
A Progressive Answer to the Fiscal Deficit

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The author would like to thank Carol Schwartz, who edited the language, prepared the tables, and provided effective advice and assistance at all phases of the research and production of this paper. Thanks also go to Jeff Faux, President of the Economic Policy Institute, for his editorial assistance.

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ECONOMIC POLICY INSTITUTE
1730 Rhode Island Avenue, NW
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ISBN 0-944826-09-1

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Introduction

The U.S. has been experiencing large and persistent fiscal deficits since 1982; long enough so that they appear to many Americans to be a permanent part of the economic landscape. One result is that both the government and the people seem to have concluded that America can no longer afford to maintain investment in its people, its environment and its public infrastructure. For want of such investments, children drop out of school and have babies, workers lack up-to-date training, pollution increases, and congestion chokes cities. As a group of 327 prominent economists recently noted, this “Third Deficit” in public investment “will have a crippling effect on America’s future competitiveness.”¹

It has become fashionable to consider the deficit to be so intractable that it requires Draconian measures, which will reduce Americans’ living standards in order to raise the revenues to reduce the deficit. This in turn leads to pessimism and despair. As is pointed out in the following pages, there is a common sense approach to the budget, which can raise sufficient revenues to reduce the budget deficits and generate spending for needed investments.

By making a strong case that the burden of paying for both the fiscal deficit and the “Third Deficit” in public investment should fall on those who have benefited most from the misguided policies of the last seven years, this paper outlines a budget strategy compatible with principles of fairness and rationality—two pillars on which tax and budget policy should rest.

What Caused The Deficit?

The fiscal year **1988** deficit was \$155 billion including the Social Security trust fund, and \$194 billion excluding Social Security. (The fiscal year 1989 deficit is projected by the Congressional Budget Office to increase slightly to \$161 billion.) Deficits which averaged .74 percent of Gross National Product (GNP) in the 1960s and 2.1 percent in the 1970s have averaged 4.2 percent in the **1980s**.

The previous and present Administrations have argued, both directly and by implication, that the deficit growth is the result of excessive government spending. Total government spending has averaged 23.2 percent of GNP in the 1980s, up from 20.5 percent in the 1970s and 19.0 percent in the 1960s. On the other hand, total revenue has averaged 18.9 percent of GNP in the 1980s, which is relatively the same as the 18.3 percent of the 1970s and 18.2 percent of the 1960s. The Reagan-Bush Administrations maintain that since spending is up and revenue is constant, spending is the problem and should be **cut**.²

But the aggregate spending and taxation numbers are misleading because of the masking effect of Social Security. Social Security spending has increased in the 1980s (as a percent of GNP) compared to other decades, but Social Security revenue has increased even more, so the Social Security system as a whole has reduced the unified budget deficit.

Since Social Security cannot account for the deficit's rise, removing it from the budget picture is necessary to establish the factors that did. When we do so, we find that spending on government programs as a percent of GNP has declined during the Reagan Administration (1981-1988), and is currently below historical averages.

As Table 1 shows, between **1981** and 1988 the non-Social Security revenue share of GNP fell by 1.7 percentage points. Spending fell by 1.4 percentage points. Interest costs rose by 0.9 percentage points, reflecting the increased borrowing to finance the deficit and high real interest rates. Clearly, the fiscal cause of the deficit has been the reduced revenues since 1981.

Table 1

Government Revenue and Spending (Other than Social Security, OASDI)

As a Percent of GNP

	1960s Average	1970s Average	FY 1981	FY 1988
Non-Social Security Revenue	15.6%	14.6%	15.7%	14.0%
Program Spending	16.0	15.9	16.7	15.3
Interest	1.3	1.5	2.3	3.2

Source: *Office of Management and Budget, Historical Tables, Tables 2.4 and 3.3.*

How Much Money Do We Need?

There is a wide range of opinion on the appropriate size and pace of deficit reduction.' Some economists argue that the budget deficit is not a problem. Others argue for exceeding the deficit reduction pace established by the Gramm-Rudman targets, which call for a balanced budget (including Social Security) by 1993. (The Gramm-Rudman target for 1990 is \$100 billion.) But it seems fair to say that the Gramm-Rudman framework dominates the discussion of budget reduction targets and timetables.

But even accepting the Gramm-Rudman targets does not settle the question of how much additional resources must be raised or freed up. At the very least the answer depends upon assumptions about economic growth, interest rates, and unemployment. The Administration's most recent estimate-based on an optimistic economic forecast-for deficit reductions necessary in fiscal year 1990 to meet the Gramm-Rudman target is \$16 billion.³ Alternatively, the Congressional Budget Office projected that \$41 billion in deficit reduction would be needed to meet the targets.⁴

But even this \$16-41 billion range understates the magnitude of the problem. The cleanup of nuclear weapons plants must still be addressed, and is not adequately provided for in these projections. Increased spending on health programs, including AIDS, and drug enforcement seems inevitable.

. Of course, macroeconomic policy isn't simply picking the "best" deficit reduction number. Monetary policy must be coordinated with fiscal policy, which means increasing the money supply and lowering interest rates before the tighter fiscal policy takes effect to insure continued economic growth. The U.S. needs to use all of its powers to encourage foreign countries, in particular Japan and Germany, to expand their economies so our trade deficit will decrease. Industrial and trade policies have important roles to play as well. These are beyond the scope of this paper but are nonetheless essential.

And even these anticipated costs are not the full story. As Table 2 shows, the shrinkage of non-Social Security spending relative to GNP in the 1980s has had a disparate impact across government programs.

Table 2

Shifts in Spending, 1981 to 1988
Spending as a Percent of GNP

	1981	1988	Change 1981-1988
Defense	5.27%	6.08%	+.81%
International Affairs	.44	.22	-.22
Science and Technology	.22	.23	+.01
Energy	.51	.05	-.46
Natural Resources	.46	.31	-.15
Agriculture	.38	.36	-.02
Commerce and Housing	.27	.39	+.12
Transportation	.78	.57	-.21
Community Development	.35	.11	-.14
Education	1.13	.67	-.46
Health	.90	.93	+.03
Medicare	1.31	1.65	+.39
Income Security	3.34	2.71	-.63
Veterans	.77	.62	-.15
Justice	.16	.19	+.03
General Government	.38	.20	-.18

Source: Office of Management and Budget, Historical Tables, Table 3.3.

The largest increase in spending, more than double any other increase, has been in military **spending**. Overall, non-military discretionary spending (as a share of GNP) has declined by 39.2 percent from **1981** to 1988.

Reduced domestic spending has left a gaping deficit of public investment in transportation, education, economic development, the environment and housing. Not all programs have the same priority, of course, and some undoubtedly have outlived their usefulness, but there is little doubt that: our nation's ability to thrive and

succeed in a global economy requires a renewed commitment to public investment in physical **and** human capital.

The need for increased public investment is widely recognized. Private sector commissions and organizations such as the American Agenda, the Council on Competitiveness, the Conference of Mayors, and the Committee for Economic Development have called for increased spending in education, job training, public works, and research and development.

This consensus reflects the recent deterioration in government investment trends. Net public investment as a percent of GNP has declined **from** over two percent of GNP in the 1960s to less than one-half of one percent in the 1980s. Including maintenance and repairs, gross spending on public works has declined from 3.6 percent of GNP in 1960 to only 2.6 percent in the mid-1980s.⁵ The growth of government-owned capital has declined from a 3.5 percent average from 1950 to 1980, to 0.9 percent in the 1980s. Federal support for state and local government spending on capital investment has fallen from 0.8 percent of GNP in 1980 to 0.5 percent of GNP in 1988.

Quantifying the investment needed to reverse these trends is difficult, but the costs can be expected to be large. The Department of Transportation estimates that it will cost \$50 billion to repair and replace the nation's 240,000 bridges. Another \$3 15 billion will be required over the next ten years to bring highways back up to their 1983 condition. The cost to modernize the air traffic control system is projected at \$25 billion by the year 2000. The Department of Housing and Urban Development estimates a \$20 billion price tag on repairing the deteriorating stock of public housing, and no one **knows** the cost of a serious effort to house the homeless. [GAO, 1988, pp. 10-11] The annual estimates of total spending needed over the next ten years for **infrastructure** investment range **from** \$118 billion (1982 dollars) by the Association of General Contractors to a conservative \$5 3 billion (1982 dollars) by the Congressional Budget Office, considerably above the \$45 billion currently being spent.

April 27, 1989, marked the sixth anniversary of "A Nation at Risk," the report by the National Commission on Excellence in Education, which warned the nation of the "rising tide of mediocrity" in American schools. Since that time a plethora of **govern-**

ment, business, and scholarly reports have detailed the importance of education to future economic success.⁶

But in 1988, close to one million young people will drop out of high schools. Another half million will graduate but will be marginally literate and virtually unemployable. The math and science proficiency of U.S. students compare poorly with students from other industrial countries. The participation by blacks, in particular black males, in post-secondary education continues to fall. A strong federal commitment to education is a necessary prerequisite for solving our educational problems. Merely returning federal support for education to **1981** levels (as a percent of GNP) would require \$7.8 billion.

While improved education is vital to upgrading America's human capital, worker training can also make our labor markets more dynamic and better match those seeking work with available jobs.' Unfortunately, federal support here has also plummeted from \$9.8 billion in 1981 to only \$5.9 billion in 1988.

It is not practical to eliminate the public investment deficit in one year, but a down payment on these neglected investment needs should be made immediately. It is precisely because many of these investments take time to generate economic benefits that they cannot be delayed. Each year that goes by sees another million students drop out of school, more workers go without training, and our transportation system become more obsolete.

Any total estimate of needed additional resources is bound to be somewhat arbitrary. No needs are absolute and even the **Gramm-Rudman** legislation loosens its targets and timetables under certain circumstances. But what should not be in debate is that resources beyond the \$16-41 billion projected for deficit reduction should be sought. The key is to reverse the trend of shrinking resource commitments to areas that will pay off in long term economic growth and competitiveness.

Given the needs, \$25 billion for additional spending in public investment would be a modest down payment for improving national competitiveness. If we take the more conservative CBO estimates of the shortfall from the Gramm-Rudman targets as a guide, this implies revenue increases or spending reductions on the order of \$65 billion for fiscal year 1990.

For fiscal year 1991, another \$40 billion would be needed for deficit reduction under **Gramm-Rudman**.⁸ Making another \$2.5 billion dent in the public investment deficit would then require total additional resources of \$65 billion in fiscal 1991 as well. The challenge of finding the needed resources for deficit reduction of *both sorts* will be with us for the foreseeable future.

Savings are obviously possible. Military spending and agriculture are two areas where, in theory, substantial reductions can be made. But under the best of circumstances, savings in these areas will take time. In defense, much of the spending is “locked in” by contractual commitments to purchase weapons systems and manpower costs. Significant savings can only come from a major redesign of military strategy and the awesome task of negotiation of a fairer burden-sharing with our allies. Squeezing substantial savings from agriculture will also require a major overhaul in national policy. Thus, in the short run, at least, much of the \$65 billion will need to come from increased tax revenue and the associated savings from reduced interest payments. The recent budget compromise is probably the last one that can be accomplished by relying on optimistic economic forecasts, asset sales and budgeting gimmicks.

Who Should Pay?

The question of who should bear the burden is inherently subject to one's views on how much distributive justice can be accommodated in a competitive economy. However, the current deficit reduction effort also takes place in a unique historical context.⁹ The policies of large tax cuts and higher defense spending, which generated the deficits, were part of an overall economic policy that produced a new economic environment. In this changed environment -characterized by huge trade deficits, growing inequality, weakened unions, high real interest rates, lower inflation, and rapid financial innovation-some people prospered and some did not.

Inasmuch as the present deficit problem (although not the total deficit) is the cost of that economic policy, elemental logic suggests that the deficit reduction burden should be borne by those who prospered during this period, not those whose living standards stagnated or declined. This is justified not only on ability to pay grounds, but also on the common sense view that the change in economic conditions, of which the deficit growth was a key element, greatly affected those who became the economic winners and losers.

The period of deficit growth has not been a time of significant income growth for most people. In 1988 the real income of the typical family was only marginally above its 1979 level, a year of comparable unemployment. Since 1979, average hourly wages, in real terms, have fallen by seven percent, and families were able to keep up their living standards only by more family members working.

Those families that did not send additional adults into the labor force saw their real incomes decline by roughly 4 to 6.5 percent since 1979.¹⁰

Yet within this overall trend of income stagnation, some families did quite well. Those in the upper 20 percent of the income distribution (and especially those in the top five percent) enjoyed sub-

stantial income growth over this period. The bottom 40 percent had their incomes fall, with those in the very bottom falling the most. The result of these income trends is the highest level of income inequality since 1947.

The Reagan Administration's policies of taxation, spending, and borrowing, far from moderating the deterioration of income shares, exacerbated the growth of inequality.

Table 3 shows the changing distribution of federal taxes by major revenue source.

Table 3

Federal Revenue by Major Source, Fiscal Years 1981 and 1988

(in billions, current dollars)

	Individual Income Tax		Corporate Taxes		Social Insurance Taxes and Contributions		Other		Total Revenue
	amount	% of total	amount	% of total	amount	% of total	amount	% of total	
1981	\$286	47.7	\$61	10.2	\$182	30.4	\$70	11.7	\$599
1988	401	44.1	95	10.5	334	36.7	79	8.7	909
change from 1979 to 1988	115	-3.6	34	+0.3	152	+6.3	9	-3.0	310

Source: CBO [1988a, Table G-31 and [FY 1990 Budget, Summary Table 2]

The most dramatic trend is the sharp increase in regressive payroll taxes. The regressivity comes from (1) the flat tax rate, currently 7.51 percent, no deductions or exemptions to reflect differences in ability to pay, coupled with the Social Security Tax ceiling, currently \$48,000, above which the tax is not levied, and (2) the exemption of unearned income (rent, interest, dividends, etc.) from the tax.”

Given the expansion of Social Security taxes and the reduction in the marginal income tax brackets paid by the wealthiest from 70 percent in 1981 to 33 percent in 1988, the federal tax system has clearly shifted the burden from the high income tax brackets to the

low ¹² Table 4 shows the Congressional Budget Office's documentation of this shift.¹³

Table 4

Effective Federal Tax Rate, by Population Decile

Income Decile	1977	1988	difference 1977-1988
1st	8.0%	9.6%	+1.6%
2nd	8.7	8.3	-.4
3	12.0	13.3	+1.3
4	16.2	16.8	+.6
5	19.1	19.2	+.1
6	21.0	20.9	-.1
7	23.0	22.3	+.3
8	23.6	23.6	0
9	24.5	24.7	+.2
10	26.7	25.0	-1.7
top 5	27.5	24.9	-2.6
top 1	30.9	24.9	-6.0
all	22.8	22.7	-.1

Source: CBO [1987b, Table 8]

The reduction in taxes since 1977 gave the top one percent an average tax reduction in **1988** of at least \$25,526.¹⁴ This tax cut is greater than the income of most American full-time workers.

Since **1981**, spending cuts in federal programs to help low- and moderate-income people compounded the regressive changes in the tax system. Real, inflation-adjusted federal spending commitments (budget authority) on low-income discretionary programs, including subsidized housing, were reduced by 55 percent from **1981** to **1989**. Excluding housing, low-income programs were reduced by 30.2 percent.¹⁵

Although entitlement programs benefitting the poor avoided these large scale reductions, several-including food stamps,

AFDC, and Unemployment Insurance-were cut back in the early 1980s.

In addition, failing to raise the minimum wage since 1981 while living costs went up by 37 percent has pushed many full-time minimum wage earners below the poverty line.

As a result, in 1987 a smaller proportion of families were being lifted out of poverty by government programs than in 1979.¹⁶

Increased interest rates also played a role in the upward **redistribution** of income.” Ownership of bonds, for example, is highly concentrated, with over 70 percent of the value of all bonds held by the richest 10 percent of the population.*

Since 1979, real personal interest income has increased by 54.3 percent compared to total labor income growth of 16.7 percent. It is not surprising to see the growth of government debt accompanied by the growth of **inequality**.¹⁹

Reducing The Deficit And Increasing Public Investment

The facts should not be in debate. The deficit growth in the 1980s is the result of the non-Social Security revenue share of GNP falling faster than non-Social Security spending. Program spending, far from being the cause of the deficit, shows dramatic declines as a percentage of GNP-with the notable exception of defense.

During a similar time frame, income distribution has worsened. This deterioration of income equity was aided and abetted by government policy changes in taxation, spending, and borrowing.

Given these facts, tax changes necessary to reduce both the budget deficit and the deficit in public investment should be *progressive*.²⁰ The remaining question is whether it is possible to achieve the needed revenue progressively. The following is an analysis of the potential revenue gains from progressive taxes.

Progressive Taxes²¹

Individual Income Tax

The post-1986 individual income tax is structured to raise large amounts of revenue from relatively small rate increases. Prior to the Tax Reform Act of 1986 (TRA), much of the revenue from raised rates leaked out through exemptions, deductions, and other loopholes. The TRA plugged up many of these loopholes.

In eliminating loopholes, however, the TRA kept much of the *effective* rate structure of the old system.** As Table 5 shows, aside from removing the very *low* income earners from the tax rolls and reducing the amount paid by the very rich, the TRA did not significantly change the relative amounts paid by low, middle, and high income groups.

Table 5

Effective **Rates for 1988 (joint return, one dependent)**

Adjusted Gross Income	Pre-reform Law ^a	As % of the Average	Reform Law Effective Rate	As % of the Average Effective Rate
0-10,000	0%	0%	0%	0%
10-20,000	5.2	35.9	4.3	32.1
20-30,000	8.8	60.7	8.3	61.9
30-50,000	12.3	84.8	11.0	82.1
50-100,000	16.5	113.8	16.0	119.4
100-200,000	23.8	164.1	21.8	162.7
200-500,000	29.6	204.1	25.0	186.6
500-1,000,000	29.8	205.5	26.8	200.0
1,000,000+	27.9	192.4	26.6	198.5
total	14.5		13.4	

a) 1986 tax law applicable to 1988 levels of income. Bracket limits and exemptions are applied as estimated for 1986 levels.

Source: Musgrave, [1987, p.66.]

Since TRA, the U.S. top tax rate on personal income is the lowest of any OECD country, whose top rates range from 7.5 percent in Sweden to 45 percent in Canada.

Because taxes based on income best reflect ability to pay, increasing the progressivity of individual tax rates is the fairest way to gain revenue and help reverse the upward redistribution of income of the recent past. In addition, raising income tax rates does not add to the complexity of the tax system. It does not add to compliance costs, enforcement costs, or private sector record keeping. Given that rate increases will be reflected in withholding and estimated taxes, the government receives additional revenue quickly. Finally, revenues will increase or decrease as incomes increase or decrease, thereby automatically adjusting to economic changes and helping to moderate the business cycle.

There are several ways to reintroduce rate progressivity into the system and raise significant new revenue:

Extend the 33 percent bracket:

The current tax rate structure is 15 percent below \$29,750 (joint return) and 28 percent above \$29,750 of taxable income. Between \$71,900 and \$192,930 (joint return), however, there is a 5 percent surcharge, raising the marginal rate to 33 percent (28 plus 5).²³ The marginal rate then falls back to 28 percent on income over \$192,930. This step rate structure (15, 28, 33, and 28) runs counter to the progressivity principle that rates should increase as the ability to pay (income) increases. A couple earning \$72,000 pays an additional 33 cents for each extra dollar of income they earn, while those with incomes over \$200,000 pay only 28 cents for their additional earnings.

Extending the 33 percent bracket to all incomes above \$192,930 would raise \$3.6 billion in the first year.

Establish a 38 percent bracket at \$192,930:

An additional five percent bracket should be added at \$192,930 (joint return), thereby creating a bracket progression of 15, 28, 33, and 38. This would reintroduce progressivity to the individual income tax at the top end of the income distribution.

This would raise an additional \$3.3 billion in the first year. (We could go further. Increasing the top rate to match Canada's 45 per-

cent and slightly lowering the income level at which the top rate applies could easily capture an additional \$5 billion.)

Raise the 28 percent bracket:

Increasing the 28 percent bracket by 2 percent would add an additional \$8.4 billion in the first year.

Tax capital gains at death:

Under current tax law, the capital gains of assets which are inherited are not taxed under the capital gains tax. Furthermore, upon subsequent sale by the heirs, capital gains taxes are only levied on the gain from the point of inheritance. This provision allows the wealthy to accumulate and pass on large concentrations of wealth, and avoid the capital gains tax **entirely**.²⁴ It also creates a perverse incentive to hold onto assets.

Taxing capital gains at death would remove this inequity and raise significant revenue.²⁵ Concerns over the need to liquidate assets to pay the tax could be addressed through lenient averaging provisions and deferred payments, which should ease the burden of this change on inherited modest-sized family farms or businesses. Overall, taxing capital gains at death could raise \$13.5 billion per year.

Corporate Taxes

Increase corporate rates:

Under the TRA, the top statutory rate on corporations was lowered from 46 percent to 34 percent. (Lower rates apply to taxable income under \$75,000 in the 1986 tax law.)

As a result, even when state taxes are included, U.S. corporate tax rates are considerably below most other industrialized countries, except for Great Britain. The top corporate rates for Germany, Sweden, Denmark, and Japan are in the 50 to 60 percent range and France, Netherlands, Italy, Canada, and Austria are in the 40 to 50 percent range. [Pechman, 1988, p.5]²⁶

Raising the top federal corporate rate to the 38 percent suggested for individuals would generate \$5 billion.

Amortize advertising expenses:

When IBM hires Alan Alda and other actors from *M*A*S*H* to sell

its computers, the advertising expenses can be totally written off that year. But when IBM purchases robots to improve their production process, those expenses are deducted over several years (reflecting the fact that the equipment will be used for several years). In other words, business expenditures for plant and equipment get deducted for tax purposes over a number of years, while expenditures for advertising expenses, which presumably have a larger than one-year impact, can be deducted immediately.

Simply requiring firms to amortize 60 percent of their spending on advertising over four years would raise roughly \$9 billion in the first several years, with the revenue gains declining somewhat after that.

Restrict corporate interest rate deduction:

Recent years have seen the corporate sector engage in a massive substitution of debt for equity, through acquisitions, leveraged buyouts, and stock purchases, and using exotic financial instruments such as junk bonds. (From 1984 to 1987, U.S. corporations raised \$116 billion through new issues of stock while retiring \$432 billion worth of stock. During the same period, they have added \$726 billion in additional debt.) [Friedman, 1988, p.100] This leaves the corporate sector much more vulnerable to relatively modest declines in cash flow due to a fall in demand or increases in other costs. This restructuring of corporate balance sheets has cost as many as 90,000 jobs.²⁷

Much of the impetus for the shift from equity to debt stems from the favorable tax treatment of interest payments relative to dividends. When corporate earnings are distributed as dividends, they are taxed at the corporate level, but when earnings are distributed as interest, they bear no corporate tax because such interest payments are deductible.

Denying or limiting the interest deduction to \$5 million per year for such buyout or takeover activities, as proposed last year by the House of Representatives, would help curb leveraged buyouts and raise about \$600 million in fiscal year 1990.

Remove tax code subsidies for U.S. business investment overseas:

The U.S. tax structure should not be subsidizing overseas investment by American corporations. Given our huge trade deficit

and growing foreign debt, we need to maximize capital investment here in America in order to expand production and increase productivity. Therefore, both the Foreign Tax Credit (FTC) and the deferral of taxation on foreign income earned by subsidiaries of U.S. corporations should be repealed.

A U.S. corporation is given a credit against U.S. taxes for any tax paid to a foreign government up to the U.S. tax liability on such income. Thus, if a company locates in, for example, New York State, it can only deduct the taxes paid to the State, and since the corporate top rate is 34 percent, for federal tax purposes every dollar paid to New York State reduces the firm's federal tax liability by 34 cents. But if the company locates overseas, every dollar paid to the foreign government reduces the company's federal tax liability by one dollar. Foreign income taxes, like state taxes, are a cost of doing business and should be treated like other costs, as a deduction.

Moreover, foreign income earned by foreign subsidiaries of U.S. corporations is not taxed in the year it is earned. Such income is only taxed if and when it is repatriated to the parent corporation. This effectively encourages foreign subsidiaries to reinvest such earnings overseas rather than bringing them back to the U.S.

Both of these loopholes also open the door for "creative bookkeeping" where earnings and profits can be moved to the location where they are taxed the lowest.

Closing both of these loopholes could raise one billion dollars per year.²⁸

Tax foreign owners of U.S. interest-bearing assets:

Under current law, interest income paid to foreigners is generally exempt from taxation. Thus, the U.S. tax code gives advantages to foreigners which are not available to its own citizens. Since foreign lenders enjoy the same security from investing in the U.S. as U.S. citizens, it is reasonable that they should help pay for that security with taxes on their U.S. interest income.

Also, since many foreign lenders do not pay taxes on U.S. interest income in their countries while U.S. borrowers often can deduct such interest payments from their U.S. taxes, large scale cross-border lending can erode the tax bases of both countries.

Taxing the income interest of foreigners at a 30 percent rate could raise over \$1 billion annually.²⁹

Minimum Taxes

Increase the alternative minimum tax to 25 percent:

Alternative minimum taxes (AMT) are efforts to limit the use of various tax “preferences” by individuals and corporations. The tax code still has many loopholes, but through the AMT, sets limits on the benefits any one taxpayer can claim. The current minimum tax rates are 21 percent for individuals and 20 percent for corporations.

By reducing the use of loopholes for upper-income taxpayers and corporations, raising the AMT to 25 percent would improve fairness and generate \$3.9 billion in new revenue in the first year.

Other Taxes

Tax financial transactions:

A tax on the transfer of financial instruments would penalize speculative market transactions based on rapid turnover—constantly buying and selling to reap short-term profits. A .5 percent tax on the value of each financial transaction would sharply reduce rates of return on funds invested week to week, but would be of little concern if paid once every five years. Thus it could help move company managers away from a fixation on short-term profits and extend investment horizons.

The financial instruments covered by such a tax should be broadly defined so as not to create distortions between financial markets. Revenue gain to the government under a broad definition would be roughly \$10 billion.

Close loopholes:

Although the TRA closed many loopholes, many still remain. Further narrowing remaining loopholes could easily raise \$1 billion in fiscal year 1990.³⁰

Possible actions could include: tightening the special cost recovery provisions which are available to oil and gas companies; lowering the deduction for business meals and entertainment; limiting the mortgage interest deductions for expensive vacation homes; and restricting real estate tax shelters.

Payroll Taxes

Make the Social Security tax more progressive:

No Social Security or Medicare taxes are paid on earnings over \$48,000. Removing the earnings ceiling on individuals and businesses would effectively convert the current regressive tax into a proportional tax on earnings.

The effect of the cap on the progressivity of the federal tax system as a whole is powerful. As Table 6 shows,³¹ the cap largely offsets the progressivity of the individual income tax in the upper-income brackets.

Table 6

Effective Federal Tax Rate for the Top Three Population Deciles

	Individual Income Tax Rate	Change in Rate from Previous Bracket	Social Insurance Tax Rate Bracket	Change in Rate from Preceding (1+3)	Combined Effective Tax Rate Bracket	Change in Rate from Preceding
	1	2	3	4	5	6
Eighth	8.9		10.8		19.7	
Ninth	10.3	+1.4	10.5	-.3	20.8	+1.1
Tenth	15.8	+5.5	6.3	-4.2	22.1	+1.3
Top 5	17.5	+1.7	4.8	-1.5	22.3	+.2
Top 1	20.9	+3.4	1.9	-2.9	22.8	+.5

Source: CBO [1987b, Table 8.]

Since the 1983 Social Security amendments put the Social Security system on a sound financial basis, new revenues are not needed. Therefore, Congress could levy a "Fill-In" Earnings Tax which would be equal to the Social Security tax rate and applied to earnings above the Social Security maximum. The proceeds would go into general revenue. (The 1988 Social Security contribution rate is currently 7.51 percent and is projected to increase to 7.65 percent in 1990. The 1989 earnings maximum is currently \$48,000.) Establishing such a fill-in would generate roughly \$16.4 billion in the first year.

While extending the payroll tax above the Social Security ceiling is important in establishing coherence and progressivity to the overall tax structure, it is not a simple matter.

The Social Security payroll tax has always been dedicated to financing either current or future Social Security benefits. Eliminating the ceiling either directly or indirectly, through a fill-in tax, and using the revenues to pay directly for government programs would be an historic break from the past. Legitimate concerns over the integrity of the Social Security system would be raised.

Ideally, the Social Security ceiling could be removed and the payroll tax rate lowered accordingly to leave the financing of the Social Security system unaffected. Then the payroll tax fall could be offset with an increase in income taxes to raise an amount equivalent to that raised by the original lifting of the ceiling.

The political difficulty of any change in this area is obvious. Yet it is equally obvious that the 15.3 percent (both employer and employee) drop in the payroll tax at \$48,000 will wreak havoc with the overall progressivity in the tax structure. Given the need for revenue and the soundness of the Social Security system, eliminating the ceiling and using the proceeds for general revenue seems the most sensible of the available options.

Estate Taxes

Raise estate taxes:

Changes in the estate tax in 1981 virtually eliminated estate taxes for all but a handful of the super wealthy. The top estate tax, which was 77 percent as recently as 1976, is now 55 percent on estates over \$3 million. No federal estate taxes are paid on estates less than \$600,000 (\$1,200,000 if half the estate goes to a surviving spouse). The estate tax is the only direct way the federal government taxes wealth. (Many industrialized countries tax wealth directly.) Given the extremely skewed distribution of wealth in the U.S., the estate tax is very progressive and should be restored to a significant revenue source.

The top rate should be raised to 60 percent and the threshold for applying the tax should be lowered to capture an additional \$1.1 billion in revenue.

Why Not Tax Consumption?

In theory, there may be ways to **offset** the inherent regressivity of consumption taxes, but such measures are for the most part either impractical, self-defeating (in the sense that you lose potential revenue gains) or minimally effective (in that the regressivity is not offset). In our current environment, raising or establishing consumption taxes will be regressive.

Excise Tax

In Fiscal Year **1988**, federal excise taxes generated about \$35 billion, about four percent of total federal revenue. Excise taxes are selective sales taxes levied on such items as gasoline, tobacco, alcohol, telephone services and airline tickets. The rationales for excise taxes vary. Some seek to discourage use or consumption of certain products by raising their prices (for example, the so-called “sin taxes” on alcohol and tobacco). Others generate dedicated revenue to fund certain government activities (funds from the excise tax on gasoline go into the Highway Trust Fund, which pays for improvements or building of highways, bridges, and mass transit; the airline ticket excise tax is deposited in the Airport and Airway Trust Fund).

Excise taxes inevitably fall hardest on those who must consume most of their income—namely the poor and middle class. Thus, raising most excise taxes would reinforce the upward shift in income distribution.

Table 7 displays the burden of various excise taxes as a percentage of income. The combined burden of all the listed excise taxes are over eight times as great for those earning under \$5,000 as for those earning over \$50,000. Rather than reversing the recent growth in inequality, imposing such taxes would clearly worsen income distribution.³²

Table 7

Average Excise Tax as Percentage of Income for Expenditures Subject to Federal Excise Tax, By Income Class, 1985

	All Incomes	Less Than \$5,000	\$5,000-\$9,999	\$10,000-\$19,999	\$20,000-\$29,999	\$30,000-\$39,999	\$40,000-\$49,999	\$50,000 or more
Average Gasoline Excise Tax (\$)	.35	1.62	.58	.50	.41	.35	.31	.22
Average Beer Excise Tax (\$)	.06	.37	.12	.10	.07	.07	.05	.04
Average Wine Excise Tax (\$)	.01	.07	.02	.02	.02	.01	.01	.01
Average Liquor Excise Tax (\$)	.15	.75	.24	.20	.16	.14	.12	.11
Average Tobacco Excise Tax (\$)	.17	1.05	.44	.29	.21	.17	.13	.07
Average Telephone Excise Tax (\$)	.10	.61	.21	.14	.11	.09	.08	.07
Average Airfare Excise Tax (\$)	.10	.43	.14	.12	.10	.08	.09	.09

Source: CBO [1987a, Table 3]

If government policy seeks to limit or ban certain products and activities, it should do so in ways which do not amount to lowering further the incomes of the middle class and the poor.³³

Value Added Tax

A value added tax (VAT) is a consumption tax, essentially the same as a national retail sales tax. The only difference is in the method of collection. The VAT is levied on the value added to a product at each stage of production. (The retail price of any product is the sum of the value added at each stage of production. Therefore a five percent VAT is equal to a five percent retail sales tax.) Exactly the same reasoning can be applied against the VAT as against the sales or excise taxes. It is regressive, and it cannot be justified after a period of widening income gaps. The following table, derived from the Bureau of Labor Statistics 1986 Survey of Consumer Expenditures, shows the effect of a five percent VAT (with and without an exemption for food) on various income classes.

Table 8

The **Effect of a VAT on 1986 Income and Expenditures:**

	Lowest 20	Second 20	Third 20	Fourth 20	Highest 20
Income After Taxes	3,665	10,371	18,143	28,753	54,868
Average Annual Expenditures	10,923	13,073	18,240	23,570	37,889
A 5% VAT	546	654	912	1,179	1,894
As % of Income tier Taxes	14.9	6.3	5.0	4.1	3.5
Average Annual Expenditures Minus Food	8,864	10,668	15,231	19,802	32,411
A 5% VAT With Food Exemption	443	533	762	990	1,621
VAT as % of Income After Taxes	12.1	5.1	4.2	3.4	5.0

While excluding food from the base of the expenditure tax lessens the regressivity slightly, in both cases the burden as a percentage of after-tax income is over twice as great for the lowest quintile as for the highest quintile.

Finally, even if efforts are taken to reduce the regressivity of excise or value added taxes, the taxes could not be adjusted for family size as is the case with the income tax.

Conclusion

The preceding tax changes could raise at least \$65 billion (see Table 9) in tax revenue in the first year. Most of these provisions would generate significantly higher revenue in the future.

This list of proposals is not exhaustive. Additional loopholes could be closed. Top tax rates could be increased further. New tariffs are a possibility. A pure wealth tax could be considered. But this list shows that even without such dramatic measures, revenues can be raised to support both needed domestic spending increases and deficit reduction in ways that promote both fairness and efficiency.

Some of these proposals stretch the perceived limits of what is politically feasible. No tax is painless. Each of these proposals, if seriously considered, would generate strong objections by affected groups.

No doubt a transfer tax will make life inconvenient for the financial industry, including pension fund managers, who will have to adjust investment strategies. Lobbyists for foreign financial interests will claim that taxing interest payments will slow foreign investment flows and lower the value of the dollar.

The wealthy will make predictions of economic doom from the effect of higher marginal tax rates and their effect on saving and work incentives. And there are those who will say that attempting to raise sums for both public investment and deficit reduction is politically unrealistic. Yet a revenue bill of this size is not without precedent. A \$65 billion revenue bill is only slightly larger than the increased revenues currently generated by the Tax Equity and Fiscal Responsibility Act which was passed in 1982.

In the end, the best argument for taking bold action is the overriding national interest in removing the stranglehold that the current fiscal stalemate has on our ability to manage the U.S. economy in an increasingly competitive world. The alternative, either of not

acting or counterproductive spending reductions, will mean a bleaker future for our children and a lower standing for our country in the world.

Table 9

Progressive Taxes and First Year Revenue Estimates

Individual Taxes	First Year Revenue
Extending the 33% bracket	3.6
Adding a 38% bracket	3.3
Raising the 28% bracket to 30%	8.4
Increase AMT for Individuals	.5
Taxing Capital Gains at Death	5.0
Taxing Wealthy Foreigners	1.0
Raising Estate Taxes	1.1
Social Security Earnings Fill-In	8.2
Sub Total	31.1
Corporate Taxes	
Increase AMT for Corporations	3.4
Increase Corporate Rates 4%	5.0
Amortize Advertising	9.0
Restrict Interest Deduction	.6
Foreign Loopholes	1.0
Social Security Earnings Fill-In	8.2
Sub Total	
Other Taxes	
Transfer Tax	10.0
Loophole Closing	1.1
Sub Total	11.1
TOTAL	\$69.4 billion

Endnotes

1. Economists' Statement, 1989.

2. For example, the latest report of the President's Council of Economic Advisers [1989, p. 74] states, "While the political process has kept Federal Government revenues within a narrow range, fluctuating around 20 percent of GNP, the same process has allowed Federal expenditures to expand as Federal entitlement programs grew. Persistent budget deficits are the result."

3. OMB, 1989.

4. CBO, 1989a.

5. The estimates are from the National Council on Public Work Improvement [1988, p.2], David Aschauer [1987, p.2] and Benjamin Friedman [1988, p.205].

6. Organizations issuing such reports include the Committee for Economic Development [1985], National Governors Association [1986], National Academy of Sciences [1984], the Education Commission of the States [1983], and the National Association of Manufacturers 1982].

7. For an extended discussion of workforce policies see Marshall and Osterman [1989].

8. CBO's baseline deficit estimate for 1991 is \$80 billion short of that year's Gramm-Rudman target of \$64 billion (CBO, 1989a). The number in the text assumes that the target for 1991 is met, reducing the baseline by the \$41 billion which CBO estimates will be necessary to hit it.

9. The history of the growth of the deficit is relevant to the prescription for deficit reduction. The American people are currently paying for the government programs and services they are currently receiving. That is, **program** spending, including Defense and Social Security, equals the total receipts of government. The

1988 deficit of \$155 billion roughly equals the \$15.3 billion interest payments for 1988. **From this** perspective, what is not being paid for is the cost of the past deficits (primarily the recent past, since 65.4 percent of our national debt has been added since 1980) which show up as interest payments.

10. For further documentation of the worsening income distribution, see Mishel and Simon [1988].

11. We excluded Social Security from our analysis of the deficit because it played no causal role. We include Social Security revenues here because it did play a causal role in shifting the tax burden.

12. The fact that those in the high income brackets have disproportionately gained in income and therefore are paying, in absolute terms, a greater share of overall taxes does not alter the fact that their tax burden has decreased.

13. There is no consensus on how to treat the ultimate incidence of corporate taxation. CBO calculates effective tax rates two ways, first by allocating all corporate taxes to capital income and second by allocating them to labor income. Allocating corporate taxes to capital income shows greater tax cuts for the rich and greater tax increases for the middle deciles. Here we present the more conservative estimates based on allocating the corporate income tax to labor income.

14. This is using the conservative assumptions. Alternate CBO assumptions would generate tax cut estimate of \$44,750 for the top 1 percent. See CBO [1987b, Tables 6 and 8.]

15. Center on Budget and Policy Priorities, 1988.

16. Center on Budget and Policy Priorities, 1988, p.8.

17. The expansion of interest payments from \$68.7 billion in 1981 to \$151.7 billion in 1988, in the context of a budgetary spending constraint, also added to the pressure to cut domestic spending.

18. Federal Reserve Bulletin, 1984, p.689.

19. With the deficit currently equal to interest payments, the government is essentially borrowing from the wealthy to make interest payments to the wealthy. Current taxation (with its distribution consequences) pays for current spending (with its distribution consequences). In order to maintain the current distribution consequences of current spending/taxation and also close the deficit/interest payments gap, the additional revenue should come by substituting the current borrowing from the wealthy with taxes on the wealthy.

20. Raising progressive taxes, for the purposes of deficit reduction and increased public investment, would aid overall economic performance. The endorsement of progressive taxes to meet the government's revenue needs would be weakened if it could be shown that such taxes would lower overall economic growth. However, in the present context this should not be an overriding concern.

First, recent history shows that a reduction in progressivity does not necessarily translate into increased saving, investment and growth. In particular, it is precisely during the 1980s, a period of large marginal tax rate reductions on the wealthy, when U.S. net personal savings rates have sharply declined from the 6 to 7 percent range to the 3 to 4 percent range. Second, the revenue increases would be used to reduce government dissavings and increase government investment, both of which increase long term growth prospects. These direct effects would overwhelm any secondary incentive effects.

21. Most of the revenue estimates are derived from the Joint Committee on Taxation [1987] and Congressional Budget Office [1989].

22. For an extended discussion, see Musgrave [1987, pp.59-71].

23. The 33 percent bracket was designed to phase out the effect of the 15 percent bracket and personal exemption so that the effective tax rate will approach 28 percent over the upper ranges. It aided progressivity between middle and upper brackets in that the effective tax rate on the upper brackets would have been even lower without its existence. However, within the upper brackets it is regressive.

24. Of course, they may be subject to the estate tax.

25. For an extended discussion of this issue, see Munnell [1988, pp. 3-26].

26. This includes both national and local rates. One would need to add state corporate tax rates, where applicable, to make a direct comparison. In addition, the definition of the tax base may differ from the U.S. In Japan for example, the tax rate is applied only to undistributed profits.

27. See Lane Kirkland's testimony before the House Ways and Means Committee, February 1, 1989.

28. There do not appear to be any firm revenue estimates from these tax changes. The actual revenue gain is likely to be much higher.

29. This estimate could be effected by treaty obligations which may set lower maximum rates on such income.

30. For a full discussion of these issues, see McIntyre [1988, p.11-14].

31. The regressivity of the payroll tax can also be seen in the Census data (1988, p. 77) which shows the payroll tax reducing income by 4.8 percent in the top quintile of households with full time workers compared to 6.4, 6.3 and 5.9 percent for the fourth, third, and second quintile respectively.

32. Some have argued that the **regressivity** of the tax could be reduced through expansion of the earned income tax credit or other progressive tax credit. [Kasten and Sammartino, 1988] Unfortunately, Congress in a deficit reduction effort is unlikely to give back a major portion of the new revenue **from** an excise tax rise through expanded credits. Furthermore, the existing tax credit is limited to those who work and have children. Even many of those who file do not receive a credit because they don't file a tax return.

33. For example, in the past the government has mandated mileage performance for cars, and placed restrictions on smoking and drinking.

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