

## REDUCING THE DEFICITS: SEND THE BILL TO THOSE WHO WENT TO THE PARTY

by Jeff Faux

Reaganomics is dead. A virtual consensus has developed among opinion-makers that the economic policies of the last seven years must be dramatically changed in order to avoid collapse. As expressed in the political cliché of the moment, **"The party is over."**

The question now is: Who will pay for the **damage**? Specifically, what sectors of the economy should bear the burden, of efforts to reduce the Federal budget deficit? . .

The debate over budget reduction has been confused by the simplistic notion that **we** Americans have been consuming **"too much."** Therefore, it is argued, the burden of deficit reduction should fall on ordinary consumers who spend most of what they earn. This, for example, is the theme of a group of financial and business executives who have launched a Bipartisan Budget Plan. They call for deep cuts in domestic spending (including Social Security) but only **"restraints"** on military spending. **Increasing taxes** should be a last resort and then **"only** in ways that discourage consumption and encourage savings and **investment."**<sup>1</sup> The poor are promised that they will be spared, as they were when Reaganomics -- based upon similar notions -- was launched seven years **ago.**<sup>2</sup>

The idea that the road to fiscal adjustment must be built on the reduction of the real income of an overconsuming public clearly has influenced the budget compromise reached by Congressional and Administration negotiators on November 20. Military spending is to be cut by \$5 billion while non-military spending is cut by \$6.6 billion. And cancelling or postponing lower tax rates for upper-income people, we are told, should be out of bounds.

In judging this compromise, lawmakers and citizens would be wise to consider the economic and social consequences of solving the problem created by Reaganomics through a strategy that repeats its basic assumptions.

At the very least, the following cautions should be kept in mind:

1. In terms of fairness, the cost of Reaganomics should be

paid by those sectors of the economy that enjoyed its benefits.

2. In terms of economic stability, we should be wary of undercutting the consumer spending that remains the major prop to a tottering recovery.

3. The process of cutting the budget deficit should not be used as a pretext for destroying the capacity of government to deal with the nation's economic and social problems, the way the process of creating the deficit was so used.

#### WHERE HAVE ALL THE BENEFITS GONE?

The central causes of the Reagan fiscal deficits were the budgetary decisions made in the first year of this Administration; military spending ballooned beyond any reasonable level and revenues were reduced through lowering effective tax rates, primarily for upper-income groups and corporations.

#### Spending

The facts regarding federal spending are shown in Figure 1 and in Appendix Table A. Military spending and interest payments have been the fastest areas of growth.<sup>3</sup> Military spending grew from 21.6 percent of all federal outlays in 1980 and is projected to be 27.6 percent in fiscal year 1988. Entitlements have maintained a relatively constant share of the total. Non-military (domestic) discretionary spending, which grew by only \$16 billion from 1980 to 1986, fell as a percentage of outlays from 24.8 percent to 16.4 percent. Interest expense on public debt grew by 160 percent from 1980 to 1986 -- a direct result of the high interest rates and accumulated debt generated by the Reagan deficits.

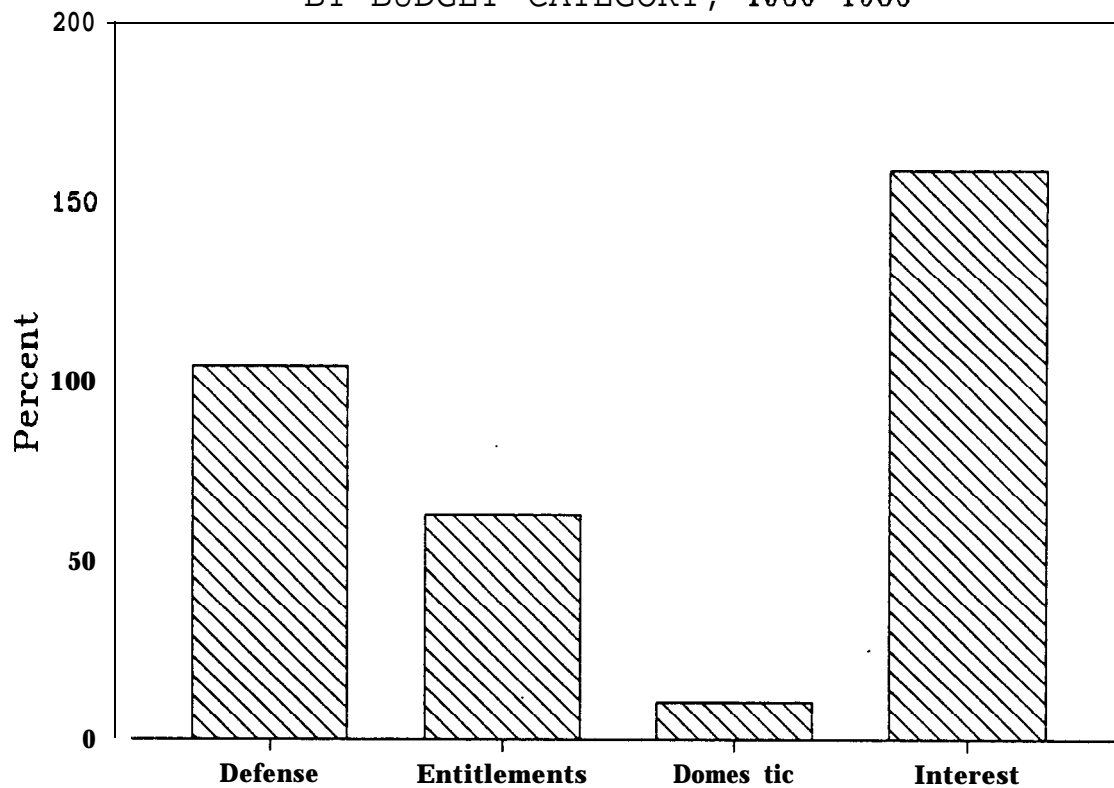
#### Taxes

The facts of the shift in the tax burden are equally clear. As shown in Figure 2 and in Appendix Table B, the federal government actually collected less corporate income taxes in 1986 than in 1980. The major growth area in revenues has been in increased social insurance taxes, primarily Social Security; social insurance taxes grew to 35.5 percent of total revenues in 1987, up from 30.5 percent in 1980, and are expected to become a larger share of revenues in the future. In terms of sources of revenue, the trend has been to reduce corporate taxes and to increase payroll taxes.

The combination of changes in tax sources and in tax rates has yielded a more regressive tax system. That is, despite the recent tax reform, tax rates for low-income people are now higher than they were in 1977 while tax rates for the rich are lower.

Figure 1

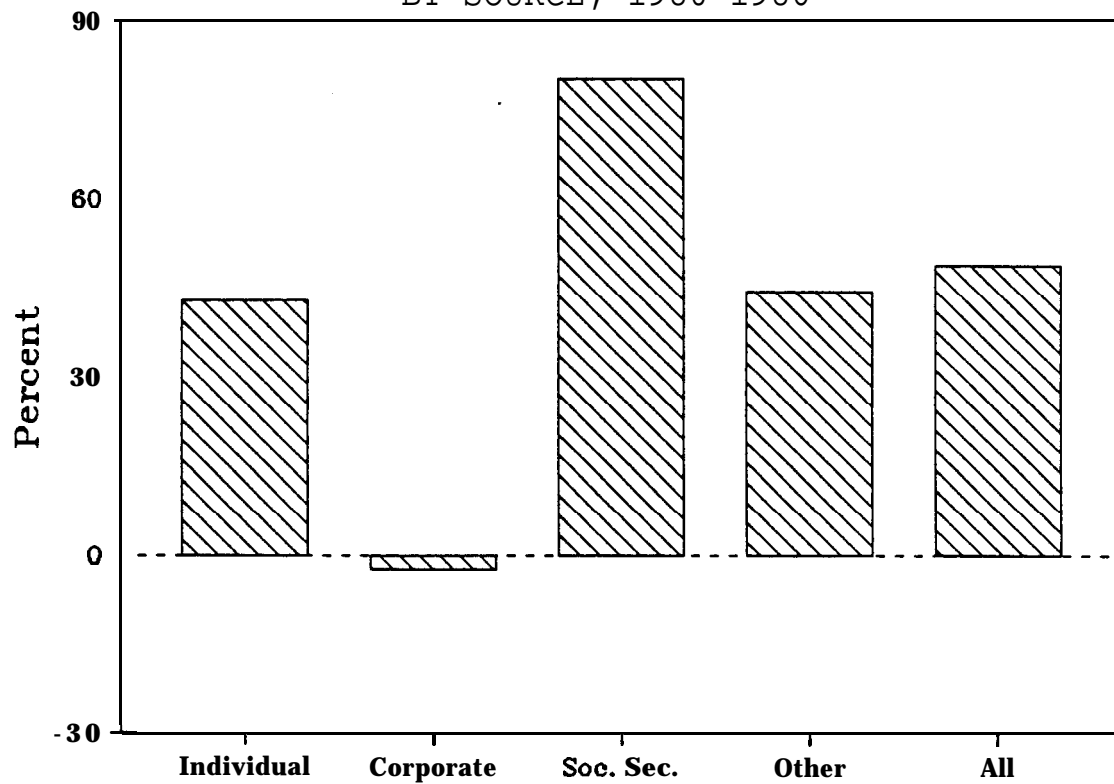
### CHANGE IN FEDERAL SPENDING BY BUDGET CATEGORY, 1980-1986



Source: Appendix Table A

Figure.2

### CHANGE IN FEDERAL TAX REVENUES BY SOURCE, 1980-1986

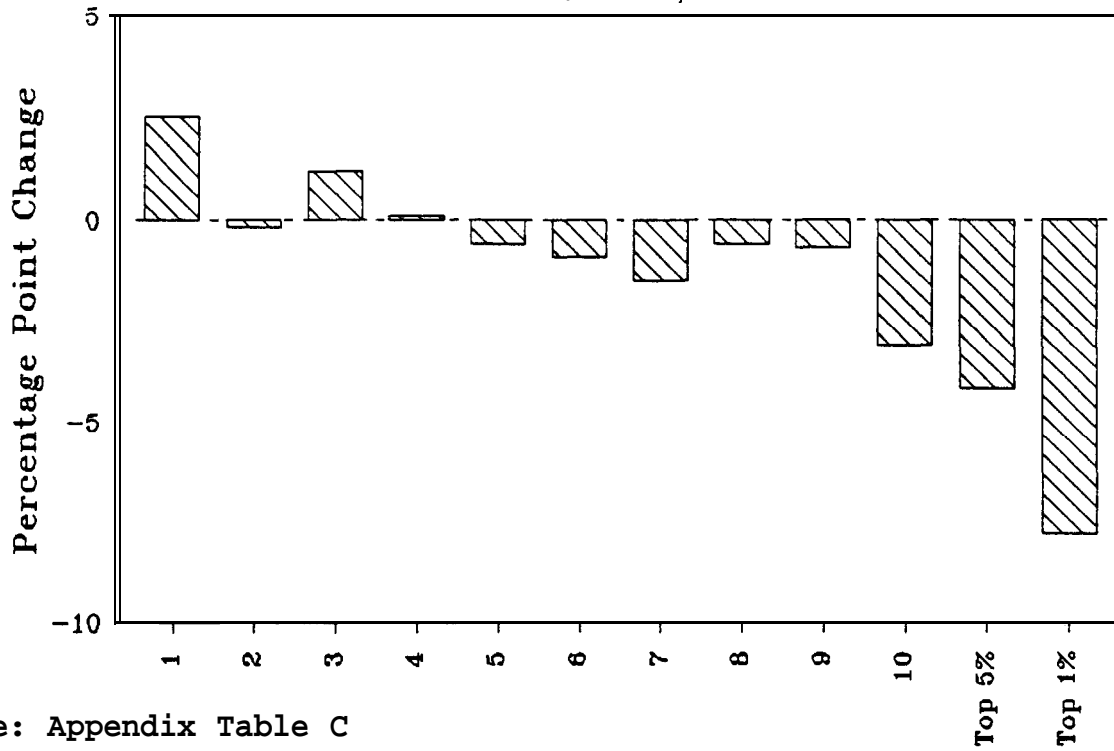


Source: Appendix Table B



Figure 3A

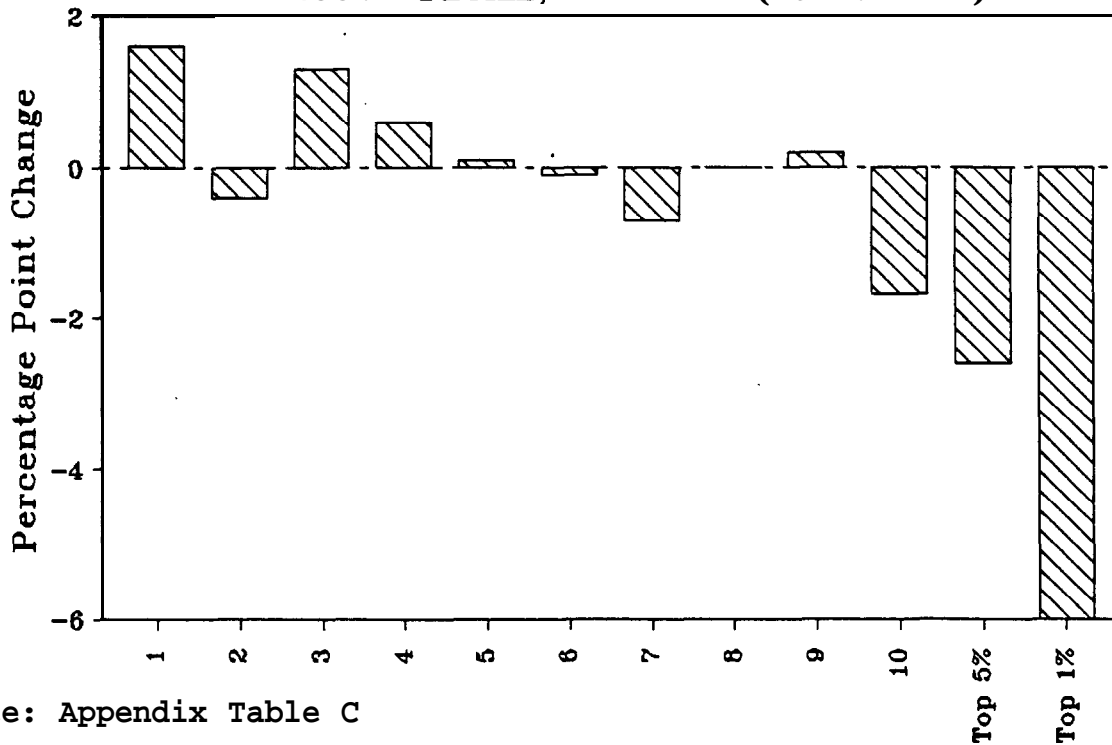
### CHANGE IN EFFECTIVE FEDERAL TAX RATES BY INCOME DECILE, 1977-1984



Source: Appendix Table C

Figure 3B

### CHANGE IN EFFECTIVE FEDERAL TAX RATES BY INCOME DECILE, 1977-1988 (ESTIMATED)



Source: Appendix Table C

The difference between actual income growth and that which would have occurred without a shift in the income distribution is shown in Table 3 and Figure 4b.

Table 3: The Effect of Increased Family Income Inequality*					
Lowest 20%	Lower Middle 20%	Middle 20%	Upper Middle 20%	Upper 20%	Upper 5%
\$-978 -11.2%	\$-1,327 -6.8%	\$-1,152 -3.9%	\$-105 -0.3%	\$3,562 5.1%	\$8,382 7.9%

\* Measured as difference between income growth presented in Tables 1 and 2 above.

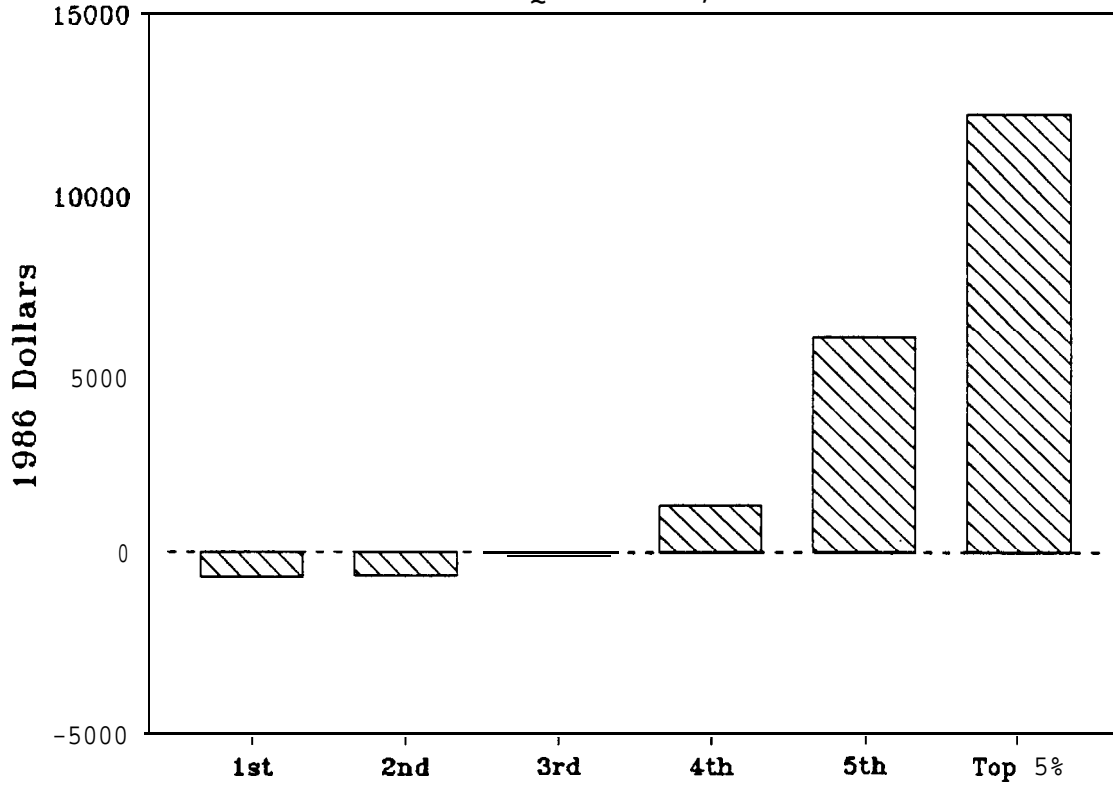
Thus, every income group except the richest twenty percent saw their real income decrease from what it **might** have been if the distribution of income had not become more unequal. In other words, the shift in the distribution of family income only benefitted the upper twenty percent.

Moreover, there is evidence that the benefits of increased inequality were concentrated in the top 10 percent of the family income distribution. Calculations based on a recent study by the Congressional Budget Office show that between 1977 and 1984 increasing inequality shifted some \$96 billion in income (1987 dollars) from the bottom 90 percent of families to the top 10 percent. This amounts to a shortfall of \$1,100 per family for the lower 90 percent and a gain of \$10,000 per family for the upper 10 percent. Projected to 1988, the total income shifted to the top 10 percent amounts to \$129 billion, or a shortfall of \$1,443 per family in the lower 90 percent and a gain of \$13,000 per family in the upper 10 **percent**.<sup>4</sup>

WHO PRODUCES? WHO CONSUMES?

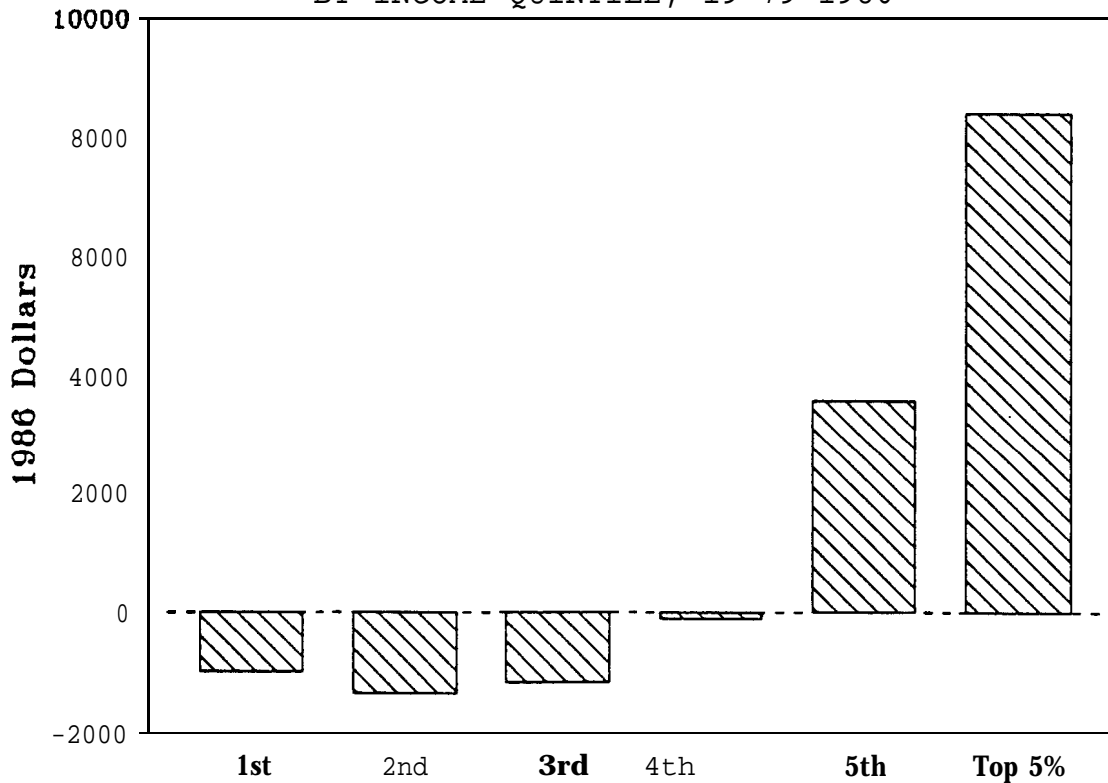
This shift in the distribution of marketplace incomes reflects a dramatic differential in the growth of incomes that derive from labor as opposed to those that are generated by property ownership. As Table 4 shows, property income is inordinately concentrated among upper-income groups.

**Figure 4A**  
**REAL FAMILY INCOME GROWTH**  
 BY INCOME QUINTILE, 1979-1986



Source: Bureau of the Census

**Figure 4B**  
**EFFECT OF INCREASED INEQUALITY**  
 BY INCOME QUINTILE, 1979-1986



Source: Bureau of the Census

Table 4: Distribution of Property Income by Quintile, 1984

<u>Lowest</u> <u>20%</u>	<u>Lower</u> <u>Middle</u> <u>20%</u>	<u>Middle</u> <u>20%</u>	<u>Upper</u> <u>Middle</u> <u>20%</u>	<u>Upper</u> <u>20%</u>	<u>Upper</u> <u>5%</u>	<u>Upper</u> <u>1%</u>	<u>Total</u>
1.3%	5.2%	9.3%	13.0%	70.9%	53.1%	36.8%	100%

Source: Congressional Budget Office, The Chanaina Distribution of Federal Taxes: 1975-1990, October 1987, Table A-3, p. 66.

Since 1979, property income -- the rent, dividend and interest income derived from owning assets -- has substantially **outpaced** income from wages and salaries (Table 5).

Table 5: Growth in Earned and Property Income, 1979-86

	<u>Growth 1979-86</u>
Labor Income*	66.6%
Property Income**	116.5%

\* Wage and Salary and Other Labor Income  
 \*\* Rent, Dividends, and Interest Income  
 Source: Appendix Table D

Thus, while the nation as a whole may have been consuming more than it has been producing, those who are actively engaged in production -- those who work for a living -- have been receiving a smaller share of the income.

**Productivity**

Table 6 shows the relationship between productivity and real compensation since the last major cyclical peak in 1979. While non-farm business output per hour rose 9.5 percent since 1979,

real hourly compensation increased a bare 0.5 percent. The differences are even more stark in manufacturing, where productivity has risen by nearly a third while compensation has actually fallen.

<u>Table 6: Productivity and Compensation Growth, 1979-1987:3</u>		
	<u>Productivity Growth</u>	<u>Real Compensation Per Hour</u>
Non-farm Business Sector	9.5%	0.5%
Manufacturing	32.5	-0.8
<u>Source:</u> Bureau of Labor Statistics		

While wages were falling behind productivity, the growth in unemployment accelerated. Unemployment in the 1980s has been far higher than in any decade since the 1930s. The unemployment rate between 1980 and 1986 averaged 7.8 percent compared with a 6.1 percent rate in the 1970s.

Senior Citizens and Social Security

The elderly have been particularly targeted by the advocates of austerity. In justifying cuts in Social Security entitlements, much is made of the fact that the poverty rate for persons over 65 has decreased while the poverty rate for the population as a whole has risen. In 1979, for example, 15.2 percent of those 65 and older fell below the federal poverty line compared with 11.7 percent of the entire population. By 1986 the poverty rate for the elderly was 12.4 percent compared with an overall rate of 13.6 percent. Therefore, goes the logic of the new austerity, the elderly as a group can "afford" to take lower incomes.

But this modest differential between the poverty rate for the elderly and the rate for the population as a whole hardly justifies cutting back on the very program that enabled many of them to escape poverty in the first place. If we look at the population living at incomes just above the poverty line, we find that 20.5 percent of the elderly are living on incomes below 125 percent of the poverty line as compared with 18.2 percent of all Americans.

Table 7 and Figure 5 show how dependent low-income senior citizens are on Social Security.<sup>5</sup> For example, almost sixty percent of the elderly make less than \$10,000 per year, and the overwhelming bulk of their income comes from Social Security.

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* Table 7: Percentage of Money Income Obtained from Social
* Security by Income Class, 1986
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*           $0      $5,000      $10,000      $15,000
*      - 4,999  - 9,999  - 14,999  - 19,999  $20,000 +  Total
* Soc.Sec. as
* % of income 79.9%   72.9%   49.6%   35.4%   15.8%   40.3%
*
* Share of 65+
* Population 25.7%   33.6%   17.0%    9.5%   14.1%   100%
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Reducing Social Security COLA increases will create an across-the-board reduction in payments, which will obviously hurt low-income Social Security recipients the most. Thus, the austerity argument -- that "middle class" entitlements need to be cut -- is translated into a policy proposal that reduces all Social Security payments thereby forcing significant real income reductions onto the low-income elderly.

Inequality, Savings, and Investment

It has been argued that the increasingly unequal distribution of incomes was necessary in order to produce the economic growth that increased overall incomes during this period. It should be remembered that the avowed aim of the Reagan tax cuts of 1981 was to increase the after-tax income of upper-income groups and business corporations on the grounds that these groups were savers and investors. Lowering their tax rates was supposed to increase the supply of savings, which in turn would produce a "supply-side" investment boom and accelerate economic growth.

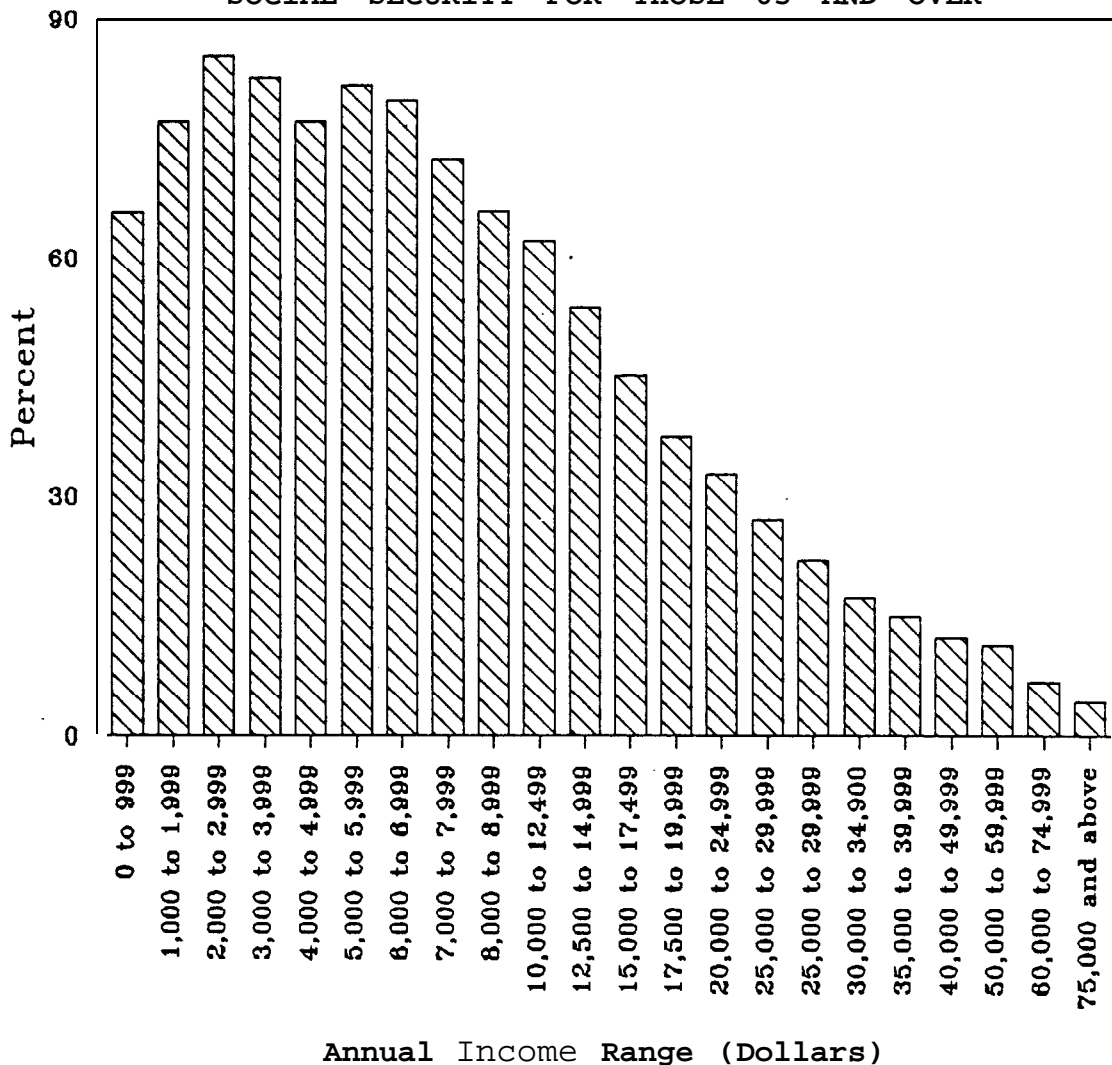
But despite the shift in real income away from "consuming" lower- and middle-income people and toward upper-income people and business, the promised boom in savings and investment never materialized. In fact, the personal savings rate dropped from 7.8 percent of disposable personal income on average for the decade ending in 1981 to a post-depression low of 3.0 percent in the second quarter of this year. And despite the fact that the corporate cash flow was swollen by increases in depreciation allowances and other tax benefits, real corporate business fixed

investment **has** risen a mere 2.6 percent per year during Ronald Reagan's tenure, as opposed to 7.1 percent under his predecessor. In terms of overall growth, **real** GNP increased by 3.0 percent per year from 1976 to 1980, in contrast with a 2.6 percent real growth of GNP during the 1980-1986 period.

There is no credible evidence that shifting taxes from business and high-income families to moderate- and low-income workers has any effect on investment. What investment we have had has come in the traditional way, i.e. business response to increases in consumer spending.

Figure 5

**PERCENT OF 1986 INCOME DERIVED FROM  
SOCIAL SECURITY FOR THOSE 65 AND OVER**



Source: Bureau of the Census

## CLEANING UP: THE FIRST STEPS

Seven years of Reaganomics has proven tragic for the American economy. It will prove to be even more tragic if we repeat the error of its assumptions in an effort to escape its consequences.

In the very short-term, we face the problem of avoiding a recession. The huge amount of debt overhanging consumers, the banking system, the U.S. government, and the Third World could turn even a shallow recession into a downward-spiraling economic collapse.

Therefore, the deficit must be reduced in a way that does not undermine the basic consumer purchasing power that has driven the little economic growth we have had. The risk is that the cuts in the deficit will be translated into reductions in consumer income and spending before an equivalent countervailing stimulus from lower interest rates and the lower dollar can take hold. As Harvard economist Francis **Bator** points out, "Bringing about such a switch is a delicate task best done gradually and when the economy is expanding rapidly. Fiscal compression works predictably and fast; monetary ease, acting in part through the exchange rate, works only slowly -- the lags are variable and **long.**"<sup>6</sup>

Those who advocate drastic sudden reductions in federal spending are asking us to risk a recession through the contraction of the buying power of a majority of Americans in order to restore "confidence" to high-income investors in the stock and bond markets and insure them against the pain of inflation. It is too high a price to pay. The **essential** purpose of economic policy should not be to re-excite the nation's financial casinos, but to ensure that the deflation in those sectors does not spread to the "**real**" economy -- the circulation of income between buyers and sellers of goods and services.

Given the "delicate **task**" of reducing the deficit and avoiding a recession, total budget deficit reductions ought to be modest, certainly no more than the \$30 billion recommended by the budget negotiators on November 20.

And given the unequal distribution of the benefits of recent economic policies, measures to reduce the deficit ought to be concentrated on those sectors of the economy which have benefited

most. A reasonable budget package might include the following major elements:

1. Maintaining the income tax rate for upper income groups at 1987 levels.

2. Freezing military spending in current dollars for the next three years.

3. Taxing economically counter-productive financial activity. Options include reducing the tax benefits for corporate acquisitions and hostile takeovers, a transfer tax on security purchases, and a tax on short-term capital gains from buying and selling of securities.

A combination of some of the above elements (together with the package of assorted loophole-closing measures in the House and Senate reconciliation bills) would easily add up to the overall target deficit reduction already agreed upon, and thus help to clean up the immediate mess. We should also avoid making any irrevocable decisions. In the event of an economic downturn, the budget reduction cure can often be worse than the disease -- as we learned in the 1930s.

There will remain, of course, the long-term structural damage done to the American economy by policies that have made us the largest debtor nation in the world. Repairing the damage will require: (1) the development of new international arrangements so that other industrial nations, particularly Germany and Japan, can share the burden of maintaining the global demand for goods and services; (2) restructuring the Third World debt so that underdeveloped nations can once again import capital goods from America to support long-term growth both here and there; (3) a multiyear strategy for increasing the competitiveness of U.S. industry through sensible trade and industrial policies to expand domestic business investment; and (4) expanded public investment in human and physical resources.

But as we begin the task of getting our economic house in order, we should be skeptical of clean-up suggestions from Wall Street that call for other Americans to make additional sacrifices in order to bolster their shaken confidence. Certainly the first people to whom we should hand the mop are those who spilled the punch.

November, 1987

APPENDIX

Table A: Federal Outlays for Major Spending Categories

<u>Year</u>	<u>Natn'l Defense</u>	<u>Entitlements</u>	<u>Domestic Spending</u>	<u>Interest</u>	<u>Outlays</u>
(in billions)					
1980	\$134.0	\$280.6	\$154.2	\$ 52.5	\$621.3
1986	273.4	457.3	170.3	136.0	1037.0
1987	282.0	N/A	N/A	138.5	1038.8
1988 est.	297.5	N/A	N/A	144.7	1077.6
<u>Increase in Outlays, 1980-86</u>					
	\$139.4 104.0%	\$176.7 63.0%	\$ 16.1 10.4%	\$ 83.5 159.1%	\$ 415.7 66.9%
<u>Shares of Total Outlays</u>					
1980	21.6%	45.2%	24.8%	8.5%	100.0%
1986	26.4	44.1	16.4	13.1	100.0
1987	27.1	N/A	N/A	13.3	100.0
1988 est.	27.6	N/A	N/A	13.4	100.0

Note: Outlays as shown above are calculated by adding "offsetting receipts" to "total outlays."

Source: For 1980 and 1986 data, Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1988-1992, January 1987, Table F-5, p. 159. For 1987 data, Department of the Treasury, Final Monthly Treasury Statement of Receipts and Outlays of the United States Government, September 1987, Table 9, p. 29. For 1988 estimates, Office of Management and Budget, Mid-session Review of the 1988 Budget, August 17, 1987, Table 13, pp. 32-33.

Table B: Federal Revenues by Major Source

<u>Year</u>	<u>Individual Income Tax</u>	<u>Corporate Income Tax</u>	<u>Social Ins. Taxes &amp; Contributions</u>	<u>Other Sources</u>	<u>Total</u>
	(billions)				
1980	\$244.1	\$ 64.6	\$157.8	\$50.6	\$517.1
1986	349.0	63.1	283.9	73.1	769.1
1987	392.6	83.9	303.3	74.3	854.1
1988 est.	396.1	105.4	331.8	75.7	909.0
<u>Increase in Revenues, 1980-86</u>					
	\$104.9 43.0%	\$ (1.5) -2.3%	\$126.1 79.9%	\$22.5 44.5%	\$252.0 48.7%
<u>Shares of Total Revenue</u>					
1980	47.2%	12.5%	30.5%	9.8%	100.0%
1986	45.4	8.2	36.9	9.5	100.0
1987	46.0	9.8	35.5	8.7	100.0
1988 est.	43.6	11.6	36.5	8.3	100.0

Source: For 1980 and 1986 data, Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1988-1992, January 1987, Table F-3, p. 157. For 1987 data, Department of the Treasury, Final Monthly Treasury Statement of Receipts and Outlays of the United States Government, Table 9, p.29. For 1988 estimates, Office of Management and Budget, Mid-session Review of the 1988 Budget, August 17, 1987, Table 11, p.29.

Table C: Effective Federal Tax Rates, By Population Decile:  
Corporate Income Tax Allocated to Labor Income

<u>Decile</u>	<u>1977</u>	<u>1984</u>	<u>1988</u>
1st	8.0%	10.5%	<b>9.6%</b>
2nd	8.7	8.5	8.3
3rd	12.0	13.2	13.3
4th	16.2	16.3	16.8
5th	19.1	18.5	19.2
6th	21.0	20.1	20.9
7th	23.0	21.5	22.3
8th	23.6	23.0	23.6
9th	24.5	23.8	24.7
10th	26.7	23.6	25.0
Top 5%	27.5	23.3	24.9
Top 1%	30.9	23.1	24.9

Percentage Point Change In Effective Federal Tax Rates

<u>Decile</u>	<u>1977-84</u>	<u>1984-88</u>	<u>1977-88</u>
1st	2.5%	<b>-.9%</b>	1.6%
2nd	-.2	-.2	-.4
3rd	1.2	.1	1.3
4th	.1	.5	.6
5th	-.6	.7	.1
6th	-.9	.8	-.1
7th	<b>-1.5</b>	.8	-.7
8th	-.6	.6	0.0
9th	-.7	.9	.2
10th	<b>-3.1</b>	1.4	-1.7
Top 5%	-4.2	1.6	-2.6
Top 1%	-7.8	1.8	-6.0

Source: Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975 - 1990, October, 1987, Table 8, p. 48.

**Note :** All Federal taxes (individual income tax, Social Security taxes, corporate income tax, and excise taxes) are included. These embody the most conservative assumptions. For example, allocating corporate income to capital income (as in The Changing Distribution of Federal Taxes, Table 7, p. 47) shows a more regressive pattern of effective tax increases and decreases across **deciles**.

Table D: Growth and Shares of Market-Based Personal Incomes, \*  
1979-86

<u>Types of Income</u>	<u>Growth</u> <u>1979-86</u>	<u>Share of Income</u>	
		<u>1979</u>	<u>1986</u>
1. Proprietor's Income	51.1%	10.4%	9.1%
2. Total Labor Income	66.6	74.6	72.1
Wage and Salary	66.9	68.0	65.8
Other Labor Income	63.9	6.7	6.3
3. Total Property Income	116.5	14.9	18.8
Rent	198.2	0.3	0.5
Dividends	68.9	2.6	2.6
Interest	124.8	12.0	15.7
4. Total Pre-tax, Pre-transfer Income*		100.0	100.0

\*Personal Incomes plus contributions for social insurance and less income from transfer payments.

Source: National Income and Product Accounts, Table 2.1

#### Footnotes

<sup>1</sup>**"Time for Decisive Action: A Bipartisan Plan,"** advertisement, New York Times, 9 November, 1987.

<sup>2</sup>**The** similarity between the Bipartisan Plan and the basic intent of Reaganomics is suggested in the following excerpt from the 1982 Economic Report of the President, February 1982, pp. 116-117: **"The** Administration seeks to increase capital formation by both raising the level of output and reducing the fraction of output consumed. ..to achieve a higher national savings rate it is important to lower the household consumption **rate."** The Administration also promised to "maintain the integrity of the social insurance programs while reforming entitlement programs to ensure that they serve those in greatest **need."**

<sup>3</sup>**Tables** 1, 2, and 3 are based on an analysis of Census Bureau P-60 series data on shares of family income by quintile, the number of families and aggregate family income (in 1986 dollars) in 1979 and 1986. Average real family income per

Footnotes (continued)

quintile is that quintile's share of aggregate real income divided by a fifth of the number of families. The growth of real family income from 1979-86 without any change in distribution is obtained by applying the mean growth of all family income to each quintile's average income in 1979. The effect of the distributional shift is the difference between actual growth of each quintile's average family income and that which would have been achieved if family income in that quintile had experienced average growth. Census data on family income includes all money income -- market-based incomes plus government cash transfers and retirement incomes.

<sup>4</sup>**These** calculations are based on an analysis of data presented in the recent CBO study, The Changing Distribution of Federal Taxes: 1975-1990, October 1987. Specifically, aggregate family income was derived as the product of mean family income in 1987 dollars from Table 6, p.39 and unpublished data on the number of families in each year in the CBO study. Table A-2, p.65 shows the share of income of the highest **decile** in 1977 and 1984 and an estimate for 1988. The total dollar amount of the shift in income due to the change in income distribution is calculated as the difference between the top **decile's** share of income at the beginning and end of a time period times the aggregate income at the end of the time period. The per family calculations distribute this change in income to 90 percent and 10 percent of the families at the end of the period.

<sup>5</sup>**The** Social Security calculations are based on unpublished tables provided by the Bureau of the Census. Aggregate total income and aggregate Social Security income (which includes some railroad retirement) by income class were computed by multiplying the number of persons receiving the income in each class and the mean income or Social Security payments of recipients in each class (taken from Tables **P14A** and **P14B**). The percentage of income for each income class derived from Social Security was then calculated by dividing aggregate Social Security income by aggregate total income.

<sup>6</sup>**Francis Bator**, "How To Protect the Global Economy," New York Times, 4 November 1987.