PERSONALLY SPEAKING

Number 55 ***February 3, 2009***

WHEN THE DUST SETTLES WHO PAYS?

Edward J. O'Boyle, Ph.D.
Mayo Research Institute

No one knows for sure how much deficit spending and borrowing the federal government will do in the months ahead in order to cope with the current economic crisis. Even so, it figures to be at least $1 trillion ($1,000,000,000,000). At current interest rates for U.S. Treasury securities which average around 3.9 percent, the interest payable on $1 trillion amounts to $39 billion per year.

We will know more after the dust settles. In the meantime, we can come to grips with the cost of borrowing by reviewing the obligations already on the federal books -- the current size of the public debt, the interest paid on the debt, and who holds the debt and therefore who gets the interest paid.

Current data from the Treasury put the public debt at $10.6 trillion. The ceiling on the debt was re-set by Congress last October at $11.3 trillion. Various government agencies hold $4.3 trillion. The Social Security Trust Fund, for example, holds $2.2 trillion. The public holds the balance -- $6.3 trillion – of which about one-half is held outside the United States. Major foreign holders include investors in China, Japan, United Kingdom, a group of six banking centers in the Caribbean, a group of 15 oil exporting countries, and Brazil.

Total interest paid on the entire public debt during the fiscal year ending last September was $451 billion. Across the entire federal budget, interest paid on the debt is exceeded only by the Defense Department ($595 billion) and Medicare ($461 billion). At $510 billion Social Security outlays also surpass interest payments, but Social Security is an off-budget item.

Over the last three months of 2008, $135 billion was paid in interest on the public debt. Projecting that over a 12-month period indicates that the total to be paid in the fiscal year ending in September could reach $540 billion.

Unless all of the budget shortfall is financed through borrowings, the deficit eventually will call for higher tax rates. A brief review of the tax side of the budget is instructive as to whose taxes likely will increase. The individual income tax contributes more to the federal budget receipts -- $1.1 trillion -- than any other tax. The corporate tax is second in line contributing a total of $304 billion. The remaining tax sources which include excise taxes, estate and gift taxes, and customs duties, taken together, contribute less than the corporate tax alone.

Federal excise taxes are imposed on gasoline, cigarettes, trucks, fishing equipment, local telephone service, and a host of other items. Does the road warrior know that the federal tax on gasoline is $.184 per gallon, on diesel for highway vehicles is $.244 per gallon?

European countries have used a similar tax called an ad-valorem tax for years. The "beauty" of such a tax is that it is hidden from view. The tax is folded into the price of the item and for that reason the average buyer doesn't know how much tax he/she is paying.

Mayo Research Institute sees the possibility that legislation will be introduced in Congress this session to adopt ad valorem taxes as a way of paying for the additional interest on the ballooning public debt. Perhaps on bread, shoes, baby formula, shirts, towels, toilet paper, toothpaste, orange juice, soft drinks, ink cartridges, and more. The consumer will notice that prices are higher and will blame it on inflation or on greedy merchants. Meanwhile, the federal government silently pockets the money.

Higher individual tax rates are a possibility because they are huge revenue generators and because roughly 40 percent of all Americans are not required to pay that tax and therefore would have little or no reason to oppose higher rates. Higher corporate tax rates also are a possibility because they too generate a large revenue stream and corporations may be able to shift the tax increase to their customers if their efforts to resist those hikes through their Washington lobbyists fail.

For years there has been support, though clearly far too little to change minds in Washington, to replace the present individual income tax with its higher marginal rates for filers with higher incomes and its voluminous details with a simple flat tax. Under a flat tax, everyone (excluding those below the poverty level on grounds that the federal government already has defined them as having too little income to meet their basic needs) would pay the same rate of taxation, no credits, no deductions, no exemptions, no loopholes. The rate could be set at a rate which would replace the $1.2 trillion in taxes paid by individuals in FY 2008. The tax revenues from the flat tax would increase automatically as incomes rise. The tax could be put in place for a fixed period, say four years, subject to renewal or change only by a national referendum at the time of the November elections. That vote, in effect, becomes a referendum on the performance of elected public officials in Washington. Conceivably that vote could be extended to the debt ceiling to force additional discipline on a Congress which at present whenever it runs a deficit and adds to the public debt simply raises the debt ceiling.

In addition to greatly simplifying tax filing, a flat tax would reduce the special interest lobbying in Washington to change the present complex tax rules and procedures for some special advantage and would reduce the inducement for lobbyists and their clients to curry favor with elected public officials by contributing to their election campaigns.

With less money to be raised for political campaigns, incumbent public officials would be able to spend less time on fundraising and more time on the public's business. And with less costly campaigns greater opportunities for newcomers to challenge incumbents. Barack Obama raised $750 million to get elected last November. In the absence of serious income and corporate tax *reform* in Washington – we've tried campaign fundraising reform and it failed miserably in 2008 -- does it seem likely that a challenger could run for president in 2012 without matching Obama's fundraising record?

We will know more when the dust settles, perhaps in time for the 2010 mid-term elections.

Edward J. O'Boyle is Senior Research Associate with Mayo Research Institute. Since completing his doctorate in economics from Saint Louis University more than 35 years ago, Dr. O'Boyle has specialized in economic research and analysis increasingly from the perspective of the human person engaged in everyday activities both as a unique individual and as a community member. In January 2004 the Association for Social Economics conferred on Dr. O'Boyle its prestigious Thomas Divine Award for lifetime contributions to social economics and the social economy. He taught economics at a state university in Louisiana for 30 years prior to his retirement in 2007.

Mayo Research Institute   1217 Dean Chapel Road   West Monroe, Louisiana 71291
edoboyle@earthlink.net   www.mayoresearch.org   318-396-5779 & 318-381-4002