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COMMENTARY

The Deficit Bugaboo

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Are we better off having lower taxes on interest, dividends and capital gains (and other taxes on capital) or having a lower deficit? Obscure as it may seem, this is the central economic debate being fought in the political arena.

To fund any given level of government spending, our political leaders have to choose how much of the spending should be funded by taxing and how much by borrowing. Historically, Republicans tended to argue more than Democrats for a balanced budget or lower debt financing. Now, the parties have reversed themselves. Republicans have slowly accepted the supply-side argument that high marginal tax rates and the double tax on capital income is more damaging to the economy than modest increases in the deficit. Democrats have bought into the argument of former Treasury Secretary Robert Rubin and his allies that deficits are destructive and should be reduced through tax increases and, at the same time, they believe "fairness" requires the rich to pay a much larger share of the tax bill.

How damaging is the deficit and at what level does it become dangerous? Within limits, economists are not concerned about the deficit in a particular year. Their concern, correctly, is with the amount of government debt held by the public in relation to GDP. As long as individuals or businesses have a yearly rise in income, they can take on more debt without getting into trouble, provided the cost of the additional debt service does not rise faster than the rise in income. The same is true for government. Forty years ago, in 1962, federal government debt as a percentage of GDP was 43.6%. It fell to a low of 23.8% in 1974, rose to a high of 49.5% in 1993, and then dropped back to 33.1% in 2001. Currently, it is about 35% of GDP, and the CBO projects it to fall back to 30.7% in 2013.

Those who argue for lower levels of debt usually claim that higher debt crowds out new investment, leading to lower economic growth, more unemployment, higher inflation and higher interest rates, and is unfair to future generations, etc. At some level of debt, the arguments against it are undoubtedly true. But again, looking at the data for the last 40 years, there is no evidence that federal government debt levels up to at least 50% of GDP have been a problem. Surprisingly, real economic growth averaged almost 1% higher (3.47%) in the

years where debt was more than 33% of GDP than in the years when it was less than 33% (2.59%.) Unemployment averaged 6.43% in the low-debt years, and only 5.65% in the high-debt years, and inflation averaged 7.6% in the low-debt years, and 2.9% in the high-debt years.

At the end of World War II, U.S. government debt was more than 100% of GDP. That level of debt was borne by the generations that came after the war, but clearly we are all better off because the war was won with debt financing. We are also better off because the Reagan administration engaged in a military buildup, financed partly through increased debt, to win the Cold War. Placing a debt burden on future generations is not wrong if it is done to help secure their liberty and prosperity.

Those who argue for a tax increase to bring down the deficit, such as Mr. Rubin and his allies, have so far failed to distinguish the differing impact various types of tax increases would have on the economy. The deficit hawks argue that an additional dollar of tax revenue received by the government, if it is used to pay down the deficit, will result in one more dollar in the private sector available for productive investment. This is true if the dollar would otherwise be spent on consumption. However, if the dollar comes from individual or corporate saving, there would be no increase in capital available for private investment and, as a result, the economy would be no better off despite a lower deficit.

Tax economists have long known that consumption taxes, for each dollar raised, are far less damaging to the economy than taxes on capital. Yet all of the Democratic candidates for president are proposing tax increases that would fall largely on capital rather than on consumption. When they advocate increasing "taxes on the rich" -- such as higher marginal tax rates on upper-income people, and higher tax rates on capital gains, dividends and corporations -- they are, in fact, calling for higher taxes on productive saving and investment. These higher taxes would depress investment, productivity and wage growth, making workers bear the ultimate cost.

The cost of tax collection is considerable, both for the government and the taxpayer. Also, as tax rates rise, the increase in revenue diminishes as people have a greater incentive to find legal and illegal ways to avoid paying the tax (i.e., the Laffer curve effect). For instance, the repeated increases and decreases in the tax rate on capital gains have clearly demonstrated that the revenue-maximizing rate is under 20%. High tax rates, particularly on capital, misallocate resources, resulting in lower economic growth. This fact had become so obvious (both from rigorous economic analysis and from casual empirical observation) that during the last two decades it caused governments around the world to sharply lower their corporate and personal marginal rates, and spurred the movement toward flat taxes. The U.S. now has the fourth-highest corporate tax rate in the OECD (35%) -- higher than even Sweden, Germany and France and almost triple Ireland's 12.5% rate.

There are costs involved whether the government obtains its funds from taxing or from borrowing. Yet the extraction costs of borrowing are far less costly than taxing. This is because the capital markets are very efficient. It only costs the government a few cents on the dollar to issue notes or bonds, and the effect of additional government borrowing on interest rates tends to be small (provided, of course, federal debt remains below 50% of GDP).

The failure of the Rubin deficit hawks to understand that high taxes on capital were more damaging to the economy than a modest deficit led them to embrace a budget surplus. While they received almost universal acclaim for this action, in effect, what they were doing was a costly drain on high-value, private-sector capital for the sake of reducing low-cost government debt. If in 2000, instead of running a surplus, the Clinton administration had enacted a tax cut to reduce the highest marginal tax rates, the corporate income tax and the double taxation of dividends, we probably would have avoided the most recent recession and all the misery, unemployment and hardship it caused.

Reducing the growth in government spending has many benefits, including less misallocation of resources and less need for both borrowing and taxes to keep the deficit within manageable range. Over the last three decades, federal government spending as a percentage of GDP has ranged from a low of 18.4% in 2000 to a high of 23.5% in 1983. This year it will be about 20.5% of GDP (or roughly the average of the last 30 years). Missing from the deficit debate, however, are serious proposals to substantially reduce the growth in spending.

To date, each of the Democratic candidates seems to have an economic plan that would repeat the mistakes of the deficit hawks. They would all increase rather than cut the taxes on capital, which would likely lead to another recession. President Ford made this mistake in 1974, as did President Carter in 1980 and the first President Bush in 1990.

The Bush team has put forth a realistic program for ensuring that the debt-to-GDP ratio will not increase over the long run, and that the deficit will decline to under 2% of GDP in the latter part of the decade. The challenge now for the president is to show that he will hit his budget targets by vetoing spending bills when necessary, and continue to reduce taxes on productive saving and investment to keep the economy growing.

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