A $10 Trillion Tax Cut-- It's more serious than you think!

By Warren B. Mosler and Thomas E. Nugent

As the politicians quibble over a few hundred million of the proposed $1.6 trillion tax cut, the world economy continues to implode. Seems the Washington elite have forgotten (or never knew?) the fundamental economics 101 accounting identity: a government surplus is NECESSARILY equal to the (same period) private sector deficit (including domestic business and individuals, and any foreigners dealing in $US). Therefore, the U.S. surplus of $250 billion reduces private sector savings EXACTLY by the same amount.

One could argue that, during an expansion, governments should run a surplus and thereby reduce private sector income and savings to slow consumption and prevent inflation. But now, during a slowdown, with consumers choking on debt as their savings hit historic lows, stock market equity reduced by over $4 trillion, intense competition, excess capacity, and rising unemployment, continuing this policy only ensures economic calamity.

There are two choices. The first is to boldly reverse course and proactively get the Federal budget into deficit to restore private sector savings. The second is to let market forces already underway restore savings through 'automatic' deficit spending via rising unemployment compensation and falling tax revenues during the ensuing economic slowdown. Obviously, the former makes a lot more sense than the latter.

How much of a fiscal adjustment is necessary? Given a projected 3.1% economic growth target over the next 10 years, and the current consensus level of Federal spending, a supportive tax structure would allow for nominal savings to grow at the traditional 2-3% of GDP annually. Targeting growth in savings means targeting an equal Federal deficit. Since the current tax structure projects a surplus of $5.6 trillion over that period, targeting the needed deficit would result in a tax structure that would project revenues over $10 trillion less than the current tax structure, with the first year's cut amounting to about $500 billion. The important thing is to remember our target is economic growth, and therefore maintaining a tax structure that supports reasonable growth.

A little bit of history is in order. Japan let it's budget go into surplus in the late 80's the same way we did 10 years later in the late 90's, and so far results have been quite similar. Their stocks peaked in 1990 as ours did about 10 years later. Their policy response was to lower interest rates, just like ours has been. They kept their budget in surplus until the slowdown erased it by 1992, and we seem intent on doing the same. Real estate prices in Japan peaked in '91 and have come down every year since, and our real estate prices seem to have peaked last year and have begun to fall, too. After '91 Japan experienced the destruction of most of the equity in the banking system due to the falling asset prices and falling income. We are in for the same fate if we also choose to rely on monetary policy alone. Fed interest rate cuts, though welcome, can perhaps encourage a bit more consumer debt, but can't replenish our lost savings. So don't expect too much from monetary policy, as Japan has learned the hard way.

Will our politicians recognize the storm on the horizon soon enough? Not likely! Our state governments, corporations, and individuals respond to falling revenues by cutting expenditures as they must, and when the green eyeshades at OMB begin to lower their surplus forecasts in the slowing economy our Federal government seems predisposed to cut spending as well. Remember, only about 10 years ago Congress not only let the recession generate the $300 billion deficits (about 5% of GDP) which restored savings and set the stage for the tech driven expansion that followed, but altered the tax structure to increase tax collections, and then went on to brag about the surpluses that are draining the lifeblood from the U.S. economy.

What can be done to avoid a repetition of the Japanese experience? Just so happens an immediate, 'temporary,' suspension of the payroll tax, at least until the economy begins breathing on its own, would remove about the right amount of fiscal drag. It would also both lower business costs and consumer prices and restore income to a group with a high propensity to spend. Unfortunately, the prevailing rhetoric has tied the payroll tax to the Social Security trust fund, and any politician that dare recommend suspension of that tax would be accused of raiding the trust fund. Ironically, however, without a gold standard (dropped in 1971), careful analysis shows that Social Security payments can simply be declared direct obligations of the US Treasury, just like the rest of the government's payroll. That simple declaration permanently insures timely remittance of any and all social security payments. It would also stop dead forever directing scare tactics toward vulnerable groups for political gain. And, of course, once free of the vestigial self-imposed constraints, Congress would be free to engage in truly responsible fiscal policy.

Warren B. Mosler is principal, AVM; L.P. Thomas E. Nugent is a vice president of Wealth Management Services

Warren Mosler
Principal, AVM L.P.
250 Australian Ave. So.
West Palm Beach, Florida 33401

Thomas E. Nugent
Vice President, Wealth Management Services
12707 High Bluff Drive, Ste 200
San Diego, CA 92130
858-350-4244

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