Economic Policy Institute

Briefing Paper

1730 Rhode Island Ave., NW • #200 • Washington, DC 20036 • 202/775-8810

DEFICIT REDUCTION FOR GROWTH AND FAIRNESS

by Jeff Faux and Max Sawicky

Because the current budget summit negotiations are concentrating exclusively on deficit reduction, there is a serious danger that these negotiations -- and the subsequent Congressional debate -- will produce an agreement which undercuts another urgent budgetary priority, the need for increased public investment to improve American productivity. If new federal revenues and savings achieved by military spending cuts are devoted solely to deficit reduction, we will effectively lock out desperately needed investment in human and physical capital for years to come. The consequences for American competitiveness and living standards would be disastrous.

This paper proposes a budget strategy that promotes fairness and economic growth by setting targets for new investment as well as for deficit reduction. It demonstrates that the problem of the fiscal deficit, including the cost of the S&L bailout, can be solved in a way that frees up resources for human development and physical infrastructure, and that facilitates conversion to a dynamic post-Cold War economy.

1. THE ECONOMIC CRITERIA FOR BUDGET REDUCTION

Any deficit reduction agreement should meet two crucial tests: Growth and Fairness.

GROWTH

The U.S. economy is like a fundamentally profitable company that has been mismanaged to the verge of bankruptcy. *Reducing* debt alone *will not* rescue *our* enterprise; fresh capital investment in schools, transportation, civilian research and development, and other priorities are essential to grow out of the financial hole.

Thus, at a minimum a deficit reduction plan strategy must also:

(i) Raise civilian public investment. We have a large and growing deficit in public investment -- including child development, training and education, public infrastructure, environmental protection, and civilian research and development. Declining public investment has now been clearly linked to the slowdown in national productivity and competitiveness. Public spending for these purposes has the support of a wide array of economists and editorial writers as well as majorities of surveyed voters.

Despite Administration claims, state and local governments cannot by themselves make up the public investment deficit. Squeezed by slow growth on the one hand and rising demands for spending to combat crime, homelessness, congestion, and other social problems, their financial capacity is too limited. Moreover, in our mobile society public investments by state and local governments generate benefits beyond their borders. The national government therefore has an obligation to stimulate investments that generate national gains.

It is usually said that before we address our domestic investment needs, we must "get the deficit behind us." But the budget deficit will not be eliminated for years, and therefore such an approach effectively locks out new public investment for the foreseeable future, with disastrous consequences for American competitiveness and living standards.

(ii) Prevent a recession. The economy is in trouble. Consumer spending is sluggish, the boom in exports is tapering off, capital investment is weak and state and local government spending has slowed down. At this point, very large federal spending reductions and/or tax increases could jolt us into a recession, particularly when there are questions about the Federal Reserve's willingness and ability -- given the globalization of financial markets -- to cut interest rates quickly and deeply enough to offset the dampening effect of fiscal contraction. In a recession the fall in tax revenues and automatic increases in entitlement spending (e.g., unemployment compensation and public assistance) would overwhelm any possible budgetary savings from a summit deal.

The latest (June 1990) CBO Baseline Deficit Projections (forecasts of the deficit. assuming the levels of federal spending that support current services and new estimates of the cost of the S&L bailout by the Resolution Trust Corporation -- RTC) show the magnitude of the reductions now necessary to reach the Gramm-Rudman-Hollings (GRH) **targets.**

Table 1

	1991	1992	1993
CBO Baseline Deficit* (Including RTC Spending)	**232** (70)	**239** (60)	**194** (12)
GRH Targets	**64**	**28**	**0**
Required deficit reduction	**168**	**211**	**194**
Required deficit reduction (Excluding RTC Spending)	98	151	182

No one **knows just** how much deficit reduction is too much. Economic forecasting is still more of an art than a science. As noted above, much depends on what the Federal Reserve will do. But most macroeconomists agree that attempting to reach the present Gramm-Rudman-Hollings targets would probably trigger a recession. As usual, there is sentiment in some

* Throughout this paper, we will use the CBO June 1990 projections. For **1991,** they are virtually identical to the official projections by the Office by Management and Budget. For subsequent years, they have the virtue of being based on more reasonable economic forecasts.

quarters for risking a "mild" recession in order to grind any vestiges of inflation out of the economy. But the huge overhang of business and consumer debt has increased the probability that a recession in the next 12 months will be at least as deep as the last one.

Earlier this Spring (before the latest deficit forecasts) Council of Economic Advisers Chairman Michael Boskin -- a strong proponent attempting to raise the national savings rate through deficit reduction -- said:

> "If you tried to get rid of the $150 billion deficit in two years, it would be hard for the economy to absorb that large a change quickly. In that event, you're talking about a change of 3 percent of GNP over two years.

Subtracting the cost of the S&L bailout from the deficit calculation would lower the required reduction to $98 billion in 199 1 and $15 1 billion in 1992. But attempting to meet even these targets would still entail an economic risk. Since the targets will have to be reformulated in any case, it would be just as well to include the RTC outlays. The subterfuge of defining away part of the deficit would fool nobody and do nothing but diminish public confidence in the seriousness of the commitment to deficit reduction.

FAIRNESS

The public is now painfully aware that the last decade has been one of "sweet deals" for the rich and well-connected, in contrast to stagnant real incomes for the middle class and dramatic cuts in living standards for the poor. This upward redistribution of income and wealth has reversed the gradual trend toward equality since World War II.

Increases in payroll taxes, cuts in domestic programs, and cuts in income tax rates have shifted the tax burden to poor and middle income people who work for a living and away from those in upper income brackets, who receive more of their earnings from interest, dividends, and capital gains.

The economic rationale for this downward shift in the tax burden and upward shift in income was that it would encourage investment and extraordinary work effort. There is no evidence that this has taken place. which means there is no reason to fear that raising taxes to cover the deficit in a way that reverses the redistributionist Reagan policies of the past decade will reduce growth. As the widely quoted title of a 1987 EPI report advises, "Send the Bill [for reducing the deficit] to Those Who Went to the Party."

2. NEW BUDGET TARGETS

Preventing recession in the short term and improving productivity and growth in the long term cannot be achieved within the current Gramm-Rudman-Hollings guidelines. Therefore the Gramm-Rudman-Hollfngs targets should be discarded and replaced with more sensible criteria.

In rethinking the targets, we should keep in mind the economic purpose, as opposed to political or accounting rationale, of reducing the deficit. It is to keep the public debt from rising as a share of national income (GNP) and thus becoming a long-term drag on economic growth, particularly since a growing portion of income leaks out of the economy in interest and dividend payments to foreign investors. In this context, it is important to understand that the level of debt per se is not the problem. Credit is the life-blood of a growing economy, so long as the loan proceeds are invested in a way that generates future income. Thus, the correct way to judge the burden of the federal deficit is not simply in aggregate dollars but 1) in relation to national income, and 2) in terms of how the borrowed funds are used.

There is another frequently advanced reason for deficit reduction: to raise the national savings rate in order to supply more funds for domestic private investment. However, the extent to which deficit reduction alone will in fact stimulate more private investment is quite uncertain. There are three problems with this often presumed relationship between deficit reduction and private investment:

(i) If the deficit reduction causes a slowdown in growth, growth in savings and investment will also fall.

(ii) There is little assurance that a cut in the deficit will be matched by an increase in private productive investment In the U.S.: it could lead as easily to more investment abroad or to speculation in financial assets.

(iii) Given the depletion of public capital over the past decade and the strategic role it plays in stimulating private investment, at this point in our economic history, directly increasing domestic *public investment is a* quicker *and more* reliable *path to the goal of raising both public* and *private investment in the United States than is radical deficit reduction.*

We cannot get rid of the debt burden overnight. The costs of the irresponsible behavior of the 1980s will have to be paid -- with interest. But it is self-defeating to cripple ourselves with an arbitrary and increasingly reckless Gramm-Rudman-Hollings law. A far safer approach is to reduce, gradually but steadily, the ratio of deficit to income in a way that is fair and that stimulates growth.

Table 2 shows that the budget deficit declined relative to GNP after 1985, and in 1989 it was 2.9 percent --just about where it was at the beginning of the decade.

However, the composition of both revenue and spending was much different. On the revenue side, the share contributed by individual income taxes shrunk substantially while the share contributed by payroll taxes rose -- redistributing after-tax income upward. On the spending side, outlays for domestic investment programs fell while military spending and interest payments rose.

As Table 3 indicates, the February 1990 CBO Baseline Deficit Projections also forecast the deficit continuing to decline as a share of GNP through 1995. But the June projections -- reflecting the drop in anticipated revenues and the increasing S&L bailout costs -- showed the deficit-GNP ratio jumping up for the next three years. Even so, assuming no recession, after 1993 the deficit share of GNP once again declines as receipts from the sale of S&L assets begin to surpass outlays. The problem of the deficit is therefore most acute over the next three years.

Table 2.

THE FEDERAL DEFICIT AND GNP IN THE 1980'S

Billions, Current Dollars

Fiscal Year	1980	1981	1982	1983	1984	1985
Total Federal Deficit	73.8	78.9	127.9	207.8	185.3	212.3
As a % of GNP	2.8	2.6	4.1	6.3	5.0	5.4
Debt Held by Public	709.3	784.8	919.2	1,131.0	**1,300.0**	**1,499.4**
As a % of GNP	26.6	26.3	29.3	34.0	35.3	37.9
Net Interest	52.5	68.7	85.0	90.0	111.1	129.4
As a % of Outlays	8.9	10.1	11.4	11.1	13.0	13.7

Sources: Office of Management and Budget, Congressional Budget Office.

Table 3.

DEFICIT PROJECTIONS AND S&L CLEAN-UP COSTS

Billions, Current Dollars

Fiscal Year	1990	1991	1992	1993	1994	1995
CBO February Baseline Deficit	159	161	124	132	121	110
As % of GNP	2.9	2.8	2.0	2.0	1.7	1.5
June Baseline Deficit with RTC Spending*	195	232	239	194	146	138
As % of GNP	3.6	4.0	3.8	2.9	2.1	1.8
Anticipated RTC Spending	36	70	60	12	-31	-19
June Baseline Deficit less RTC Spending	159	162	179	182	177	157
As % of GNP	2.9	2.8	2.9	2.7	2.5	2.1

(Numbers may not add due to rounding.)

*Assumes changes in law to accommodate anticipated S&L bailout.

Source: Congressional Budget Office, June 1990.

In contrast. inadequate domestic investment is a problem of much longer term duration. It requires us to raise spending for this purpose throughout the 1990s.

Federal support for education, training, child development, civilian research and development, transportation, natural resources and similar investments fell by almost one-third in the 1980s. In 1980 federal spending for such purposes stood at 3.6 percent of GNP: in 1989 it was 2.0 percent. To reach the 1980 investment share would have required spending about $85 billion more in 1989. Even that figure would not have made up for the cumulative effects of bridges not repaired. children not educated, and rivers not cleaned up during the 1980s.

Adding up the bill from individual sectors which have suffered from underinvestment gives an even higher total. For example, it would take another $20 billion annually just to bring the U.S. up to the average share of GNP spent on K-12 education by our major industrial competitors, $19 billion annually to reach the share of our income going to employment and retraining programs a decade ago, another $45 billion to repair and expand physical infrastructure. $17 billion in new solid waste disposal facilities...and so on. However one measures the public investment gap, it is substantial.

The effect of the public investment gap on the economy has also been significant. Among other economists. David Aschauer of the Federal Reserve Bank of Chicago and Alicia Munnell of the Federal Reserve Bank of Boston have shown a strong link between the decline in spending for public sector physical infrastructure and the decline in private sector productivity. Aschauer concludes that the public sector has been so starved of funds that an extra dollar spent on public infrastructure today generates a higher economic return to the country than a dollar spent on private investment.

To be sure, money is not sufficient; government programs must be more efficient, imaginative, and responsive. But today even programs universally judged effective are woefully underfunded. Moreover, without financial commitment there is little incentive to take the political risks of innovation and to attract creative people to the solution of public problems. It is the history of great public improvements -- from highways to space, from land-grant colleges to Headstart -- that public commitment comes first.

Unfortunately, large parts of the public sector have been weakened and demoralized by the policies of the past decade. It will take time to rebuild the capacity of federal, state and local agencies to use these new funds effectively. New people must be hired and trained, new forecasts made of local labor markets, transportation needs, environmental problems, research and development opportunities, and so forth. Even if we had enough resources to fill the investment gap immediately, we could not spend all of it effectively today.

There are two implications for budget policy. First, there is complementarity between the goal of sensible deficit reduction, which requires somewhat more loading at the "front-end", i.e., 1991 and 1992, and the goal of a gradual build-up of public spending, which will require greater resources at the "back-end" -- 1993 and beyond. Second. it is essential that a commitment to sustained increases in domestic investment spending be made now, so that both the public and private sectors can prepare to absorb new investments.

Thus, we need targets for both objectives: 1) lowering the fiscal deficit and 2) Increasing public Investment.

The deficit reduction target for Fiscal Year 199 1 apparently has already been selected through the political process. Negotiators for the Republican White House and the Democratic Congress have agreed tentatively that the deficit for next year should be reduced by roughly $50 billion from the 199 1 baseline forecast of $232, i.e., to $182 billion. This would be a drop in the deficit share of GNP from the expected 3.6 in 1990 to 3.1 percent in 1991.

Given that the next fiscal year is so close, a reasonable domestic investment target is now lower than it might have been a few months ago, when there would have been more time to set priorities and to prepare. At this point a level between $5 and $10 billion in new domestic investment is a modest and minimal target. This would allow expansion of critical programs and provide an incentive to state and local governments to develop strategies. Because definitions vary, both the Administration and the Congress would have to agree on the list of new expenditures that qualify as investment.

Over the next five years, as capacity builds up, we should aim for a total of at least $240 billion more in domestic investment than we would spend on our current path. Hitting this target would bring the domestic public investment share of GNP to about 3 percent in 1995, up from 2 percent in 1990. The result would still leave us reinvesting considerably **less** of our income in human and physical capital than we were ten years ago, and should therefore be regarded as a conservative goal.

Inasmuch as we will be simultaneously reducing the budget deficit, this implies an important shift in the composition of the budget. **Specifically,** given the ending of the Cold War, it means a shift from spending resources on military consumption. spending which does not generate future income, to **civilian *investment*,** spending which does. As the character of government spending becomes more investment-oriented, any given level of deficit will be less problematic. The borrowing that it represents will be paid off by the future income stream that it generates.

Table 4 displays a five-year budget strategy. It embodies the current deficit reduction target of $50 billion for Fiscal Year 1991 and an initial commitment of $7 billion for domestic investment. It describes a deficit reduction path that results in a deficit of $90 billion in 1995 -- 1.2 percent of GNP. Moreover, with the shift in the composition of spending in favor of civilian public investment, the entire deficit will represent capital spending, which common business practice tells us should be financed by borrowing since the resulting beneflts and income **will** be generated in future years. Thus, for all economic intents and purposes, we will have achieved a balanced budget. In any event, a budget deficit of roughly one percent of GNP is scarcely a cause for alarm. If the deficit was only one percent of GNP today -- regardless of the composition of spending -- it would not be seen as a problem.

Table 4.

EPI DEFICIT REDUCTION PACKAGE AND CONSEQUENCES

Billions, Current Dollars

Fiscal Year	1990	1991	1992	1993	1994	1995	'91-'95 Totals
Baseline Deficit with New RTC Spending	195	232	239	194	146	138	949
Deficit Targets		182	174	132	99	90	677
As a % of GNP		3.1%	2.8%	2.0%	1.4%	1.2%	
Required New Revenues/Spending Cuts		50	65	62	47	48	272
Targets for New Public Investment		7	21	42	79	91	240
As a % of GNP		0.1%	0.3%	0.6%	1.1%	1.2%	
Total Federal Civilian Public Investment as a % of GNP		2.1%	2.3%	2.6%	3.1%	3.2%	

(Numbers may not add due to rounding.)
Source: Congressional Budget Office, July 1990.

Indeed, as early as 1993 capital spending could be a greater share of GNP than deficit spending (2.6 percent vs. 2.0 percent). The deficit at that point would be more than offset by capital spending that would generate higher growth and tax revenues in the future.

3. REACHING THE TARGETS

Within a framework of encouraging growth and promoting fairness, targets for deficit reduction and public investment can only be met with a package of progressive tax changes and military spending cuts.

Table 5 describes a reasonable, balanced set of tax and spending changes that would solve the budget problem over the next five years without compromising a commitment to both fairness and growth. They are taken from menus developed by the Congressional Budget Office and Citizens for Tax Justice.

The first two parts of the package are miscellaneous spending cuts and revenues which the Bush Administration and the Democratic Congressional leaders have suggested.

Bush Revenues include the "revenue initiatives" and new offsetting collections in the Resident's budget, but exclude cuts in the capital gains tax and increased payroll taxes on state and local government employees, both of which violate the criteria of fairness and growth. Items include increasing the ability of the IRS to collect taxes owed by the government through improvements in management and enforcement, minor new or increased "user fees" on air travel, shippers, securities market transactions, mine reclamation, commodities trading, telephone calls, etc. There are also increased charges for use of various government services by the public, such as fees for boating, review of new drugs, import-export transactions, etc. All the items are small relative to the activity involved and none have notable, adverse implications for the distribution of the tax burden.

Table 5.

DEFICIT REDUCTION
AND DOMESTIC SPENDING PACKAGE

Billions, Current Dollars

Fiscal Year	**1991**	**1992**	**1993**	**1994**	**1995**
Required New Revenues/Spending Cuts	50	65	62	47	48
Bush Revenues	11	9	4	3	5
House Budget Committee Spending Cuts	5	6	6	7	7
Add a 38% Bracket	13	26	29	34	40
Stock Transfer Tax of .5%	8	12	12	13	13
Cut Anti-Growth Incentive					
Mergers & Acquisitions	1	2	2	2	2
Runaway Plants*	0	0	0	0	0
Multinational Corporations	2	3	3	3	3
Foreign Interest	1	2	3	3	3
Subtotals	40	59	60	65	74
Reduction from Baseline Military Outlays	17	27	44	61	65
TOTAL REALLOCATION	57	86	104	126	139
Public Investment Spending Targets	7	21	42	79	91
Resulting Total Deficit (Incl. RTC)	182	174	132	99	90
As a % of GNP	3.1	2.8	2.0	1.4	1.2
Debt Held by Public	2,566	2,740	2,872	2,971	3,061
Debt Held by Public as % of GNP	44.0	44.1	43.4	42.1	40.7

* Less than $500 million per year.
(Numbers may not add due to rounding.)
Sources: Congressional Budget Office, Citizens for Tax Justice,
Economic Policy Institute, July 1990.

House Budget Committee spending cuts are those in this Spring's budget resolution. They are aimed at cutting waste and misallocation of resources in domestic programs (e.g., agriculture subsidies, Medicare) in ways that do not significantly affect fairness or growth criteria.

The next two items in Table 5 are taxes that meet the fairness and growth criteria.

Adding a 38 **percent marginal tax rate** bracket would be a modest gesture towards restoring progressivity to the income tax code. In 1991 it would apply to single filers with taxable incomes for more than $101,600 and to joint filers with taxable incomes of $169,350 or more, roughly 1 percent of taxpayers -- the group whose share of national income has risen dramatically over the past decade.

A financial securities transfer tax **of** 0.5 percent on each transaction would not only raise revenue but would assist economic growth by discouraging the waste of resources in speculative market transactions based on frenetic short-term buying and selling. It would have a positive effect on medium- and long-term investment in financial assets. The financial instruments covered by such a tax should be broadly defined to avoid creating distortions among financial markets.

Elimination of Anti-Growth Incentives refers to a set of reforms that raise revenue by deleting business tax deductions that are harmful to U.S. growth. One such reduction Is interest payments on debt a corporation takes out in order to purchase stock. This deduction encourages indiscriminate leveraged buy-outs and stock repurchases which do nothing to enhance the national output and which exacerbate the fragility of the financial system by allowing firms to leverage themselves to unsafe levels.

Another deduction is for the cost of closing down plants in the U.S. for the purpose of sending jobs overseas. The U.S. taxpayer should not subsidize the export of American jobs.

Additional revenue also can be gamed by reforming the way In which foreign-owned companies operating in the U.S. are taxed. The proposed changes would allocate the profits of global corporations similar to the way most American states treat the profits of multi-state U.S. companies.

Finally, we should **eliminate** the tax exemption given to interest earned by foreigners on loans to Americans and replace it with a 5 percent tax. Income earned by foreign lenders should be taxed the same as income earned by domestic lenders.

On the military side, the range of military savings proposals goes from the Secretary of Defense's low estimate of roughly $95 billion through the House **Democrats' $251 billion** and others' estimates of over $400 billion in **five** years.

The military spending reduction figures of Table 5 reflect the moderate path proposed by former Defense Department analyst William **Kaufmann** of Harvard. Kaufmann's plan provides a five-year savings, consistent with national defense needs, of $214 billion;

In order to meet the 199 **1** deficit reduction target of $50 billion, **$10** million of that year's peace dividend is allocated to deficit reduction and $7 million to domestic investment. Savings from military cuts grow over time as budget **deficit** needs diminish. By 1995 some $65 billion is available for domestic investment. It should be noted that these military savings estimates are fairly conservative. Kaufmann's proposed outlays exceed those of the House or Senate Budget Committees' projections and err on the side of caution.

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The American political and economic landscape has changed dramatically in the past year. Internally, the Savings and Loan scandal has triggered outrage against the *laissez-faire* deregulatory excesses of the past decade. Externally, the ending of the Cold War has made America vulnerable to a new global competition that is both complex and cutthroat.

The budget crisis cannot be resolved in isolation from these issues.

Failure to come up with a budget package that addresses the economic redevelopment needs of the nation ensures continued slow growth and an erosion of living standards. Failure to address the issue of fairness will preclude popular support for the difficult choices that must be made in order to work our way out of the debt that the nation has incurred over the last decade.

Without a balanced, progressive solution that encompasses both fairness and growth, the budget crisis will persist -- no matter how carefully a political deal is crafted to get us through the next few months. We can afford fewer such mistakes in the new world that confronts us.

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