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A Proposal to Reduce the Federal Deficit and the National Debt

by Ruth Beier and Robert Kleine

The federal budget deficit and the national debt continue to grow despite Gramm-Rudman-Hollings and a general consensus that deficits do affect the economy.[1] The slowdown in economic growth we expect in late 1988 or 1989 will result in slower federal revenue growth and larger federal expenditures, making the budget situation even worse. This paper looks at historical trends in federal revenues and expenditures, discusses the immediate and long-run effects of the deficit and the national debt, and proposes a national tax on consumption coupled with obligatory spending limits in order to raise enough revenue to eliminate deficit spending in four years and eventually retire a large portion of the national debt.

HISTORICAL TRENDS IN THE DEFICIT AND DEBT

Deficit spending (a technique of fiscal policy under which the government spends more than it receives in revenue) was popularized by British economist John Maynard Keynes in the 1930s. The original objective of deficit spending was to stimulate the economy, by increasing government spending or decreasing taxes, so as to shorten a period of negative or slow economic growth. The U.S. government has used this tool to combat seven recessions since World War II. Unfortunately, deficit spending has become standard government policy, regardless of the state of the national economy. Huge annual deficits have become common in the last ten years, even during periods of substantial economic growth.

Recent budgets have produced record deficits. Exhibit 1 shows that the federal deficit, which was $220 billion in 1986, has only fallen once since 1977.[2] Exhibit 2 shows the deficit as a percentage of gross national product (GNP).[3] From 1950 through 1983, the deficit was only above three percent of GNP once, during the recovery from the 1974 recession. As recently as 1979, the deficit was less than two percent of GNP. The recession in the early 1980s resulted in a slightly larger deficit by the end of the Carter administration (2.6 percent of GNP in 1981), but had Carter's tax and expenditure policies remained in place beyond his term of office, the resumption of economic growth that began in 1982 would have reduced the deficit to about two to three percent of GNP in 1982 and beyond. The link between economic conditions and whether the government incurs a deficit ended with the Reagan administration's tax cuts and acceleration in defense spending beginning in 1982. The deficit has been at least five percent of GNP for the past four years, despite a strong recovery from the 1982 recession.[4]

The national debt and interest payments on the debt have been growing since 1970 (see exhibits 3 and 4). As a percentage of GNP, the national debt has been growing at a remarkable rate since 1981 (Exhibit 5). The size of the debt and the market interest rate affect the government's interest payments, which have been growing as a percentage of total federal outlays each year but one since 1975 (Exhibit 6). In 1987, 14 percent of all federal outlays were interest payments on the national debt. **Although moderate changes already in place in tax and expenditure policy could significantly reduce the annual budget deficit, more extreme and concentrated efforts are needed to make a dent in the current $1.8 trillion national debt.**

[1]The federal budget deficit is the amount by which federal government expenditures exceed revenues each year. The national (or public) debt is the total indebtedness, including accrued interest, of the federal government. Whenever annual federal expenditures exceed revenues, that deficit is added to the national debt.

[2]The deficit declined to $148 billion in 1987 but is likely to increase again in the current fiscal year.

[3]When looking at the deficit and debt over time, the most appropriate measures are relative to GNP (the market value of all final goods and services produced in the economy in one year). Today's deficit of more than $200 billion is not as significant in today's $4 trillion economy as it would have been in the 1970 economy of $1 trillion.

[4]The Reagan administration inherited a manageable deficit of 2.6 percent of GNP; it also inherited a defense budget that had been declining during most of the Carter administration and a tax system that resulted in record tax revenue as a percentage of GNP.

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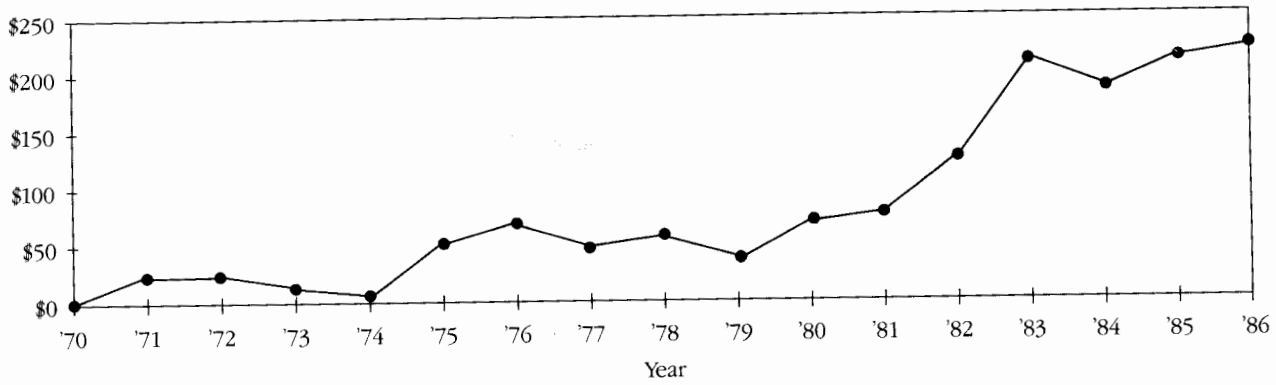
EXHIBIT 1

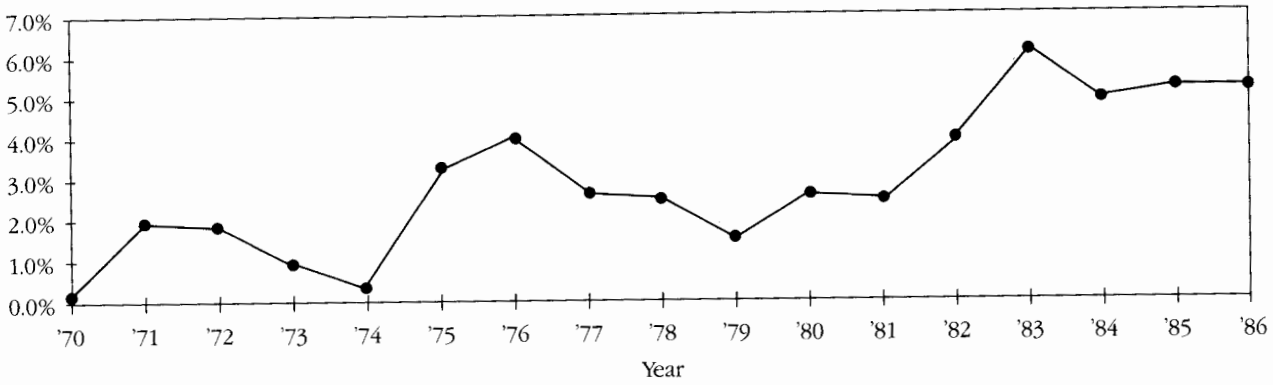
Federal Deficit, 1970–1986
(in billions of dollars)



SOURCE: U.S. Department of Commerce, *Statistical Abstract of the United States*, 1987.

EXHIBIT 2

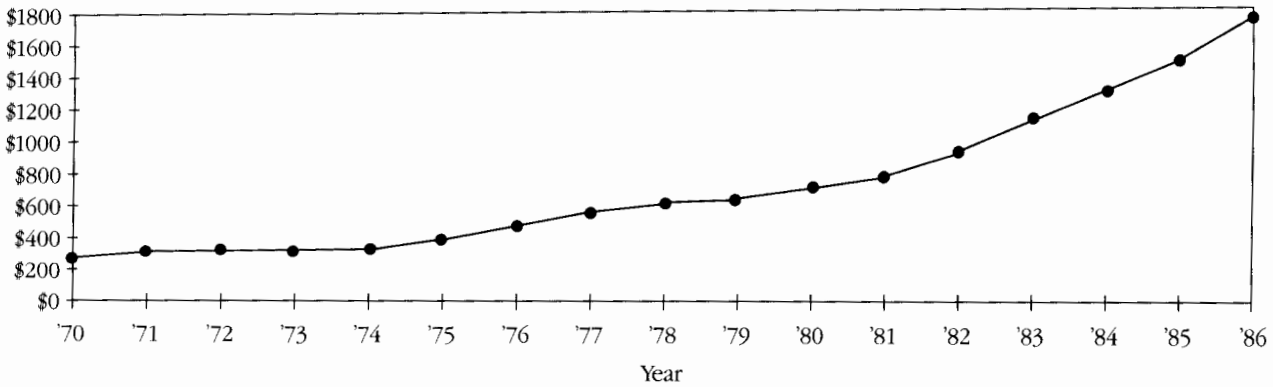
Federal Budget Deficit as a Percentage of GNP, 1970–1986



SOURCE: U.S. Department of Commerce, *Statistical Abstract of the United States*, 1987.

EXHIBIT 3

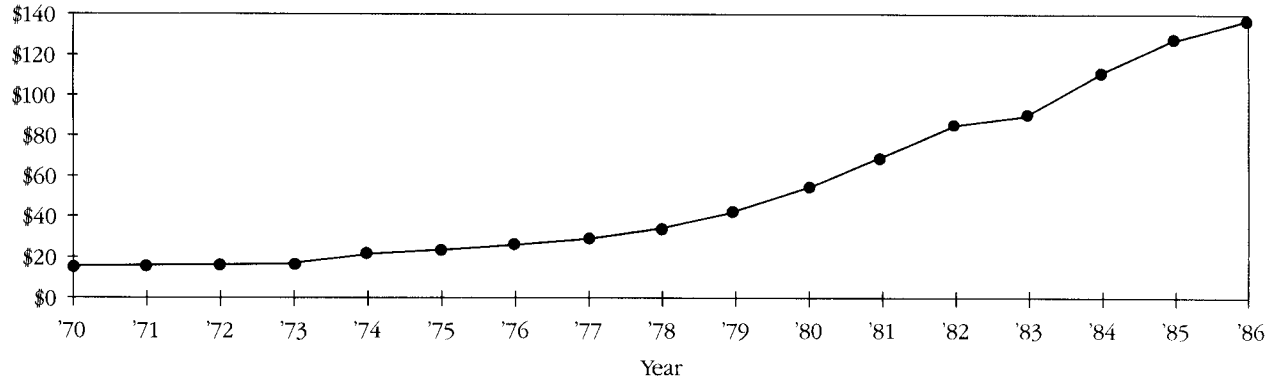
Federal Debt, 1970–1986
(in billions of dollars)



SOURCE: U.S. Department of Commerce, *Statistical Abstract of the United States*, 1987.

EXHIBIT 4

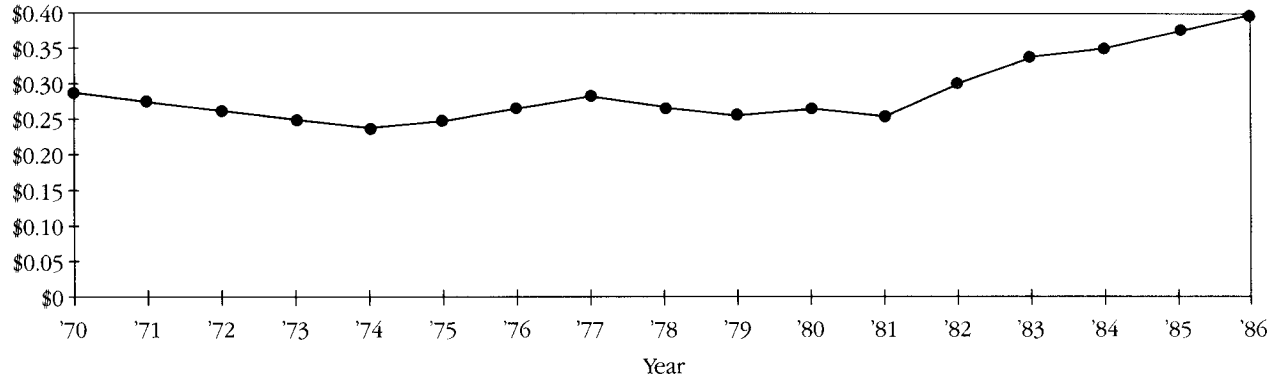
Interest on Debt, 1970–1986
(in billions of dollars)



SOURCE: U.S. Department of Commerce, *Statistical Abstract of the United States*, 1987.

EXHIBIT 5

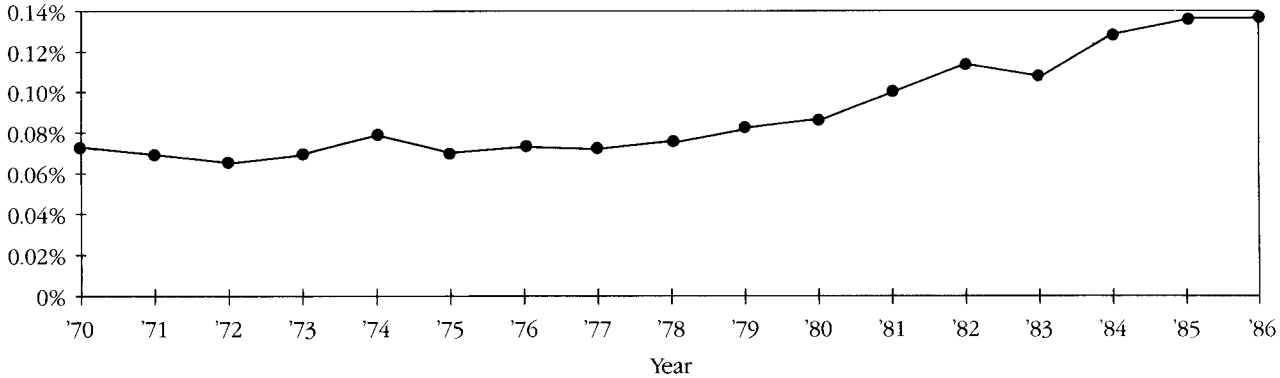
Federal Debt as a Percentage of GNP, 1970–1986
(in billions of dollars)



SOURCE: U.S. Department of Commerce, *Statistical Abstract of the United States*, 1987.

EXHIBIT 6

Interest on Debt as Percentage of Outlays, 1970–1986
(in billions of dollars)



SOURCE: U.S. Department of Commerce, *Statistical Abstract of the United States*, 1987.

ECONOMIC EFFECTS OF THE DEFICIT AND DEBT

Although the degree to which deficit spending improves or hinders the economy is open to theoretical economic debate, there is general agreement on the following broad principles.

- Increases in government spending (whether within or beyond revenue raised) can boost demand for goods and services in the economy and reduce the length and severity of a recession. Such expansionary fiscal policy also can cause inflation if the economy is already growing at a healthy rate.
- Significant hikes in taxes or reductions in government expenditures designed to reduce the deficit just before or during an economic downturn could worsen the effects of the downturn.
- Deficit spending results in government borrowing which, in periods of economic growth, may result in higher interest rates.
- Government borrowing that elevates interest rates also raises international demand for the U.S. dollar, pushing up its value. A higher valued dollar relative to other currencies expands imports to the United States and hurts our export industries.
- Persistent annual deficits may reduce investor confidence in the U.S. government and economy, making it more difficult for the government to borrow and causing instability in worldwide financial markets. Deficit spending results in an unrealistically optimistic evaluation of the U.S. economy as long as investors believe that nothing will be done to reduce the deficit or debt. Loss of confidence can occur if the level of indebtedness becomes so large that investors believe that the federal government must soon do something to address the problem. It is impossible to predict at what point the federal deficit will have a significant effect on investor confidence, although most analysts agree that the deficit at its current level has some effect on investment decisions.
- Although deficit spending permits the government to spend beyond its means, allowing higher levels of personal consumption and income, deficits have negative effects as well: annual deficits are added to the public debt, on which interest must be paid each year. This reduces government revenue available for other expenditures. In addition to paying current interest, the growing debt itself must be paid sometime in the future; this will greatly reduce future levels of personal income and consumption. It is arguably inequitable for future generations to pay so heavily for this generation's overspending.

Whether deficit spending is wise in a particular year usually depends on the economic climate that year; a case often can be made for increasing government spending or lowering taxes to ameliorate the negative effects of a recession. **The proportions to which the federal deficit and debt have grown, however, make the costs of future deficit spending and of ignoring the debt much greater than the benefits of continued deficit spending.** Our total indebtedness and our current propensity to overspend excessively each year have had the following negative effects.

- Confidence in the U.S. economy is faltering, wreaking havoc in international financial markets, and making consumers wary of long-term investments.
- Our debt has grown to nearly 40 percent of our annual GNP. Unless an effort is made soon to reduce this debt, the burden of doing so will fall on an ever-shrinking number of taxpayers as a larger and larger proportion of the country's population retires from the job market.
- Real interest rates are rising, increasing the cost of financing the debt and restricting government revenue.
- Surpluses in Social Security trust funds (resulting from 1983 amendments designed to address the Social Security problem that will occur when the baby boom generation retires) are being used to offset overspending in other accounts. Continuing to finance deficits with payroll tax receipts will further jeopardize the Social Security system.

The benefits of continued overspending (in terms of higher current consumption) pale compared to these negative effects.

A PROPOSAL TO REDUCE THE DEFICIT AND DEBT

The revenue needed to shrink the deficit could be raised by increasing existing federal taxes, cutting federal spending, or instituting a new tax. Neither a moderate increase in existing taxes nor a decrease in spending would be much help, however, in reducing the public debt.

The two major federal revenue sources are the personal and corporate income taxes. The federal Tax Reform Act of 1986 was enacted with a modicum of public support and a promise from Washington that it was a true base-broadening reform that would not become a tax increase. Many taxpayers would view an increase in the income tax rate at this point as a betrayal. Neither the current administration nor any successful presidential aspirants are likely

to support increasing the income tax to reduce the deficit. Moreover, sufficient cuts in annual federal spending are unlikely given growing defense and domestic spending needs.

If there is to be a reduction in the deficit and headway made on retiring the debt, expenditures will have to grow at a slower rate, and revenue will have to be raised—most probably through a new revenue source. We offer the following solution:

- Institute a national tax on consumption beginning in 1990. Start with a rate of one percent and raise it to four percent over four years. The tax base should be broad, and very few exemptions should be allowed. Income-based refunds could be used to reduce the proportion of the consumption tax burden falling on the poor.
- Earmark a portion of the consumption tax revenue for reducing the current deficit and later for lowering the national debt.
- Restrict government expenditures. Require that expenditures (including interest payments) not exceed government revenues (net of the earmarked consumption tax revenue) each year after 1993.
- Allow the federal government to spend more than it receives in revenue in any year that there is a national recession or emergency.

A VALUE ADDED TAX VS. A SALES TAX

A national tax on consumption could take the form of a national sales tax or a national value added tax (VAT);[5] both fall on consumption. The major differences are in (1) the treatment of capital goods, (2) the collection process, and (3) the implications for intergovernmental fiscal relations. The differences between the two taxes and the arguments for and against each are discussed below.

The Treatment of Capital Goods

Capital goods should be exempted from the tax.[6] A consumption VAT[7] allows an immediate deduction for the purchase of capital goods. It is difficult to exclude goods used in the production process under a retail sales tax. Taxing capital goods under a retail sales tax is objectionable because it can result in multiple taxation of a given item and defeats the objective of a uniform tax burden on consumers.

The Collection Process

A retail sales tax is imposed at the final stage of the production-distribution process and is collected by the retailer, based on the final selling price. The VAT is collected at each stage in the production-distribution process, based on the value added by each firm.

Exhibit 7 illustrates the collection process for a five percent VAT. A manufacturing firm buys $100 worth of inputs and sells its output to a wholesaling firm for $200. The manufacturing firm's VAT liability is $5, which is equal to the VAT due on its sales ($10) less the VAT paid on its purchases ($5). The wholesaler purchases $200 worth of inputs from the manufacturer and sells $500 worth of output to a retailing firm. The wholesaler pays a VAT of $15, again the difference between VAT due on sales and VAT paid on purchases. The retailer purchases $500 worth of inputs from the wholesaler, sells the final product for $700, and incurs a VAT liability of $10. Total value added is $600, and total value added tax paid is five percent of value added, or $30. This example also illustrates the equivalency of the VAT and a retail sales tax. A five percent sales tax levied only on the retail price of $600 would also yield revenue of $30.

Intergovernmental Fiscal Relations

Some state and local officials are concerned that a federal VAT or national sales tax might make it harder for states and localities to increase their sales taxes. A VAT generally is viewed as a form of retail sales tax; its use at the national level might affect public acceptance of higher state and local sales taxes. In a 1973 report, the ACIR reached the conclusion that a national VAT and a national sales tax would have similar effects on intergovernmental fiscal relations.

> The retail sales tax would be as direct an intrusion as possible; it is, after all, the tax instrument used by states and localities. Yet, the value added tax offers nothing salutary either . . . . [It is] . . . in essence, equivalent to a retail

[5]A value added tax is one collected at each stage in the production process. Value added can be calculated in many ways, but it is simplest to visualize as the difference between a firm's sales and its nonlabor purchases of inputs. Since the retail sales price of a good equals the combined value added during all stages of production (including the retail stage), a tax on value added at each stage will raise the same amount of revenue as a retail sales tax.

[6]Capital goods are goods purchased by business to be used in the production process and not to be resold as output to consumers or other firms. A VAT is designed to tax output and not capital goods.

[7]Under a consumption VAT (hereafter referred to simply as VAT) businesses are not taxed on capital goods. Other types of VATs include capital goods in the base, but the consumption VAT is the type most often discussed in the United States and used in Europe. A pure consumption VAT would exclude **all** items not sold as output. In practice, such a VAT would exclude many investment purchases, but would probably include many items (pencils, paper, chairs, and so forth) used in the production process.

EXHIBIT 7

Collection of a Five Percent VAT

	Manu-facturer	Whole-saler	Retailer	Total
Value of Purchases	$100	$200	$500	
Tax on Purchases	$5	$10	$25	
Value of Sales	$200	$500	$700	
Tax on Sales	$10	$25	$35	
Value Added	$100	$300	$200	$600
Value Added Tax (Tax on sales minus tax on purchases)	$5	$15	$10	$30

sales tax confined to consumption goods with the singular difference being in method and nomenclature. As such, neither tax is likely to assuage fears of federal intrusion into the sales tax field.[8]

How much a federal VAT intrudes on the revenue-raising ability of state-local sales taxes will be determined largely by two factors: rate and visibility. For example, at the relatively high rate of eight percent, the portion of the VAT that is tacked on at the point of retail sale would reduce states' ability to raise their own sales taxes. Conversely, a VAT with the relatively low rate of three percent that is included in the retail price would have much less effect on states' sales taxing ability.

The Michigan experience with the single business tax (a form of value added tax) suggests that a VAT may not necessarily be viewed as a retail sales tax and thus seen as an intrusion into state and local taxing authority, particularly if the additive method[9] is used and the tax is included in the price. Even if a national VAT were to use the tax credit method[10] of calculation, the effect on the states' ability to use the sales tax is unlikely to be significant if the rate does not exceed three or four percent.

Which Tax Is More Desirable?

Which is the more desirable addition to the national tax system—a VAT or a national sales tax? There are good arguments for each. Lindholm lists a number of reasons for favoring the VAT.[11]

- If a retailer evades the tax, all revenues are lost if it is a retail sales tax; if it is a VAT, only that part of the VAT due on value added by the retailer is lost because a VAT is collected at several stages.
- A retail sales tax generally does not cover services, most of which are exempted from existing state and local sales taxation. The breadth of coverage is much less a problem with a VAT. Rather than having to exempt all services of one type, certain activities, for example, small businesses or labor-intensive firms, can be shielded under the VAT.
- A retail sales tax often levies a tax on capital goods. The VAT avoids this problem because the VAT paid on these goods is deductible by each firm along the production process until the end use is reached.
- Under the federal General Agreement on Trade and Tariffs (GATT), exporters can receive a refund on all VAT paid. The VAT can also be levied on imports as a border tax. Used in this way, the VAT can encourage exports and discourage imports, improving our trade balance. The retail sales tax cannot provide these benefits.
- Exempting small businesses from the VAT will not result in the loss of all revenues from the entire production distribution process. For example, small manufacturing firms could be exempt from VAT without exempting all manufacturing firms. A national sales tax does not allow this flexibility.

The U.S. Treasury also favors a national VAT over a national retail sales tax.

> Though they [the two taxes] are economically equivalent in their purest form, there are administrative differences between the retail sales tax and value added tax that tend to favor the value added tax. In particular, a value added tax may be superior to a retail sales tax in freeing capital goods and other business purchases from taxation.[12]

On the side of a national sales tax is McLure, who sees no economic difference between the two taxes, but prefers the sales tax for administrative reasons.[13] He sees the advantages of the sales tax as follows.

- State and local sales taxes can be piggybacked on a national sales tax—something that cannot be done if a national VAT were adopted.
- A well-designed retail sales tax can promote tax consciousness: a direct tax on consumer goods might heighten awareness of the cost of government. Some

[8]Advisory Commission on Intergovernmental Relations, *The Value Added Tax and Alternative Sources of Federal Revenue* (Washington, D.C.: 1973), pp. 81 and 84.

[9]Under the additive method as used in Michigan's single business tax, a firm's value added tax liability is calculated by adding together the components of value added—wages, rent, interest, and net profit—and then applying the tax rate to that sum.

[10]The tax credit method is used in the European consumption VAT. Tax liability is the tax rate times gross sales less the tax rate times purchases made by firms. (See Exhibit 7 for an example of the credit method.)

[11]Richard W. Lindholm, *The Economics of VAT* (Lexington, Mass.: D.C. Heath, 1980), pp. 106–109.

[12]U.S. Department of Treasury, *Tax Reform for Fairness, Simplicity, and Growth*, November 1984.

[13]Charles E. McClure, Jr., and Norman B. Ture, *Value-Added Tax: Two Views* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1972).

observers of the European VAT believe that one weakness of the VAT has been that it is too easy to raise when revenue is needed. This is unlikely to be the case with a retail sales tax.

- A retail sales tax involves fewer taxpayers, resulting in lower administrative overhead.

Public Sector Consultants feels that, on balance, a national VAT is preferable to a national sales tax mainly because a VAT would be less likely to intrude on state-local fiscal matters, would reduce taxation of capital goods, would provide trade advantages, and likely would be more acceptable to the public than a retail sales tax. Opposition from state-local government officials can be deflected by sharing with these governments a portion of the VAT revenues not earmarked for federal deficit reduction. This would reduce the need for state-local governments to raise their own sales taxes if they need more revenue in the future.

THE BASE OF THE TAX

We recommend a broad-based VAT with few consumption items exempted. The broader the base, the better is the revenue potential of the tax and the fewer are the distortions in consumers' purchasing decisions. A number of items could be exempted from the tax for administrative or social reasons. The rental value of owner-occupied housing is a consumption expenditure, but its correct calculation is extremely difficult and costly, making it impractical to tax. It should be exempt for administrative reasons; rent payments should then also be exempt. Foreign travel, local transportation, and insurance and finance expenditures could also be exempt for administrative reasons. Medical care, education, religious, and welfare expenditures could be exempt for social reasons. Assuming these exemptions were allowed, the remaining base in 1990 (the first year of the tax) would be approximately $2,603 billion. (See Exhibit 8.)

FEDERAL DEFICIT AND DEBT REDUCTION

After credits, the VAT proposed would raise approximately $23 billion in 1990 (at one percent), $51 billion in 1991 (at two percent), $74 billion in 1992 (at three percent), and $99 billion in 1993 and each year thereafter (at four percent.)[14]

We recommend that the revenue be allocated as follows.

EXHIBIT 8

Estimate of Value Added Tax Base, 1990 Levels of Expenditures[a] (in billions of dollars)

Total personal consumption expenditures		$3,382
Less:		
Rental value of owner- and tenant-occupied housing (including farms)	$498	
Medical care (including health insurance)	251	
Insurance and finance (other than health insurance)	80	
Education	52	
Religious and welfare	51	
Foreign travel	14	
Local transportation	9	
Other: food produced and consumed on farms, military-issued clothing, domestic services, and so forth	8	
		−963
Plus: Sales of new housing		184
Comprehensive value added tax base		$2,603

Source: U.S. Department of Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, November 1984.

[a]Treasury estimates were for 1988, these data were adjusted for four percent inflation each year to get 1990 estimates.

- From 1990 to 1992, use all VAT revenue to reduce the federal deficit. Assuming a $200 billion deficit in 1990 (before the extra revenue), this would reduce the deficit to approximately $52 billion by 1992.
- In 1993, dedicate $52 billion of the VAT revenue to eliminating the deficit and the remaining $47 billion to reducing the national debt.
- After 1993, prohibit budget deficits unless there is a national recession or emergency. In years with no recession or emergency, allocate one-half the VAT revenue to general government and one-half to reducing the national debt. The portion of the revenue earmarked for the debt would be used to reduce the deficit in times of emergency or recession. This means that the federal government would have $50 billion more to spend each year after 1993 than it has from current sources, but would have to eliminate the deficit by 1994.
- With few annual increases in the debt, this plan would totally eliminate the public debt in about forty years. However, it may not be wise to eliminate the debt completely. Reducing the debt will have a dampening effect on the economy that may outweigh the benefits of reducing the debt below a certain level. After that level is reached, the VAT rate could be reduced and

[14]This assumes that consumption as a percentage of GNP would remain constant over time. The values are in real (inflation-adjusted) dollars with a base year of 1990. Credits would be equal to the amount of VAT paid by low-income individuals on the level of consumption necessary to maintain a minimum standard of living.

the revenue used to reduce other taxes, such as the corporate income tax, to ensure the viability of the Social Security system or to build surpluses in other vital accounts.

OTHER ASPECTS OF A NATIONAL VAT

Aside from eliminating the federal deficit and eventually the debt, instituting a national VAT would have the positive effect of diversifying the nation's tax structure and reducing the relative importance of the federal income tax. A national VAT also would have some negative effects—the most important of which would be on prices, costs of administration, and on the overall progressivity (equity) of the national tax structure.

Prices

A national VAT of four percent levied on the base we propose (about 75 percent of total consumption) would probably result in a one-time increase in the overall price level of about three percent. This would mean an increase in inflation of three percent (above the level that would have occurred without the tax) in the first year of the VAT. In European countries that have instituted a VAT, the effect on prices has been limited to the first year. We expect a similar price reaction if the United States institutes a VAT.

Costs of Administration

The U.S Treasury estimates that administering a national value added tax would require 20,000 additional employees and cost about $700 million per year. This cost would have to be made up out of nonearmarked VAT revenue or out of other federal revenues.

Equity

The most serious drawback of a consumption tax is that much of the burden of a sales or value added tax falls on the poor unless adjustments are made either in the base or collection of the tax. A VAT without such adjustments would be regressive; that is, the amount of tax paid as a percentage of income would be greater at lower income levels than at higher income levels. This is because individuals with lower incomes consume a larger percentage of their income than do individuals with higher incomes. Wealthier individuals also spend a greater proportion of their incomes on nontaxable consumption items that would be exempted from the VAT. Adding a regressive VAT to the current federal tax system would reduce its overall progressivity.

Some states ease the regressivity of their sales taxes by exempting food and other necessities or by allowing a refundable income tax credit for sales taxes paid by low-income taxpayers. Exempting food and necessities is an inefficient way to reduce regressivity since it benefits the wealthy as well as the poor. We suggest that the VAT proposed here include a reimbursement to low-income individuals roughly equal to the amount of value added tax paid on the consumption necessary to attain a minimum standard of living. This would effectively reduce the VAT burden borne by low-income individuals. The reimbursement would be phased out as income rises. It would be administered as a credit against federal income tax liability, refundable to low-income individuals who do not pay income taxes. The U.S. Treasury estimates that if such a refund is phased out between 100 and 150 percent of poverty level income, it would greatly reduce the overall regressivity of the tax and only reduce the revenue of the VAT by five percent.

CONCLUSIONS

Political discussions about the current federal budget deficit and the national debt typically pertain to debt ceilings, the magnitude of the deficit, how the deficit will be spent, and the effects of the deficit and debt, rather than to whether an annual deficit or accumulated debt is justifiable. We believe that unless expansionary fiscal policy is vitally necessary to the general health of the economy, deficits are not advisable or justifiable. The adverse immediate and long-term effects of the deficit and debt make it unwise economic policy to continue overspending. In addition, this generation should not have the license to overspend at the expense of future generations. The national VAT and expenditure restrictions proposed in this paper would help secure our future by reducing the deficit and the debt, while diversifying and increasing federal revenue.