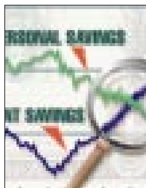
IPI
Insights
FEBRUARY 2000

A BALANCED VIEW OF THE DEBT

BY JUDE WANNISKI



INSIDE: Government Surplus at The Expense of YOUR Savings.

ALSO: Old Economy Wrestles with New

While it's always nice to have some extra money (surplus income) left over at the end of the month, it does present some problems—though they are *nice* problems. What should be done with the money?

When determining the best use of surplus income, most people do not have to be taught that credit card debt at an 18% interest rate should be paid down first before paying down a 7% mortgage rate. Nor does it make sense to pay off a car loan early if the house needs a new roof or if the kids are about to enter college. *If there are better uses to which surplus income can be applied, it makes no sense to pay down debt.*

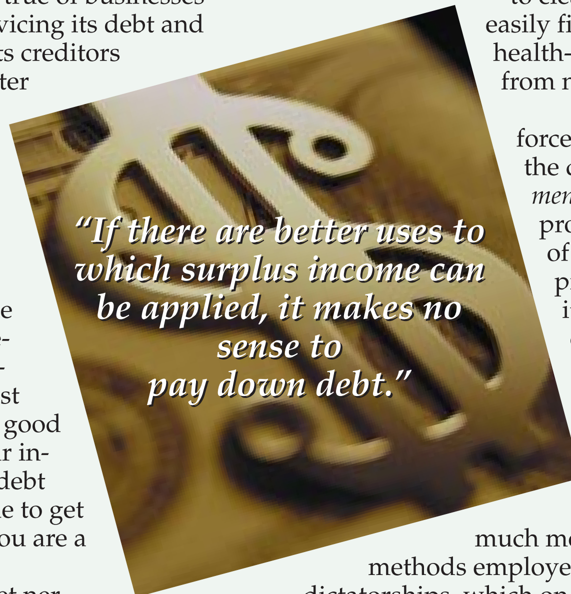
A BALANCED VIEW OF THE DEBT

The bank that holds the debt will be perfectly happy to accept timely payments of interest and principle. The bank would even be pleased to see a new roof go on the house, since the bank has an interest in the house it has collateralized. Creditors will almost never object so long as they see that the family is managing its finances in a way that makes it likely that it will be able to meet its future debt obligations. In fact, it is often those families who are the deepest in debt who find it easiest to borrow more, because their future earning power seems so secure. The same is true of businesses—so long as the business is servicing its debt and managing its finances well, its creditors are happy to grant even greater levels of credit.

How can this be? It's really quite simple. When a borrower (debtor) can persuade lenders (creditors) that it will absolutely, positively pay back dollars that will buy as much at some future date as they can at present, the creditors will bid interest rates down to the lowest possible levels. If you have a good credit rating — based on your income, wealth and history of debt repayment — you will be able to get credit at low rates whether you are a government or a household.

When do creditors get nervous? When they see governments who owe them money losing battles in war, when businesses whose paper they hold appear headed toward failure, or when breadwinners become unemployed and the family begins missing payments. Why then is there no more persistent snake-oil involving public finance than that which recommends a balanced budget? With the federal government now contemplating official estimates of a $2 trillion revenue surplus in the next decade, why are both major political parties seemingly so transfixed with paying down debt? Surely there are better uses of our surplus national income than paying down low-interest debt?

The answer lies in the political realm. In every family — the nation's basic political unit — there are always discussions, at times arguments, over how to spend current *and future* income. Father or mother may manage the checkbook of household finance, but even the children participate in the *process* of allocating the family's resources. The national government — the executive and legislative branches in this case — represent the opinions of a hundred million families. If there is a reliable estimate of resources *becoming available* to the nation over the next decade, the president and the members of Congress must decide on how to optimize the return on the public investment of those resources.



Should the monies be directed at increased public spending — for social programs, federal infrastructure or national defense? Or should tax rates be reduced — to promote targeted social objectives or expand the economy through supply-side effects? Or should the $3.5 trillion national debt be paid down by running budget surpluses — to clear the decks in order to more easily finance public pensions and health-care programs a generation from now?

Each of these questions forces upon the elected officials the question of *return on investment*. At the end of the budget process each year, the amount of money authorized and appropriated for a specific line item represents the best guess of the government on its ROI — whether the investment is in the National Endowment for the Arts or another aircraft carrier.

The process is a messy one, but it is ultimately much more efficient than the methods employed by fascist or communist dictatorships, which on the surface seem so much neater.

In our system, when there is no clear mandate from the people to the government on which of the paths to take, the safest one is to pay down debt — at least until a new national election clears up the favored public choices. The Republican tax legislation of 1999 was so poorly designed, for example, that the president's veto seemed reasonable and the electorate sided with him.

Classical (supply-side) economics has no opinion on spending priorities, for example, except to note that on certain capital projects — fixing roads and bridges, for example — there may be a higher ROI than in lowering certain tax rates. In other words, higher federal spending and a bigger government *can* be compatible with a supply-side economic system. That is, there is no reason why Democrats cannot embrace supply-side tax and monetary principles to promote economic growth in order to finance their favored social programs. Indeed, President John F. Kennedy in 1963 proposed supply-side cuts in high marginal income tax rates despite a federal budget deficit.

The GOP administrations of Harding and Coolidge in the 1920s explicitly based their tax-cut-

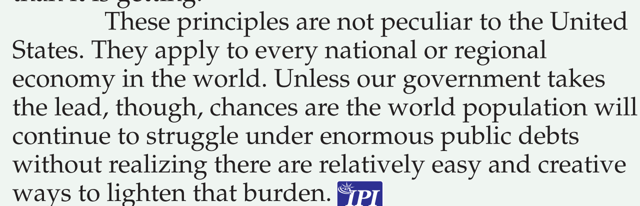
ting plans on the idea that lower tax rates in certain cases would produce higher revenues and thereby reduce the burden of the national debt. It was not until 1960 that this issue was addressed in a formal academic setting. In the December 1960 issue of the *Journal of Political Economy*, the Canadian supply-sider Robert Mundell demonstrated in a Keynesian framework that a lower tax on corporate profits could *lower interest rates* on government debt even as the budget deficit increased.

Mundell, the 1999 Nobel Laureate in economics, used similar proofs to provide the intellectual underpinnings for the Reagan personal income tax cuts of 1981. *The tax cut need only produce sufficient economic growth so added revenues would be able to pay the interest on the bonds floated to finance the tax cut.* In the 1980 campaign, George Bush called this "voodoo economics," but it is the same rationale used in private enterprise. If a business can issue debt to finance an expansion of a product line, it need only sell enough at a profit to service the debt. Anything else is gravy, but the equity markets will not punish it as long as it does well enough to cover interest.

Opponents of the Reagan policies to this day blame the ensuing budget deficits on his tax cuts, but one need only observe that *the deficits were accompanied by declining interest rates on government bonds* to see the wisdom of Mundell's hypothesis. The investment made in lower tax rates in the Reagan years — and the bipartisan tax cuts of 1997 — produced the economic growth responsible for the "profits," or budget surpluses, that have emerged today.

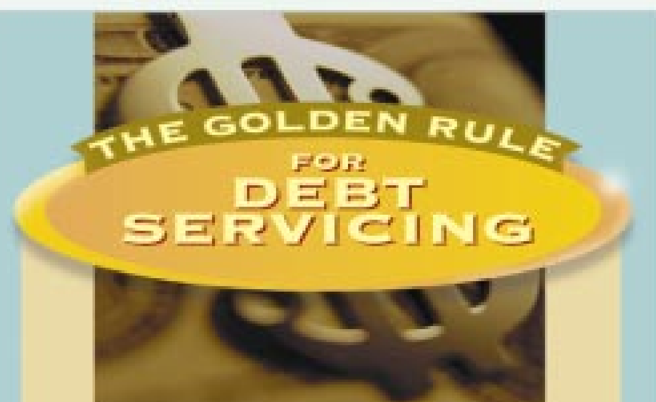
To solve the longer-term problem of actuarial deficits in Social Security and Medicare, at least a portion of the projected near-term surpluses should be devoted to lowering those tax rates on capital and labor that are higher than they need to be. Only if the amount of capital available to labor is increased by 50% over the next 20 years will it be possible for two workers instead of three to provide for a pensioner. *Merely paying down the debt will not accomplish that goal.*

And if the U.S. dollar were fixed to gold instead of a floating greenback, interest rates on government bonds would be closer to 4% than 7%. The cost of debt service would decline by more than $80 billion a year over the average five-year maturity of the debt. This is a policy that deserves far more consideration than it is getting.



These principles are not peculiar to the United States. They apply to every national or regional economy in the world. Unless our government takes the lead, though, chances are the world population will continue to struggle under enormous public debts without realizing there are relatively easy and creative ways to lighten that burden. IPI

Jude Wanniski is the author of the book The Way the World Works *and teaches political economics at his virtual "Supply Side University,"* *www.polyconomics.com*.



In 1902, a young American college student who was to become one of the most influential economists of the century wrote his doctoral dissertation on the Union government's financing of the Civil War. Wesley Clair Mitchell propounded the view that the Lincoln administration should not have left the gold standard in 1862 in order to pay for the war with "greenbacks," i.e., dollars whose value was no longer guaranteed in gold by the government. Mitchell demonstrated that in the inflation that followed, it quickly took twice as many greenbacks to buy an ounce of gold — and twice as much to buy the materials of war. In addition, interest rates doubled on the greenback bonds the government floated, which meant the taxpayers were burdened by much higher post-war costs of debt service.

Mitchell became a well-regarded professor of economics at Columbia and a founder of the National Bureau of Economic Research. His ideas about the financing of war debt became a fixture in the decades that followed. They were in many ways responsible for the United States keeping the dollar as good as gold, at $35 an ounce, as it financed WWII, the most expensive war in its history, at 2% interest rates. The public debt in 1945 was the equivalent of $2,400, or 68.5 ounces of gold per capita. By contrast, today's public debt is $11,500 per capita. But after a half century of inflation, the amount is equivalent to only 40 ounces of gold. In other words, a much heavier debt in 1945 was being financed by the government's creditors at a third of today's 6% rate.

A PENNY SAVED . . . IS A PENNY TAXED

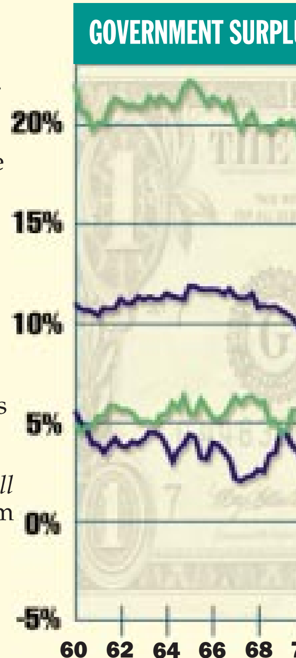
BY STEPHEN J. ENTIN

Most people instinctively understand the importance of setting money aside for a rainy day, an emergency fund, college tuition and retirement. It has always been hard to save, but when the economy is growing at a healthy pace with both low unemployment and low inflation, it should be easy to save money, right? After all, the stock market is booming and politicians tell us that the economy is in terrific shape, what with the federal budget in surplus and all. What could be wrong with this picture?

Surpluses at the Expense of Savings

Ironically, despite the economic growth of the past two decades, the personal savings rate (saving as a percent of disposable after-tax income) has plunged over the past 15 years. In the mid-1980's, the rate was about 9%. Today that same figure is a mere 2.5%. Meanwhile business saving has scarcely changed. The result: Total private saving (personal and business combined) is in decline.

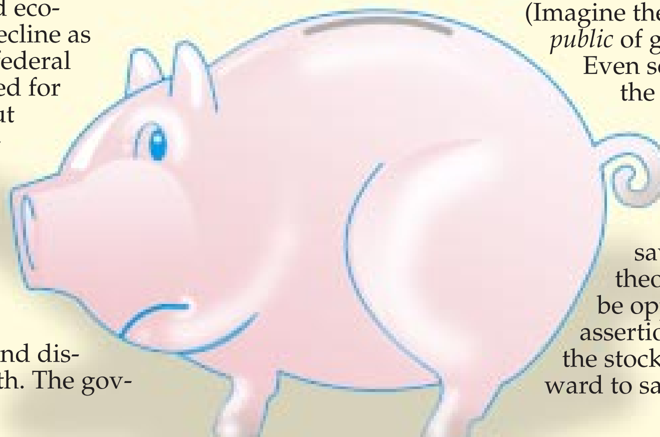
Many politicians and economists fret that this decline will retard economic growth. They use the decline as an excuse to hang on to large federal government surpluses projected for the next decade, rather than cut taxes. They argue that government surpluses add to national saving and promote growth. The truth is government surpluses do not raise national saving and investment. The excess taxes imposed to create the surpluses reduce private saving and discourage investment and growth. The government should not do our saving for us. Instead, it should cut the tax barriers that punish private saving and investment. The country would be far better off with pro-saving and pro-investment tax cuts than with big budget surpluses.



As Taxes Go Up, the Saving Goes Down

A key factor in the saving rate decline is the fact that most Americans have less money to save with. *Payroll taxes*, for instance, rose from 13.4% in 1983 to 15.3% in 1990, and the amount of income subject to the tax has risen each year. In addition, the *income tax* has risen. As real incomes have grown, people have been pushed up through the graduated tax rate structure. In addition, there were explicit income tax increases in 1990 and 1993.

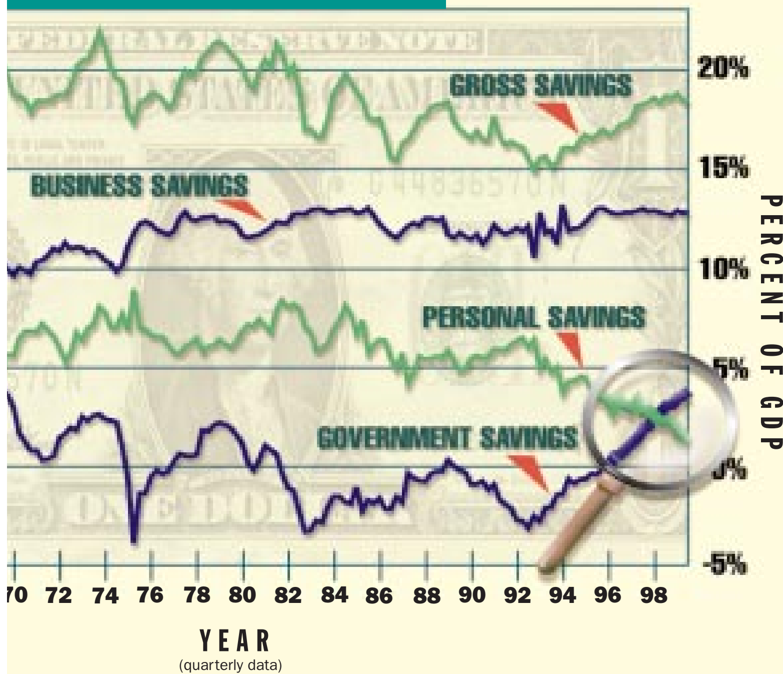
Taxes have been raised on *corporations and on owners of small businesses,* keeping business saving and investment from rising as much as they might have. Business saving is usually about two-thirds of private-sector saving and is the chief source of funding for expanding capacity, productivity and wages. The tax bias against investment restricts the amount of capital formation in the United States, which depresses productivity, wages and employment.



The Blame Game

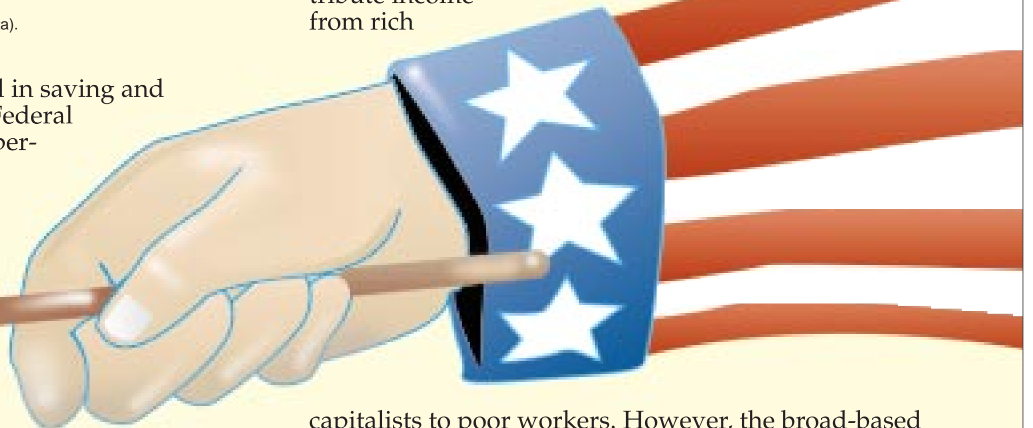
Politicians and some economists blame the public for the low saving rate. They claim that the public is too shortsighted to save, or that it is taking advantage of the rising stock market to go on a spending spree. (Imagine the *government* accusing the *public* of going on a spending spree!) Even some economists theorize that the rapid rise in stock prices has lowered the personal saving rate and encouraged consumption, because people have seen their wealth increase without having to save any current income. This theory makes individuals out to be opportunistic spendthrifts. The assertion is twisted logic. The rise in the stock market has increased the reward to saving and has probably

US AT THE EXPENSE OF PERSONAL SAVING



(quarterly data)
Data from Bureau of Economic Analysis (incorporating Revised NIPA data).

caused people to be *more* interested in saving and buying stock, not less. In fact, the Federal Reserve has just reported that the percent of families owning stock jumped from 31.6% in 1989 to 48.5% in 1998.



The Capital Gains Culprit

There are other ways, however, that the rising stock market may have cut the saving rate. People who have traded stock at a profit have had to pay substantial capital gains taxes. In order to reinvest all the proceeds of their stock sales, so as not to eat into their accumulated savings, they have had to pay the capital gains tax out of their current income. Their saving out of that same income fell by roughly the amount of their tax payments, and their saving rate as a percent of their current ordinary (non-capital gains) income dropped.

In 1992, the Treasury collected nearly $29 billion in capital gains taxes. In 1997 (last available data), the Treasury collected nearly $79 billion in capital gains taxes, a $50 billion, or 170% increase, over five years. (The jump in gains may have grown much larger since then.) That $50 billion increase was equal to 40% of the personal saving done in 1997. Had that extra capital gains tax money been left for taxpayers to save, it would have boosted the measured saving rate that year from 2.1% of disposable income to 3%. *The culprit is the capital gains tax, not savers.*

The Basics of Tax Biases

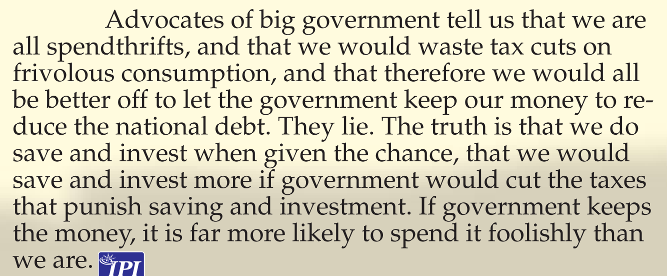
Our current tax code is strongly biased against saving and investment. Under the ordinary "broad-based" income tax, income is taxed when earned. If it is used for consumption, there is generally no additional federal tax on the enjoyment of the goods and services. If the income is saved, however, there is a tax on the earnings of the savings. This is the basic income tax bias against saving relative to consumption.

Additional tax biases against saving and investment are created in other ways, such as taxing already-taxed corporate earnings a second time as dividends or as capital gains. The estate and gift tax on accumulated savings is also a bias against saving, as is denying businesses a full and immediate accounting for certain business costs by requiring depreciation instead of immediate expensing, which inflates business taxable income and raises the effective tax rate.

These multiple layers of tax on saving and investment were designed and advocated by academics and social activists in Washington to redistribute income from rich capitalists to poor workers. However, the broad-based income tax retards investment, which reduces wages and employment, and penalizes saving, keeping those who lack capital from getting any. It hurts the poor more than the rich.

Conclusion

Advocates of big government tell us that we are all spendthrifts, and that we would waste tax cuts on frivolous consumption, and that therefore we would all be better off to let the government keep our money to reduce the national debt. They lie. The truth is that we do save and invest when given the chance, that we would save and invest more if government would cut the taxes that punish saving and investment. If government keeps the money, it is far more likely to spend it foolishly than we are. IPI



Stephen J. Entin is the Executive Director and Chief Economist of the Institute for Research on the Economics of Taxation, a non-profit Washington, DC public policy think tank. Prior to joining IRET, he was Deputy Assistant Secretary for Economic Policy in the Reagan Treasury Department.

ENTERING A DIGITAL DECISION
The Old Economy Wrestles With the New

BY BARTLETT CLELAND

In October 1998 Congress passed into law the Internet Tax Fairness Act. The intent of the legislation was to stop new taxes on Internet access (taxes on the money spent for services such as AOL), as well as multiple, or discriminatory taxes on electronic commerce (taxes not placed on another means of commerce, such as catalog sales).

In addition, the new law required the creation of a congressionally appointed commission to review the issues related to electronic commerce and make a recommendation as to any actions that Congress should follow. The appointed commission, called the Advisory Commission on Electronic Commerce, will meet for the final time in Dallas, Texas, on March 20 and 21. In April they will forward their findings to Congress. Don't expect dramatic results.

From the beginning the Commission has been defined more by politics than principled policy. Two camps of thought immediately developed. The first group has argued that sales transacted via the Internet should not be taxed. The other side has argued that without the tax of Internet sales, cities will crumble. Several commissioners have remained non-committal to either mode of thought. Neither side has cornered the full story.

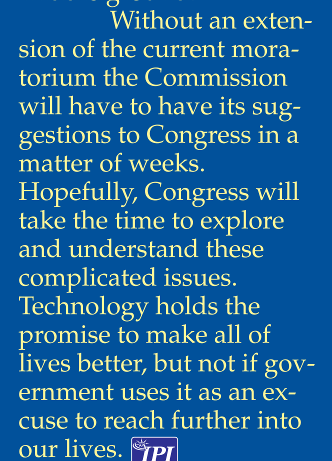
The principled and intellectually honest position falls somewhere between the Commissions rhetorical positions. Some simple questions demonstrate this point. If sales from within a state are taxable in the state, then why would the means of the sale change the tax? Does the recommendation create a simpler, more consistent tax philosophy? If remote sales (sales across state lines) are not taxable, except through use taxes, then why should the involvement of a computer change the result? Can the states cut a deal with Congress to override constitutional precedent as determined by the Supreme Court in order to gain broader taxing authority?

The Commission should consider the many issues that are tough and that must be addressed as the national debate goes on. The most basic question does not even involve a discussion of the electronic age: Does the current quilt of thousands of taxing authorities make any sense? Regardless of the answer, does the federal government have any role to play in how a state decides to tax? Where does the physical transaction take place in our wired world? Are the definitions in tax law of dozens of years ago or even five years ago of any use today?

None of these questions are easily answerable and none of these questions will be any easier to answer in the future. These questions are increasingly important — this past Christmas on-line sales continued their rapid increase. All predictions indicate that electronic purchasing will continue to increase for the foreseeable future.

Recently, some members of the opposing groups have begun to talk about a compromise. Importantly, the representatives from the business world have put forth a detailed proposal in an attempt to find a reasoned middle ground.

Without an extension of the current moratorium the Commission will have to have its suggestions to Congress in a matter of weeks. Hopefully, Congress will take the time to explore and understand these complicated issues. Technology holds the promise to make all of lives better, but not if government uses it as an excuse to reach further into our lives. IPI



Bartlett Cleland is the Director of IPI's new Center for Technology Freedom.

IMPACT

ON THE HILL...

C-SPAN Zooms in on Aldona Robbins' Testimony Before House Ways and Means Subcommittee

CSPAN caught IPI's Senior Research Fellow Aldona Robbins on camera as she testified February 15, 2000, before the Subcommittee on Social Security of the House Ways and Means Committee.

Dr. Robbins explained to the committee why the Social Security earnings test, a measure that heaps unnecessary financial burdens upon our retirees and ultimately forces some out of the job market, is long overdue for its own retirement.

LOCALLY...

IPI Sponsors Lewisville Chamber of Commerce Luncheon

IPI proudly sponsored its local Chamber of Commerce Luncheon for the month of February 2000 by featuring guest speaker Bill Murchison, senior columnist of *The Dallas Morning News*.

Murchison's educational but entertaining perspective of political responsibility imparted vision to Lewisville's business and community leaders. The lunch also provided an opportunity to highlight IPI's presence and hard work in and around the Lewisville community.

House Majority Leader Dick Armey, IPI Chairman of the Board Dr. Michael E. Williams and IPI President Tom Giovanetti

IPI Supporters Team Up at the Dallas Cowboys Game

The December 1999 Dallas Cowboy fundraiser was a winner! Friends and sponsors of IPI, including IPI founder House Majority Leader Dick Armey, kicked back and enjoyed themselves with great conversation, good food, and, of course, good ole' Texas football.

The event, hosted annually by IPI, provides a relaxing atmosphere for folks to get caught up in touchdowns, touchbacks and field goals, while chatting about the policy issues that matter most and supporting the work of IPI.

IPI Unveils the Center for Technology Freedom and Hires Bartlett Cleland as Director

IPI is proud to announce the creation of its Center for Technology Freedom under the directorship of Mr. Bartlett Cleland.

IPI understands that the rapid explosion of technology in all areas of life—health, education, commerce and entertainment—warrants a need for "hands on" understanding of today's discussions regarding hot issues facing the technology industry. IPI and the Center for Technology Freedom will be the source for those who love freedom for how we should think about government and technology.

Bartlett joins IPI with extensive experience within the technology world, including serving as technology and policy counsel for Americans for Tax Reform (ATR) and prior to that for Senator John Ashcroft of Missouri. Bartlett received his MBA from St. Louis University and his J.D. from the St. Louis University School of Law.

You can join IPI's venture into the e.conomy frontier. Just send your email address to ipi@ipi.org and begin receiving the Center for Technology Freedom's publications.

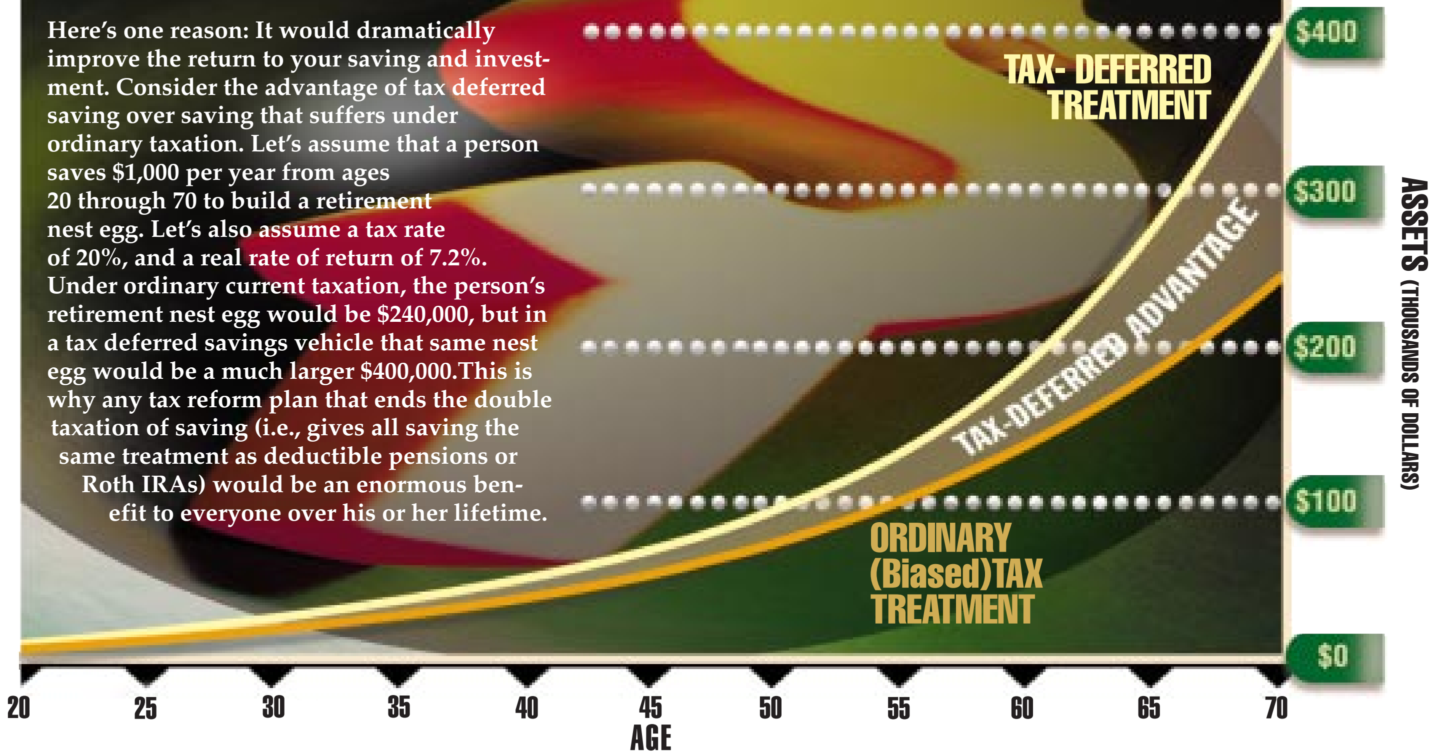
Bartlett can be reached at IPI by email at bcleland@ipi.org.

Center for Technology Freedom Debut Coincides with E-Commerce Hearing

IPI launches its Center for Technology Freedom at a March debut luncheon and press conference at the Fairmont Hotel in Dallas. The Center will also release its first two studies, **Should We Tax the Internet?**, by Merrill Matthews, Jr., and **Old Constitution @ New Economy**, by Lawrence Hunter and George Pieler.

The press conference precedes the last of four nationwide Advisory Commission hearings on electronic commerce, also hosted at the Fairmont. Technology experts and press from around the country will be exposed to IPI's expertise and commitment to technology liberty.

Matthews and Pieler will participate, along with Center Director Bartlett Cleland.



PARTING SHOTS

South Dakota's Governor Bill Janklow warns that a failure to tax the Web might force his state to "disrupt interstate commerce." He might, he says, have to begin "sending out the highway patrol to start pulling over little brown (UPS) trucks," sort out the Internet packages and then "follow" them to their final destinations, where his men would collect the "use tax" citizens owe on out-of-state purchases.

The Wall Street Journal

The Census Bureau has just issued its annual poverty report, claiming that nearly 35 million Americans (13% of the population) are 'living in poverty.' But just what does living in poverty mean?

Today, the typical American defined by the government as poor has a car, air conditioning, a refrigerator, a stove, a VCR, a microwave, a stereo, and a color TV. He is able to obtain medical care. His home is in good repair and is not overcrowded. By his own report, his family is not hungry, and in the last year he had sufficient funds to meet all his essential needs. While his life is not opulent, it is far from what the popular consciousness understands by "poverty."

Robert Rector in *National Review*

The IRS made $51 million in bookkeeping errors; made nearly $16 million in "potentially fraudulent"refunds during the first nine months of last year; and about 25% of the time takes longer than the law allows to remove tax liens on property. Now the Treasury Department wants the IRS to ferret out what are being called "abusive tax shelters." Unleashing an agency with a record like that of the IRS on U.S. business is cruelly ironic.

Investor's Business Daily

The prize for the most intrusive and unnecessary government action has been won hands down by the Labor Department. It sent out an opinion stating that if you work for your employer in your own home, your employer is responsible for federal health and safety violations that occur at your home; i.e., the employer must fix anything in your home that is deemed a safety hazard.

[And] for the quickest backdown, [the] prize goes to the Labor Department, which recanted its opinion two days after news of it hit the papers. Labor Secretary Alexis Herman, however, still says she wants to have a "national dialog" about it.

Caspar Weinberger, *Forbes*

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Direct all inquiries to:
Institute for Policy Innovation
250 South Stemmons, Suite 215
Lewisville, TX 75067
972•874•5139
FAX: 972•874•5144
Email: ipi@ipi.org
Website: www.ipi.org

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