The Heritage Foundation

Backgrounder UPDATE

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/2/90 Number 141

THE BUDGET SUMMIT AGREEMENT: SERIOUS DAMAGE TO THE ECONOMY, PART II

(Updating *Backgrounder Update* No. 140, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," and *Backgrounder* No. 787, "Rx for the Federal Deficit: The Four Percent Solution," October 1, 1990.)

After five months of negotiations, congressional and Administration budget negotiators produced an agreement which can be only described as deplorable. The package combines the largest first-year tax increase in America's history, dubious economic assumptions, phony spending cuts, and inadequate enforcement provisions. At a time when annual economic growth has collapsed to less than one percent, enactment of the agreement surely would throw the nation into recession. Among the most damaging provisions in the agreement are:

NEW TAXES

Tax revenues are already projected to increase by $397.8 billion between 1990 and 1995, an average of $80 billion in new money each year. Apparently this flood of new tax revenues is not enough to quench Capitol Hill's thirst. Thus Congress has demanded and obtained from the budget agreement $133.8 billion in explicit tax increases over the next five years.

Major provisions include a 12 cents per gallon increase in gasoline taxes, 2 cents of which would be levied at the wholesale level, raising more than $50 billion over five years. To make matters much worse, rather than using gas tax revenues for repair and construction of highways and bridges, the agreement undermines the integrity of the Highway Trust Fund by using half of the money for general government spending. This thus opens the sluice gates for future gas tax hikes simply to fund general revenue outlays. Not only is this bad economics, it raises the cost of travel for every American and undermines one of the nation's most prized characteristics: the easy mobility of Americans.

In addition, there are higher taxes on aviation. The air passenger ticket will jump by 25 percent. Domestic air cargo taxes and aviation fuel taxes also will increase by 25 percent. These taxes will take nearly $12 billion from the travelling public. America is a large country with a highly mobile population. Increasing transportation costs has a particularly detrimental impact on the American economy because of the long distances goods are shipped. Consumers will be particularly hard hit, making it more expensive to visit family members and make business trips.

The package also increases tobacco, beer, wine, and alcohol excise taxes, raising $10 billion over five years. What is most alarming about the kind of taxes being raised is that the agreement sets the precedent for a national sales tax by imposing a 10 percent tax on so-called luxury items, raising nearly $2 billion. Exactly what constitutes a luxury is defined by Congress. It is certain that Congress will add new items to this list over time. The negotiators pulled a tried and true budget gimmick out of the hat. They claim that through stricter enforcement, the Internal Revenue Service can collect $9.4 billion in new revenues.

In addition to a wide range of taxes on American businesses, the package also destroys the insurance nature of Medicare by raising the cap on income subject to the payroll tax from $51,300 to $73,000. Furthermore, the agreement undermines the protections in the tax code for home ownership, state and local taxation, and charitable deductions by restricting the use of itemized deductions.

The agreement contains more tax increases than meet the eye. In what surely must be a deliberate attempt by the White House and Congress to deceive the public, they are including several tax increases in the "spending cut" portion of the package. The monthly tax that senior citizens pay to Medicare will be increased, but the revenues generated by that change are counted as a spending cut. Seventeen different "fees" are to be increased, generating an additional $14.2 billion in revenue for the government over the next five years, yet this money is to be counted as a spending cut. Nearly $5.4 billion of the supposed five-year spending cuts are actually revenues being transferred to the general budget from the Postal Service, which is now off-budget, resulting in no real savings.

Worse still, the agreement contains an automatic tax increase provision by requiring that any future tax cuts be offset by tax increases. Had it been in effect, this provision would have prevented the enactment of Ronald Reagan's Economic Recovery and Tax Act in 1981. At the very least, this provision effectively eliminates any opportunity to pass tax-cut legislation to pull the economy out of the recession which the budget agreement will cause.

DUBIOUS ECONOMIC ASSUMPTIONS

White House and congressional negotiators agreed to "cook the books" to minimize the obvious negative effects of the agreement. While most economists agree that the package will reduce economic growth, the budget summiteers somehow make the assumption that enactment of the package will nearly double the rate of economic growth next year, from 0.7 percent to 1.3 percent, and almost triple growth in 1992, from 1.3 percent to 3.8 percent.

Herbert Hoover thought tax increases would strengthen the economy in 1930. He was wrong; a recession became a depression. More ominously, the budget agreement would push taxes to nearly 20 percent of Gross National Product (GNP). The only two occasions in peacetime that taxes reached 20 percent of GNP, in 1969 and 1981, the economy fell into recession the following year. A recession is the biggest enemy of the budget deficit: The Congressional Budget Office estimates that the deficit would increase by $32 billion for each percentage point that the unemployment rate is higher than projected.

Negotiators have stated explicitly that they want the Federal Reserve Board to adopt an easy money policy in response to the agreement. Yet they ignore the inflationary impact of such a policy by assuming that the inflation rate, as measured by the GNP deflator, will fall to 2.8 percent by 1995. Since government spending is often tied to the price level, a more realistic inflation estimate would expose how much spending will actually increase compared to what is claimed in the agreement.

Perhaps the most unrealistic element of the package is the assumption that interest rates will decline. More than $64 billion of the alleged savings hinges on the interest rate on three-month Treasury bills falling to 4.2 percent and rates for 10-year Treasury notes dropping to 5.3 percent. Since interest rates normally rise and fall with changes in the inflation rate, this assumption has no credibility.

PHONY SPENDING CUTS

Negotiators are trying to sell the agreement as one of "shared pain." Other than the fact that the defense budget is projected to decline by $8 billion, from $300 billion this year to $292 billion in 1993, there are absolutely no cuts in spending. Even excluding the costs of the deposit insurance bailout, total spending under the agreement will rise by more than $220 billion over the next five years.

Since Congress has violated the spending limits in every previous budget agreement, it is a sure bet that spending actually will climb considerably more than the $220 billion already projected. Once realistic interest rate and inflation rate projections are included, any hope of limiting spending increases to $220 billion disappears. Furthermore, if a recession occurs, as many economists predict, spending on welfare and unemployment programs automatically will rise beyond currently projected levels.

INADEQUATE ENFORCEMENT

If history serves as a guide, the meager budget process reforms included in the agreement will fail to break the chronic cycle of tax and spend. Major reforms were completely rejected.

The package does not include a balanced budget amendment. The President was not granted a line-item veto. The current services budget, the feature that allows the negotiators to pretend they are cutting spending when outlays are actually rising, remains untouched. Minor revisions are made by the agreement to strengthen the Gramm-Rudman Deficit Reduction Act. Yet even with these changes, the law can still be waived by the Rules Committee in the House and by 60 votes in the Senate.

CONCLUSION

In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) was enacted with the promise that every dollar of higher taxes would be accompanied by three dollars of spending cuts. The higher taxes became law, but spending actually increased by more than $200 billion over the following three years. This week's proposed budget agreement makes TEFRA look good by comparison.

If enacted, the current agreement is almost certain to push the economy into a recession. What few savings exist on the spending side are almost wholly dependent on unrealistic economic assumptions. The budget agreement effectively repeals Reaganomics and will put an end to the economic prosperity America experienced during the 1980s.

Daniel J. Mitchell
John M. Olin Fellow in Political Economy