and thereby temporarily increase the availability of funds for private investment. Increasing tax rates to increase government saving could undo the effects of tax reform on incentives to invest, and thereby do much to discourage private capital formation. If increases in tax rates to en-

courage government saving discourage sufficient private capital formation, they will be self-defeating.

Economists generally agree that saving must be encouraged to increase the tax base to fund future social security benefits. Disagreements arise about the best way to accomplish these objectives. The view of this Administration is that a consistent long-term fiscal policy designed to keep marginal tax rates low and provide incentives for work effort, saving, and investment remains the best way to encourage future capital formation. The growing real social security trust funds' surplus should not be used as an excuse to expand Federal Government outlays.

Social security pension benefits and finance are matters with which the Nation must grapple in the future as the population ages and the proportion of retirees to workers continues to increase in the 21st century. Retirees will consume growing portions of national output. Unless the elderly are encouraged to remain in the labor force as productive workers, or the real level of the social security pension benefits is cut, the best way to finance the consumption of future retirees—without devoting the major portion of the Federal budget to that end—is to encourage saving and investment now to increase taxable real income in the future.

INSTITUTIONAL CHANGE TO CONTROL FEDERAL OUTLAYS TO REDUCE THE DEFICIT

Mechanisms to curb spending increases are a key component in a fiscal policy designed to bring Federal outlays in line with a tax burden of no more than 20 percent of GNP. Gramm-Rudman-Hollings provides a framework for reducing the deficit through 1993. Over the long term, however, institutional changes in the budgeting process might be desirable to control the growth of government outlays.

Some economists have proposed dividing the current unified budget into an operating budget and a capital budget. The Federal budget now presents a comprehensive statement of anticipated cash outlays and cash receipts lumping together consumption and investment outlays for the current fiscal year. Separating capital expenditures from operating expenditures could more clearly link operating receipts with operating outlays, which would, in turn, more clearly identify the operating deficit or surplus of government. A capital budget would also link investment outlays with borrowing and provide a basis for linking payment for government debt-financed investments with taxes on future taxpayers. Further, a capital budget would distinguish borrowing used to finance capital investments from borrowing to finance current consumption. Capital budgeting could pro-

vide information necessary to plan an increase in the investment component of government spending.

Unfortunately, problems involved in actually implementing a capital budget for the Federal Government more than offset its possible advantages. A capital budget would significantly reduce the constraints on total government spending and make it more difficult for the Administration and the Congress to formulate fiscal policy. Total Federal spending would no longer be shown; the budget would no longer provide a comprehensive comparison of total Federal spending for different programs and purposes. Because a capital budget would record depreciation in place of capital expenditures, only a small fraction of the cost of a proposed capital purchase would be apparent to policymakers deciding about the overall level and composition of government spending. This would greatly increase the incentive for the government to purchase capital goods.

Conceptual and practical measurement problems also arise. Rules would be needed for depreciating Federal assets, for valuing government assets and measuring its liabilities, and for identifying types of outlays that constitute capital formation, e.g., whether to include in the capital budget education and other programs that build human capital. Care would have to be taken to avoid losing control over government spending, deficits, and debt by categorizing current programs as capital expenditures, by using inaccurate depreciation rates, or by introducing costly programs with small, initial outlays. Thus, a capital budget could lead to renewed increases in the growth of spending. For these reasons, the Administration has opposed proposals for a separate capital budget.

The Administration favors adoption of a line-item veto. A line-item veto would enable the President to veto individual items in appropriations bills, subject to the current provisions for overriding a veto of any bill. Effective use of a line-item veto would give future Presidents more flexibility in pursuing fiscal policies to encourage capital formation. The President could selectively veto wasteful new government spending programs that increase consumption without sending an entire appropriation bill back to the Congress. The line-item veto would discourage the Congress from enacting wasteful spending programs that are not in the national interest. Such a provision could forestall special-interest programs that benefit a few at the expense of many taxpayers.

A balanced budget and tax limitation amendment to the Constitution offers a comprehensive form of restraint to control spending. This approach would change the rules under which decisions are made to borrow or to increase Federal outlays and receipts relative to GNP. One proposal would require that total outlays not exceed

total receipts unless three-fifths of the whole number of both Houses of Congress votes to break that rule. Other approaches seek to limit the growth in Federal outlays to the growth in real GNP. An amendment could place similar restraints on the national debt, prohibiting increases unless a substantial portion of the Congress voted in favor. These limitations would help to establish an institutional framework that creates incentives for limiting Federal spending. Constitutional limitation would require political compromise to cut the rate of growth of Federal outlays and to keep spending in line with the public's willingness to pay taxes. Further, constitutional limitation would help to change the way in which decisions are made. Under a constitutional limit, everyone agrees to limit demands on government in exchange for a commitment that others will be bound by the same limit. Proposals for increased spending would be compared with current spending, and policymakers would have to pay increased attention to the merits of alternative programs. Constitutional spending limitation would bring fiscal discipline.

CONCLUSION

The challenge of the future is to enact reforms that adjust institutions and incentives to reduce the growth of Federal outlays and increase both public and private investment. By doing so the Federal budget deficit can be reduced and the government sector can make a greater contribution to increasing the Nation's rate of capital formation and improving its standard of living.

The Nation must avoid the temptation to increase marginal tax rates to reduce the Federal budget deficit. To raise marginal tax rates on labor and capital income would adversely affect the incentives to work and invest that are the foundation for improved future living standards. The reduction of the Federal deficit through reducing spending represents an important component in a policy to increase national saving. However, deficit reduction must not come at the expense of incentives for private capital formation.