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The Economic Outlook for 1987
A Supply-Side View

By Bruce Bartlett

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THE ECONOMIC OUTLOOK FOR 1987: A SUPPLY-SIDE VIEW

by Bruce Bartlett

The outlook for 1987 is, in my view, going to be largely determined by tax considerations and by the way politicians in Washington react to the consequences of those considerations. 1987 will be a transition year in many different ways, with a great many conflicting signals as to the future course of the economy. Some of these signals, however, are temporarily going to be distorted by the way individuals and businesses react to the new tax environment, thus creating the danger of inappropriate policies being implemented. If such policies are avoided, then the outlook for 1988 and beyond is considerably brightened. If, on the other hand, policy makers misinterpret the economy's signals next year, all the benefits of tax reform may be washed out.

Leaving aside the political uncertainties, my view is broadly consistent with those of the National Association of Business Economists' survey; i.e., the impact of tax reform will be positive in the long run, but in the short run, the economy may suffer from transitional problems. It is difficult to know, unfortunately, how significant these transitional problems may be. They may be as significant as the transition from an inflationary economy to a disinflationary economy has been for us the last several years, or we may find people adapting to the new tax environment relatively easily.

At the extreme, we might argue that a very significant portion of investment in our economy has been directed not by fundamental economics, but by the tax code, just as investment was determined largely by the prospect of rising inflation for many years. Liquidating this malinvestment could be quite painful.

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We do not really know the magnitude of tax-induced distortions in the economy. Various estimates put it at billions of dollars per year in efficiency losses.[1] The goal of tax reform has been to eliminate such malinvestment by creating greater horizontal equity among individuals and industries and by lowering marginal tax rates across the board. On paper, we all know that a reduction in marginal tax rates with the average rate remaining constant should unambiguously lead to increased growth. And most economists seem to accept the idea that this is what the bill will do.

It is important to keep in mind, however, that we have also learned a lot from rational expectations and public choice in recent years. People react to such things as changes in the tax environment in ways that aren't easily predicted, and we must always be aware that the politicians operate according to different rules entirely. The result, of course, is that things that seem perfectly obvious in simple theory do not always work out the way they are supposed to in the real world.

One important way in which theory and reality will quickly diverge is in the revenue consequences of tax reform. As you know, the legislation has been designed to be "revenue neutral." There is, however, little question in my mind that the bill will ultimately come to be viewed as a net revenue loser--perhaps significantly so. Obviously, if this proves to be the case, it will have major consequences for the economic implications of the bill and for policy as well.

There are many reasons why I believe this. For one, there are numerous revenue-raising provisions in the bill which, in my view, will raise little if any revenue to offset rate reductions. Perhaps the best example is capital gains. It is now generally accepted that the 1978 and 1981 cuts in the tax rate on long-term capital gains increased revenue. Yet the official estimates of the tax reform bill

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1. See, for example, Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," American Economic Review, March 1985, pp. 128-138; idem, "The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach," National Tax Journal, June 1985, pp. 125-140; Jacqueline M. Browning, "Estimating the Welfare Cost of Tax Preferences," Public Finance Quarterly, April 1979, pp. 199-219; Charles Stuart, "Welfare Costs per Dollar of Additional Tax Revenue in the United States," American Economic Review, June 1984, pp. 352-362; and Alan J. Auerbach, Laurence Kotlikoff, and Jonathan Skinner, "The Efficiency Gains from Dynamic Tax Reform," International Economic Review, February 1983, pp. 81-100.

assume that raising the maximum rate on long-term capital gains from 20 percent to 28 percent will also raise revenue.[2]

There are also serious questions about the impact of other provisions. I remember clearly hearing Senator Russell Long, when he was chairman of the Finance Committee, complain about the revenue estimates from changes in the investment tax credit (ITC). He noted that every time the ITC was eliminated the government lost revenue instead of gaining it, and whenever the ITC was reinstated government revenue rose instead of falling.

Perhaps more important, congressional economists have grossly underestimated the revenue implications of phasing-in the rate reductions. This creates an enormous incentive for people to postpone income into the future while realizing losses and speeding up deductions. Virtually everyone I know is already making plans to incur deductible expenses this year while putting income off at least until next year. They are also looking for one-year tax shelters to get them through next year, so as to realize income at 1988's tax rates.

The effect of these actions will be to weaken reported income in the fourth quarter of this year and in the fourth quarter of 1987. It is hard to say how much this will distort the GNP figures, but there is little doubt in my mind that the weak GNP growth in the first quarter of 1986 was largely attributable to businesses shifting investment planned for 1986 into 1985 in order to take advantage of the investment tax credit, which was repealed retroactively to January 1, 1986.

Similarly, there will be some businesses for whom the new depreciation schedules are somewhat of an improvement over current law, which will want to put off investment from 1986 to 1987. This is because of the provision allowing the double-declining balance method for depreciation of assets in the three, five, seven, and ten year classes. In addition, the amount of personal property which may be expensed is increased from $5,000 to $10,000, which, again, may push some investment off until next year.

On the income side, I would expect to see multinationals, in particular, reporting significantly lower profits this year, since they have more freedom than most companies to time the realization of profits from foreign operations. To some extent, they can also shift income from U.S. operations overseas.

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2. Ideally, capital gains should not be taxed at all. See Bruce Bartlett, "The Case for Ending the Capital Gains Tax," Financial Analysts Journal, May/June 1985, pp. 23-30.

Timing also will have a big impact on capital gains revenues. With the top rate on capital gains rising next year, there will be a big incentive to realize profits this year. There also will be an incentive for individuals to realize losses this year in order to charge them against this year's higher tax rates. But on the other hand, next year's short-term capital gains tax rate will fall for many taxpayers, although for some low- and middle-income taxpayers the rate will rise. How all this will affect the stock market is hard to predict. Certainly, the big drop in the stock market in July was largely attributable to rumors that the maximum capital gains rate would rise retroactively.[3] Some analysts also suggest that last week's drop in the market was possibly due to institutions anticipating tax-induced stock selling by individuals later in the year.

It is also possible that timing considerations may motivate some corporations to cut back on dividend payments next year and allow shareholders to realize them in terms of higher payments in 1988. I would guess also that the rise in the capital gains rate combined with the reduction in marginal income tax rates will, in the long run, induce corporations to increase dividend payments. At present the combined individual and corporate marginal tax rate on corporate profits is 73 percent. When fully phased in, this rate would fall to just 52.5 percent under the new legislation. Thus corporations will have less incentive to shelter profits for their shareholders by holding cash or buying back shares, so that profits could be realized in the form of higher stock prices and taxed at capital gains tax rates. In the short run, these factors may cause personal income to be lower than it would be otherwise, but in the long run it should be higher.

Another important factor influencing the economic outlook will be the extent to which tax changes have an impact on borrowing. The elimination of the interest deduction for car loans and consumer interest will unquestionably have some impact on incentives to incur debt. Of much greater significance, in my opinion, is the rise in the after-tax cost of mortgage interest, which results automatically from the reduction in tax rates. A dollar of mortgage interest to someone in the 50 percent bracket is only 50 cents, but this will rise to 72 cents when the top rate falls to 28 percent. This will discourage some home buying, primarily, I believe, among those looking to trade up, rather than among first-time buyers.

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3. Another factor might have been that any new investments made after July 1 would automatically no longer qualify for long-term capital gains treatment, since such assets have to be held for at least six months.

I would also note that the scale-back in tax shelters will potentially have a significant effect on borrowing. At present, most tax shelter arrangements involve the incurring of debt in order to achieve multiple write-offs. Therefore, to the extent that such shelters are closed by the passive loss limitations and the expansion of the minimum tax it may reduce debt accumulation.

This should be bullish for interest rates, particularly if the Fed does not tighten monetary policy. And in my opinion, the Fed will not as long as the economy remains sluggish and inflation stays down. I believe the Fed will continue to disregard money growth figures in its policies, again as long as inflation appears under control.

Some might say that the prospect of lower--although still substantial--budget deficits will also be bullish for interest rates. However, in light of my prediction that revenues will be lower as a result of tax reform, it is quite possible that by midyear the deficit forecasts may be substantially above current forecasts, Gramm-Rudman notwithstanding.

This is where my major political concern arises. It is my judgment that Congress may well panic next year and enact a major tax increase. Although there has been talk about raising revenues for deficit reduction for some time, and although the President remains opposed to new revenues, I believe that the pressure next year may make past tax increase efforts seem inconsequential.

This will particularly be the case if, as I believe, the current account deficit also balloons next year. It will balloon because I think capital will be attracted to the U.S. by the prospect of higher after-tax returns, just as it was in 1981, and the only way capital can get into the country is through a current account deficit. In conjunction with this, I also believe that upward pressure will be put on the dollar, especially vis-a-vis the yen. A rising dollar and a rising current account deficit will add to the pressure for a tax increase because many people believe that the budget deficit is responsible for drawing in capital and raising the value of the dollar with all of the effects that has on trade.

Illinois Congressman Dan Rostenkowski, Democrat chairman of the House Ways and Means Committee, is already talking about an increase, not merely in tax revenues, but in tax rates as well. Although it is highly unlikely that Congress would support a tax-rate increase so soon after struggling to bring rates down, there is some likelihood that it may turn toward some type of broad-based consumption tax. The campaign for this has been launched already by a number of business interests. They believe Congress will never cut spending enough to balance the budget and that it will inevitably turn to new revenues. To forestall the possibility of higher business taxes, they are

getting out front early with a form of taxation that can be passed on to the consumer, such as a value added tax (VAT).

Although conventional wisdom suggests that Congress will never enact a VAT, I believe the prospects may not be so bad for two reasons. First, the revenue-raising potential of the VAT means that large amounts of revenue can be raised from low rates. A 1 percent VAT with no exemptions would raise $25 to $30 billion. Thus Congress may find itself attracted to the idea of dealing with the deficit once and for all by the simple institution of a 5 percent VAT. Second, there are many people who believe a VAT is a quick fix for the trade deficit. Since a VAT would be applied at the border on imports and rebated on exports, so the reasoning goes, there should be some restriction of imports and some stimulus to exports. In fact, as the literature makes quite clear, such a system has no effect on trade at all; it simply puts imports and exports on the same footing.[4] Nevertheless, the superficial attractiveness of the idea may win the day.

The Administration probably will counter with renewed efforts to get our major trading partners to stimulate their economies. I suspect we will see a round of discount rate cuts in Germany and Japan before the end of the year, but I think it unlikely that they would adopt much in the way of fiscal stimulus or go as far on the monetary side as the Administration would like. On the other hand, the prospects for some form of U.S.-style tax reform, in at least some countries, is pretty good. Canada will almost certainly adopt some kind of tax reform and similar efforts are already underway in France, Germany, and elsewhere. If these efforts come about quickly, they may mitigate some of the capital outflow, and accordingly, the U.S. current account deficit may not end up being so large.

I believe the merchandise trade deficit will improve next year as the effects of the lower dollar take hold. However, this is unlikely to put an end to protectionist pressure. I increasingly hear talk in Washington about a revenue tariff. This would, so the argument goes, raise revenue for the government, lower the budget deficit, and improve the competitive position of American industry all at once. Again, although such a policy will certainly be opposed by the Administration, I am just not as confident as some of my conservative friends that Reagan will be able to withstand the pressure.

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4. Harry Johnson and Melvyn B. Krauss, "Border Texas, Border Tax Adjustments, Comparative Advantage, and the Balance of Payments," Canadian Journal of Economics, November 1970, pp. 595-602; Melvyn B. Krauss and Peter O'Brien, "Some International Implications of Value-Added Taxation," National Tax Journal, December 1970, pp. 435-440; and Gerard M. Brannon, "Does VAT Provide a Balance of Trade Advantage?" Tax Notes, March 31, 1986, pp. 1387-1391.

Lastly, in assessing the political factors that may have an effect on the economy, we must remember that the presidential race will begin in earnest as soon as the 1986 elections are over. Although President Reagan is not a candidate, he will be under enormous pressure to ensure that another Republican succeeds him. Moreover, as Vice President Bush is a leading candidate to succeed him, we can expect presidential election politics to increase as a dominant factor in policy. In what precise ways policy will be influenced, I cannot say. But just because Reagan is a lame duck is no reason to believe that the 1988 election will not influence his actions.

In sum, I find the greatest threat to the economy coming from political factors. If we can go through 1987 without a major tax increase, without major protectionist legislation, and without some kind of monumental misjudgments by the Federal Reserve, I think we should have smooth sailing from 1988 and beyond, as the positive effects of tax reform take hold. The President will fight strongly for the right policy, but political pressure from Congress and elsewhere may prove overwhelming. For the time being, I am betting on Reagan; but I have my fingers crossed.

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