

THE DEBT TAX

A drain on our pocketbooks and the economy

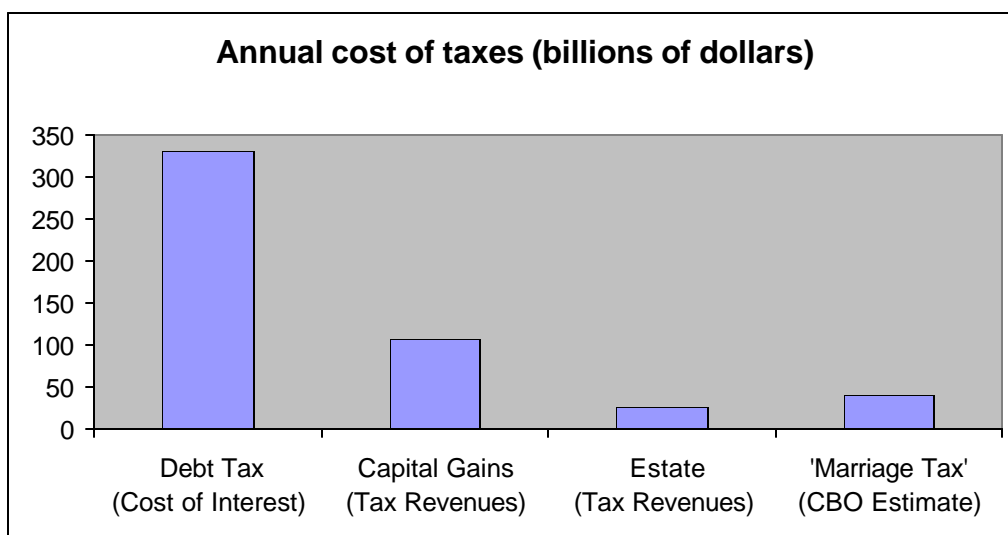
Talking points

What is the 'Debt Tax'?

The United States federal government paid \$332.5 billion in interest last year on the national debt.¹ This payment, equal to 11% of the total federal budget, does not build roads, nor does it provide education, subsidize housing, or create any other service. It merely services the \$6.6 trillion (and growing) national debt. These interest costs are equivalent to a “Debt Tax” – a tax that drains income but does not produce any corresponding service benefit for today's taxpayers.

The Debt Tax is equivalent to \$1,155 annually for each man, woman, and child in the country. That is to say, the average American household pays approximately \$3,153 in taxes annually – about enough to lease a car for a year – just to service the debt. To these households, the Debt Tax is simply money spent with nothing to show for it.

The Debt Tax is bigger than the estate tax (“death tax”), capital gains tax, and “marriage tax” combined.² What’s more, its burden falls on *all* Americans. In contrast, the estate tax is paid by less than 0.1 percent of U.S. households (overwhelmingly, wealthy families), and 90% of capital gains taxes are paid by people with annual incomes of over \$100,000.³ The Debt Tax siphons off revenues that could have been spent on services like health, education, defense, or Social Security – services that would benefit all Americans.



The Debt Tax is likely to grow in the coming years, hurting lower-income Americans the most.

The Debt Tax has been relatively constant over the past 8 years. Interest rates have fallen to historic lows, allowing the government to borrow money more cheaply even as debt continues to rise. The cost of borrowing our \$6.6 trillion national debt in mid-2003 is about the same as the cost of borrowing our \$5 trillion debt in 1995. However, two factors are likely to push the Debt Tax up dramatically over the next several years: 1) rising interest rates; and 2) the increased gap between government expenses and revenues.

First, most economic forecasters believe that interest rates are at or near the end of a long decline, and are likely to rise again in the future. This will increase the cost of borrowing money even if the national debt does not increase. An increase in interest rates would also impose new costs on every American family paying off a mortgage or holding a monthly balance on a credit card. Brookings Institute estimates suggest that current deficits will lead to a run-up in interest rates of at least 1.5% and perhaps as much as 4%. An increase of even 1.5% would raise the mortgage payment on a \$150,000 house by almost 20% (from \$850 to \$1000 per month) and would drive up the average family's credit card interest payments by \$120-\$320 per year.⁴ Such increases would be felt the most by lower-income Americans, who tend to have more credit card debt.

Second, recent budget decisions have increased the gap between federal government expenses and revenues. Federal spending has increased by 13.5% in the past three years, rising from 18.4% of national income in 2000 to 19.9% in 2003. Only half of this increase is attributable to the ongoing "war on terrorism" – and it does not include the extremely expensive engagements in Iraq and Afghanistan.⁵ In addition, the tax cuts of 2001 and 2003 are projected to reduce revenues by \$1.35 trillion and increase interest payments on the debt by more than \$400 billion over the next eight years.⁶

The most recent Administration projections of the federal deficit tell a grim tale. The fiscal year 2003 budget, once expected to be in surplus, is expected to run a deficit of \$455 billion, the largest in the nation's history.⁷ If interest rates remain constant, this year's budget alone will add approximately \$22 billion to annual interest payments - *\$22 billion in Debt Tax, or more than \$200 for every household in America.*

Without big spending reductions or reversal of tax cuts, the Debt Tax burden will grow rapidly. All told, the Administration's figures project that the debt will grow by half through 2008. That could mean an annual increase in the Debt Tax of 50 to 100 percent, adding somewhere between \$500-\$1000 to the average American's tax bill, or \$1,500-\$3,000 to the average family's tax bill. This means that *in five years, the average family could be paying between*

*\$4,500-\$6,000 or more each year in Debt Tax alone – or coping with greatly reduced government services.*⁸

Political issues

It is always easier to agree to pay for something later than to pay for it now. People have a natural tendency to defer costs to the future, and this has allowed the Debt Tax to resurface periodically throughout our nation's history. Nevertheless, past efforts to control the debt have drawn the support of both major political parties, and most Americans recognize the dangers of too much debt.

Past bipartisan support for deficit/debt reduction

In both the 1980s and 1990s, Congress exhibited bipartisan support for deficit reduction. The Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985 set deficit reduction targets for each year, mandating across-the-board spending cuts if deficits were not brought into line.⁹ The Concord Coalition's "Honor Rolls" of Congressional deficit reduction supporters include both Republicans and Democrats.¹⁰

Republican President George H.W. Bush and a Democratic Congress worked together to pass a five-year deficit reduction plan in 1990. And, after passing a tax increase in 1993, Democratic President Bill Clinton worked with a Republican Congress through the rest of the 1990s to restrain spending and bring the budget into balance. In fact, in the mid-90s, the Senate twice came within one vote of the two-thirds needed to pass a balanced budget amendment.¹¹

All Americans can understand the need to reduce the Debt Tax

The potential harm of the Debt Tax is easy for Americans to understand. A government running a large national debt is kind of like an individual running a big balance on a credit card. Most American households use credit cards, and more than half of cardholders carry over credit card debt from one month to the next.¹² However, few would go so far as the federal government currently does. Today's national debt is the equivalent of \$62,000 on each family's credit card! Reducing deficits is a little like cutting back on credit card spending – while some consumers may have trouble restraining themselves, most agree that fiscal responsibility is a good idea.

This sentiment is clear from public opinion polls regarding the 2003 income tax plan. According to two Gallup polls taken in 2003, the share of Americans who say that the federal income tax is "too high" is lower than in any year since 1962.¹³ And, by a 53 to 41 percent margin, Americans say they would rather hold down the federal deficit than lower their taxes.¹⁴

Rebuttals to arguments against

“Debt reduction is not a priority when we're trying to get out of a recession.”

Response: Short-term stimulus packages can be effective.¹⁵ But recent fiscal policy will increase the Debt Tax without providing much short-term stimulus. Just 17% of the tax cuts enacted in the last three years will end up in consumers' pockets this fiscal year, while 54% will not be distributed until the last three years of the ten-year projection period.¹⁶ The tax relief will thus arrive too late to affect the short-term economic picture. By the time it does arrive, the problem may be an overheating economy, not a slumping one.

“Fighting the war against terrorism is more important than debt reduction.”

Response: Homeland security and supplementary defense expenditures are responsible for only a small part of the increase in the budget deficit over the past few years. Congress has budgeted \$90 billion each year in 2003 and 2004 related to the war in Iraq, post-September 11th security increases, and fighting terrorism. This amount represents less than one-fourth the size of the expected budget deficit in 2003.¹⁷ So, while these expenditures contribute to the budget deficit, they are not the main cause – and eliminating them would still leave us with a large deficit. Tax cuts over the past few years have had a much larger impact.¹⁸

“Cutting taxes is a stimulus to economic growth, and may even increase tax revenue by encouraging people to work harder and earn more (taxable) income.”

Response: Cutting taxes may provide a stimulus to economic growth if managed properly, but does not come without costs. Cutting taxes will definitely not increase tax revenues.

Cutting taxes can encourage consumers to spend more, providing a stimulus to economic growth in tough economic times. However, the benefits from cutting taxes must be weighed against the potential costs – ballooning deficits that increase interest rates and choke off growth. William Gale and Peter Orszag of the Brookings Institute calculate that a one percent increase in the deficit leads to a 0.5-1% increase in long-term interest rates.¹⁹ Compared to maintaining balanced budgets, then, the current deficit of 3-4% of GDP may raise interest rates by at least 1.5% and perhaps as much as 4%. Gale expects the tax cuts to slice economic output by 1.6% over the next decade.²⁰

No one has ever successfully demonstrated that cutting taxes actually increases tax revenues. N. Gregory Mankiw, the recently appointed Chairman of President George W. Bush's Council of Economic Advisers, dismissed this notion in a recent textbook as "an example of fad economics."²¹ After the tax cut of 1982, government revenue fell from \$617 billion to \$601 billion in 1983.²² In each of the two years since the 2001 tax cut, federal revenues have fallen.

The Congressional Budget Office estimates that the tax cuts enacted in 2001 and 2002 will reduce this year's revenues by \$126 billion.²³

“Deficits today do not necessarily lead to higher taxes tomorrow. If we reduce spending, we'll be able to devote some of tomorrow's tax dollars to the interest payments, and the total tax bill won't rise.”

Response: Federal spending can and should be reduced when it doesn't effectively serve worthy goals. For instance, each year the government doles out somewhere between \$65 billion and \$195 billion in corporate subsidies that shackle competition and reduce economic prosperity. But the scale of today's deficits is too great to eliminate simply by eliminating these subsidies. Balancing the budget through spending reductions would likely require major cuts to one of three areas – defense, health and Medicare, or social insurance (Social Security and unemployment insurance) – that make up three-quarters of the federal budget. Most of these expenditures have wide public support. The only other alternative is to increase revenues through higher tax rates and collections.

“A Debt Tax is not as bad as an estate tax. Estate taxes hurt small family businesses, and force families to sell them off to pay taxes.”

Response: The claim that estate taxes hurt small businesses is overblown. First of all, this concern applies to *very* few estates – only six of every 10,000 people who die leave a taxable estate in which a family business or farm forms the majority of the estate.²⁴ In 1998, only 1,418 taxable estates in the entire United States fell into this category!²⁵

Second, the tax laws already include special provisions for small businesses. In 2001, a couple with a family business or farm could pass on \$2.6 million of assets without any tax at all. And when the business comprises a significant portion of an estate, tax payments can be deferred over multiple years with interest at below market rates.²⁶

“Too much focus on reducing the debt hurts important spending programs.”

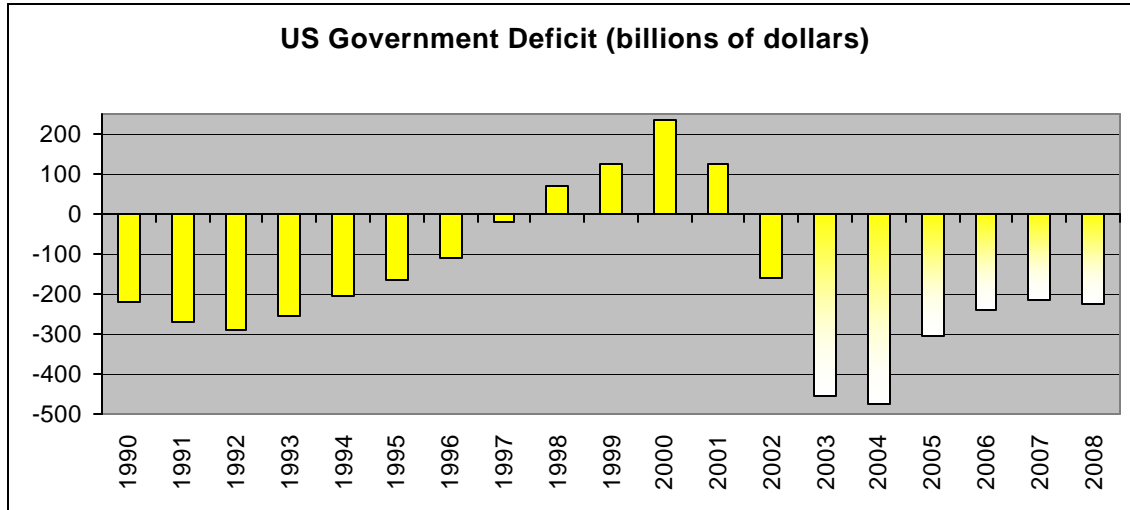
Response: Our government provides many valuable services, including national defense and Social Security to name just two. The question of which services are most valuable to U.S. citizens, and which should be provided by government, is worthy of public debate. But the answer to this question does not change the realities of accounting. What is not paid for now must be paid for at a later time, with interest. Eventually the government must bring its fiscal policy under control, or face a crisis. When the crisis comes, it is almost certain that severe spending cuts will be part of the package. This kind of 'boom-bust' cycle in government spending is destabilizing for the economy, and for citizens who come to rely on useful government programs.

"Many corporations borrow substantial sums of money and use it to invest productively. Why shouldn't America do the same thing to accelerate its growth?"

Response: The analogy of the United States economy to a corporation raises some interesting and useful questions. It's true that many companies are able to borrow money, invest it well, and pay back the loan with excess to spare. However, many economists feel that while this model is appropriate for the business sector, it is not the optimal model for a government. Even when the government uses borrowed money productively, it must be judicious as it pushes up the interest rate for private corporations, potentially 'crowding out' their own investments.

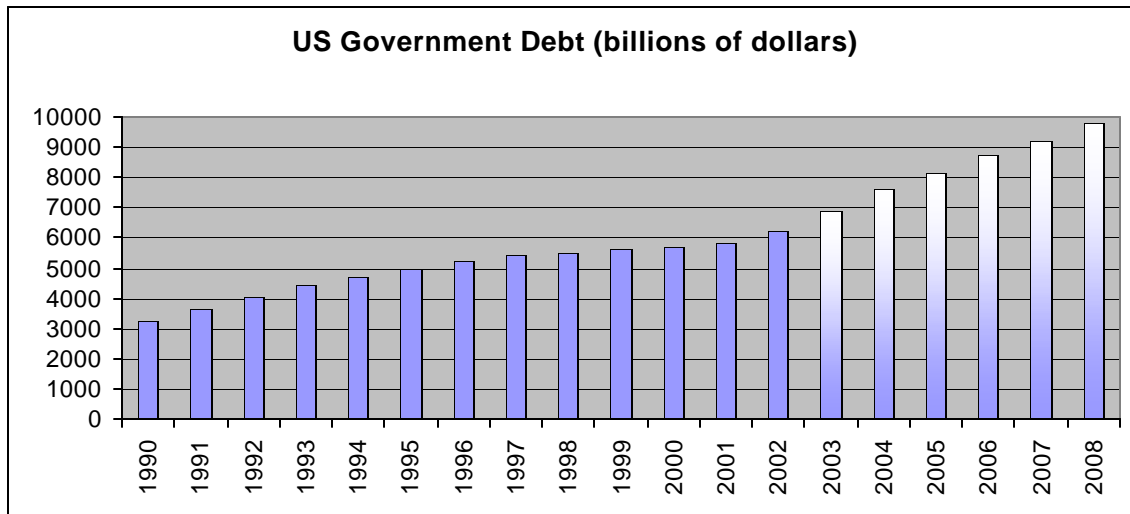
Data appendix

Government deficits



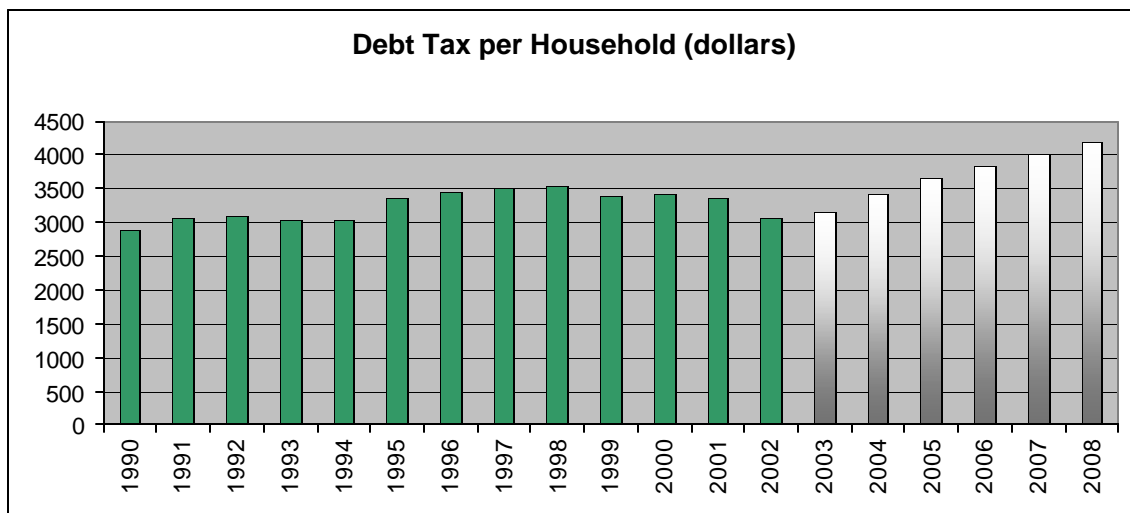
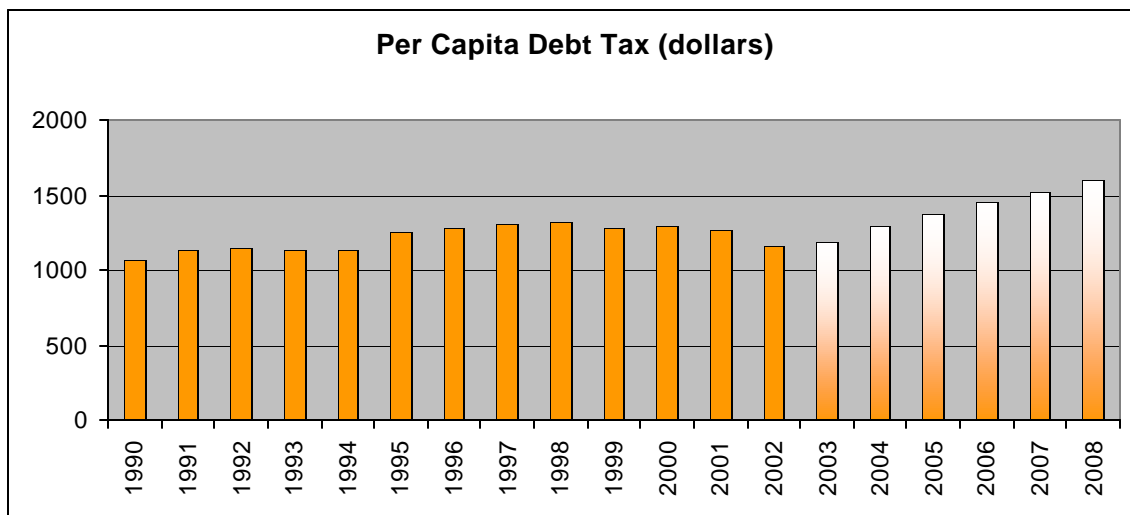
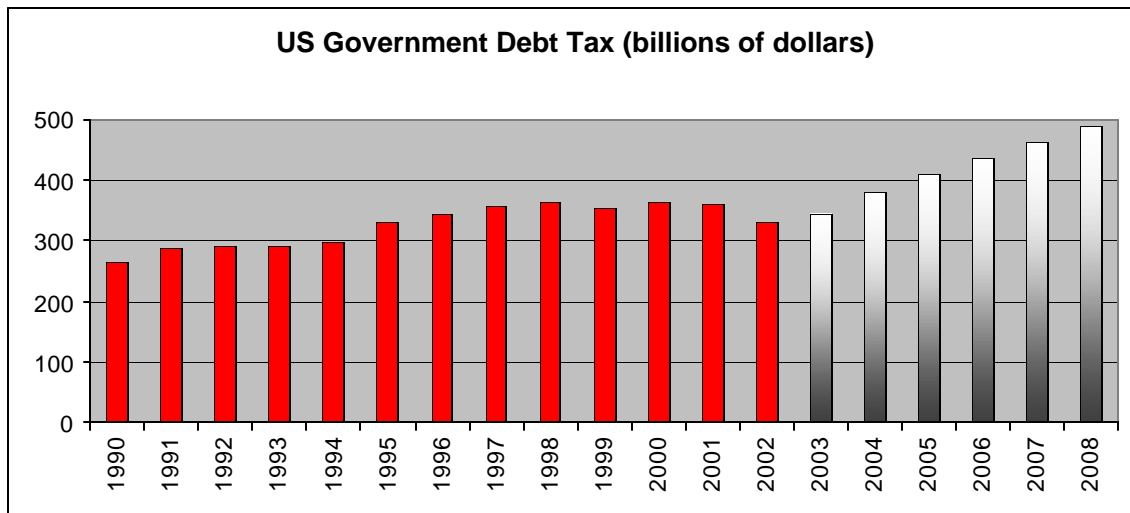
Source: Historical Tables, Budget of the United States Government, Fiscal Year 2004," p26 (available at <http://www.whitehouse.gov/omb/budget/fy2004/pdf/hist.pdf>). Data for 2003 to 2008 are projections from the White House Office of Management and Budget, 2004 Mid-Session Review.

Government debt



Source: Historical Tables, Budget of the United States Government, Fiscal Year 2004," p120-121; available at <http://www.whitehouse.gov/omb/budget/fy2004/pdf/hist.pdf>. Data for 2003 to 2008 are projections.

Estimated size of Debt Tax



¹ Financial Report of the U.S. Government. This includes publicly held debt of \$175 billion plus debt held by federal government accounts.

² Debt Tax is calculated as interest payments on U.S. government debt. Capital gains tax receipts equal 1997-2000 average (source: Annual Report on the U.S. Government 2000), estate tax receipts are for 2002 (source: Statistical Abstract of the United States 2002, p.314). Marriage tax is the maximum estimate of \$40 billion from a June 1997 CBO study ("For Better or For Worse – Marriage and the Federal Income Tax"). The net impact of marriage on taxes across all couples was actually a tax savings; the estimate represents the total amount from couples that had to pay more jointly than they would have separately.

³ Only about 46,000 households are subject to the estate tax in a given year, according to the Center On Budget and Policy Priorities. (See "Estate Tax Affects Very Few Family Businesses," June 17, 2003; available at <http://www.cbpp.org/6-17-03tax-fact2.htm>) The ratio of capital gains taxes paid by high-income households comes from analysis of IRS Individual Tax Statistics (summary data from 2000 individual income tax returns). The specific data is available at www.irs.gov/pub/irs-soi/00in14ar.xls (see the column on taxes paid under 'net gains').

⁴ Mortgage payment calculation uses Interest.com calculator, assuming initial interest rate of 5.5% annually.

⁵ All figures in this paragraph come from *The Economist*, July 3, 2003.

⁶ Brookings Institute, William R. Gale and Samara S. Potter, "The Bush Tax Cut: One Year Later," June 2002, available at <http://www.brookings.org/comm/policybriefs/pb101.htm>.

⁷ Office of Management and Budget, Fiscal Year 2004 Mid-Session Review, p.1. (www.whitehouse.gov/omb/budget/fy2004/pdf/04MSR.pdf)

⁸ To make matters worse, demographic shifts are worsening the long-term fiscal picture. The nation is rapidly aging, and Social Security spending is projected to increase from less than half to almost two-thirds of non-interest federal spending. The coming years will bring a stark choice: reduce outlays on retirement benefits (by raising the retirement age or scaling back benefits), or raise tax rates significantly.

⁹ "Gramm-Rudman-Hollings' Hold on Budget Policy – Losing its Grip?" Preston Miller, Federal Reserve Bank of Minneapolis, 1989. The law was later found unconstitutional, and changed to give OMB the responsibility for making spending cuts.

¹⁰ See www.concordcoalition.org/congress_outreach

¹¹ While a mandatory balanced budget would severely limit our ability to fight economic downturns, the amendment's near-passage demonstrates the strong bipartisan support for fiscal responsibility.

¹² Consumer Federation of America, "Facts about Credit Card Debt and Bankruptcy."

¹³ Peter Peterson, testimony to the House Financial Service Cmte, 4-30-03.

¹⁴ NPR/Kaiser Family Foundation/Kennedy School of Government poll, April 2003; summarized at www.npr.org/news/specials/polls/taxes2003

¹⁵ The Reagan tax cut of 1981 and the Clinton economic stimulus package of 1993 probably both played a role in spurring subsequent economic expansions.

¹⁶ Peter G. Peterson, testimony before the House Financial Services Committee, April 30, 2003.

¹⁷ "War, Tax Cuts, and the Deficit" by Richard Kogan, Center for Budget and Policy Priorities, July 8, 2003.

¹⁸ Ibid.

¹⁹ Gale and Orszag, "The Economic Effects of Long-Term Fiscal Discipline." A few economists claim that there is no strong evidence for a link between deficits and interest rates. See, for instance, "Do Budget Deficits Raise Long-term Interest Rates?", available at <http://www.cato.org/pubs/tbb/tbb-0202.html>. However, the most finds strong support for a link between deficits and interest rates in both economic theory and empirical studies. Gale and Orszag report that only one of 17 studies have concluded that deficits push interest rates down, while twelve concluded that deficits cause interest rates to rise.

²⁰ www.brookings.org/comm/transcripts/20020604.htm.

²¹ *Principles of Economics*, N. Gregory Mankiw, 1998.

²² Budget of the United States Government 2004, Historical Tables, p. 26 (www.whitehouse.gov/omb/budget/fy2004/pdf/hist.pdf)

²³ "New CBO Data Show Deficit Will Be Higher", Isaac Shapiro, Center on Budget and Policy Priorities, May 2, 2003.

²⁴ "Estate Tax Reform – A Costly Windfall for the Wealthiest Americans". Iris Lav and Joel Frideman, Center for Budget and Policy Priorities, February 2001.

²⁵ Ibid.

²⁶ Ibid.