NCPA

National Center for Policy Analysis

POLICY BACKGROUNDER No. 105
For people with limited time and a need to know.

For Immediate Release
September 6, 1990

Budget Summit Issue:

DO WE NEED NEW TAXES?[1]

"With the U.S. economy on the verge of a recession, do we need an increase in taxes?"

Background. In budget summit negotiations, the President and Congress originally had agreed in principle to reduce the federal deficit by $50 billion next year and $500 billion over the next five years. About half (or $25 billion) of the first year's reduction was to come from reduced spending and the other half from increased taxes. Events in the Middle East and an apparent economic recession, however, have caused many to question the wisdom of any tax increase at this time.

Arguments for a Tax Increase. Proponents of a tax increase argue that (1) a tax increase will reduce the federal deficit, (2) a reduction in the deficit is good for the long-term health of the U.S. economy and (3) the deficit cannot be reduced by spending cuts alone.

Arguments Against a Tax Increase. Opponents of a tax increase argue that (1) the federal government already has enough money to meet legitimate spending needs, (2) a tax increase at this time would cause a deeper economic recession and (3) an increase in taxes is unlikely to reduce the deficit.

ARE TAXES TOO LOW?

A widespread public impression is that tax cuts during the 1980s caused the current federal deficit and led to an expanding national debt. One source of this impression is the lowering of tax

- more -

First Interstate Plaza 12655 N. Central Expy., Suite 720 Dallas, TX 75243-1739 (214) 386-NCPA FAX 386-0924

rates during the 1980s. For example, the income tax rate paid by the wealthiest taxpayers was lowered from 70 percent (on unearned income) in 1980 to 28 percent today. Yet one of Washington's best kept secrets is that total federal tax receipts climbed steeply during the 1980s — whether measured in nominal terms, in real terms or as a percent of gross national product:

"A $25 billion tax hike would create the highest tax burden (as a percent of GNP) since World War II."

- In nominal terms, federal tax receipts *doubled* between 1980 and 1990.[2]

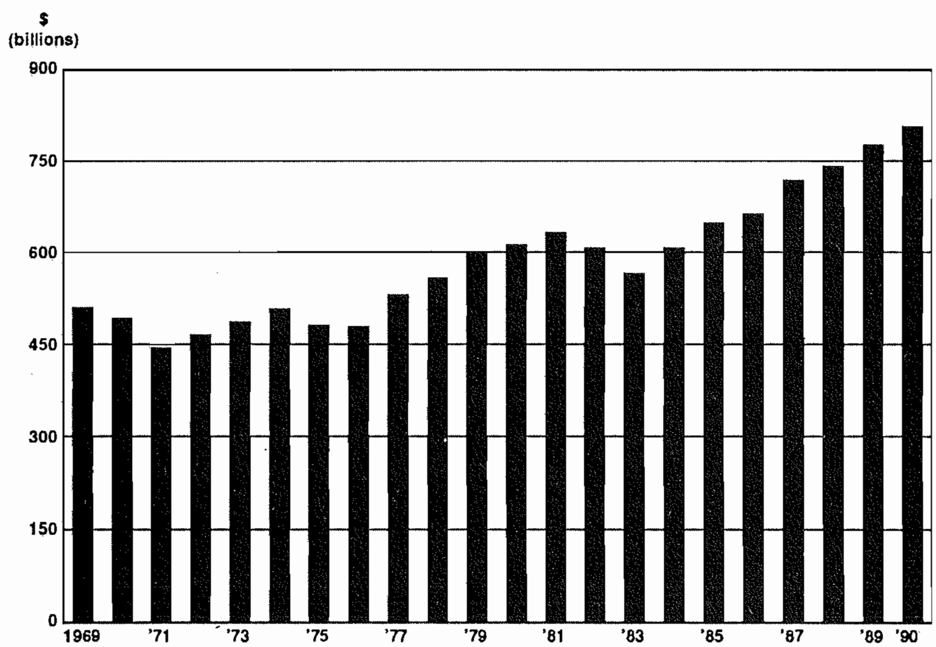
- In real terms, the increase in federal taxes in the 1980s is one of the steepest increases in the post-World War II period [see graphic].

- As a percent of GNP, federal taxes next year will consume 19.9 percent of our national output — the highest tax burden in all but two of the last 45 years.[3]

A $25 billion tax increase — the original goal of the budget summit — would give us a tax burden equal to 20.2 percent of GNP, the highest tax burden in modern times.

"In real terms, the increase in taxes in the 1980s was one of the steepest in the last several decades."

FEDERAL TAXES, IN CONSTANT 1982 DOLLARS



Source: *1991 U.S. Budget*

Tax Burdens for Middle-Income Taxpayers. Not only is the overall tax burden higher today than it was in 1980, but each of the major types of taxes paid by middle-income wage earners also is higher:

"Although tax rates fell in the 1980s, total tax payments continued to rise."

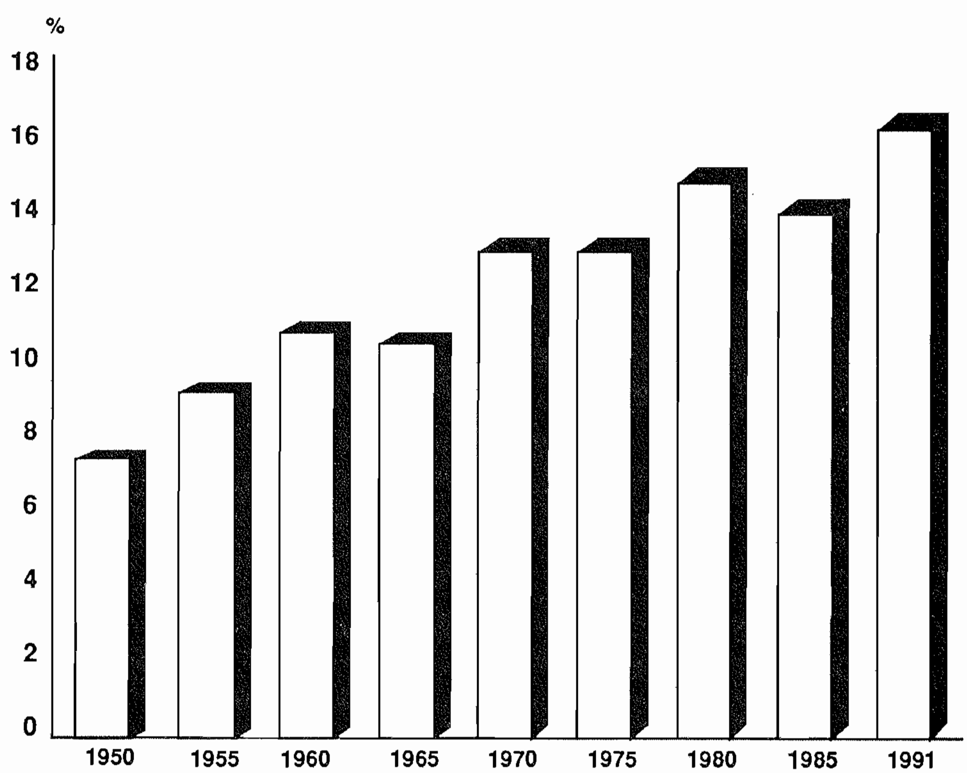
- Although income tax *rates* fell dramatically during the 1980s, total personal income tax *payments* (as a percent of GNP) have now climbed back near their peak levels of the early 1980s.

- Social Security and Medicare payroll taxes (FICA) consume 7.2 percent of GNP today, compared with 5.9 percent in 1980.

- The combined burden of personal income and payroll taxes will be 16.2 percent of GNP in 1991, compared with 15.0 percent in 1980. [See graphic.]

INCOME AND PAYROLL TAXES AS A PERCENT OF GNP

"Income and payroll taxes have reached a new high."



For the typical middle-income family, these higher taxes mean substantially lower take-home pay. For instance, last year the nonpartisan Tax Foundation calculated that a typical moderate income ($45,000 per year) family with two wage earners and two children paid more than $14,000 in federal taxes, and an additional $5,000 in state and local taxes, leaving them with take-home pay of roughly $26,000.[4]

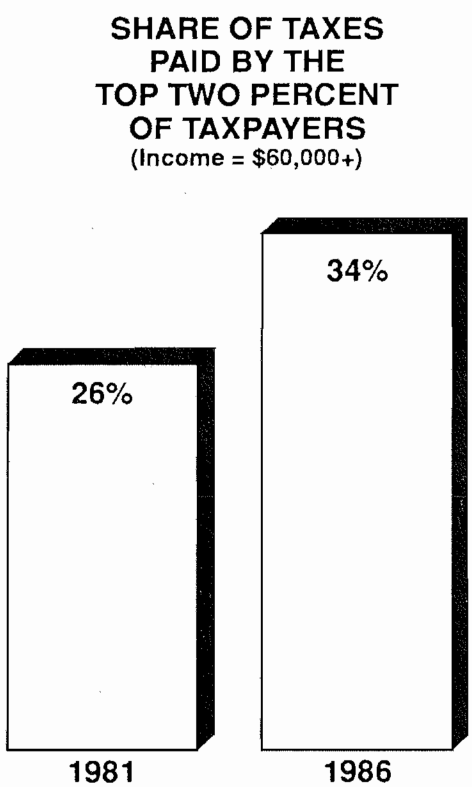
Why Has the Tax Burden Increased? The main reason is that highly publicized tax cuts during the 1980s were largely offset by less-well-publicized tax increases.[5]

- Fourteen separate tax *increases* have been enacted since 1982, eroding all of the gains made by taxpayers from the 1981 Economic Recovery Act (the Kemp-Roth bill).

"The Reagan tax cuts were offset by 14 separate tax increases."

- Between 1982 and 1989, the Reagan tax cuts *reduced* federal revenues, using a static analysis, by $1.49 trillion.

- The fourteen tax hikes over this period *raised* revenues by $1.54 trillion.



WHAT ABOUT TAXES PAID BY THE WEALTHY?

In the early 1980s, Democrats and Republicans alike agreed that high marginal tax rates encouraged taxpayers to seek tax shelters and spend considerable time and resources in tax avoidance and tax evasion. The consensus was that if tax *rates* were brought down, people would channel their time, energy and money into more productive activities. Some even predicted that the response of high-income earners would be so great that they would pay *more* total taxes at lower rates. This prediction proved accurate.

According to Harvard economist (and current White House advisor) Lawrence Lindsey:[6]

- The top 0.1 percent of taxpayers (making more than $200,000 a year) saw their share of tax payments rise from 7 percent in 1981 to 14 percent in 1986.

- The share of taxes paid by the top 2 percent (making more than $60,000) rose from 26 percent to

- more -

"The wealthy pay a larger share of total taxes than they did in 1980."

- The share of taxes paid by the top 2 percent (making more than $60,000) rose from 26 percent to 34 percent.

- The middle class ($26,000 to $60,000) saw their share drop from 67 percent to 60 percent and the share paid by lower-income families dropped from 7 percent to 6 percent.

The 1986 tax cuts reduced the tax rate paid by the wealthiest taxpayers from 50 percent to 28 percent and eliminated many deductions. These changes also would have increased the share of taxes paid by the wealthy. But the potential revenue gains were more than offset by an increase in the capital gains tax rate.[7]

IS FEDERAL SPENDING TOO HIGH?

Although tax revenues increased throughout the 1980s, federal spending increased even faster. The argument is often made that deficit reduction must be tackled mainly through higher taxes, because federal spending has already been sharply cut back. There is also a common perception that spending has been growing in only one area: defense. The facts contradict both assessments:

- Between 1980 and 1990, federal outlays doubled in nominal terms, and the budget grew by $210 billion in constant 1982 dollars.

- The main culprit was entitlement spending, which expanded by $175 billion during the Reagan years — 40 percent more than the dollar increase in defense outlays.

"Nondefense spending grew twice as fast as defense spending during the 1980s."

- Nondefense spending since 1980 has grown twice as fast as defense spending, and more than 90 percent of the growth in expenditures since 1986 is a result of increased outlays in nondefense spending.

- The Reagan military build-up ended long ago. Since 1986, real defense spending has actually *declined.*

There has been some recent progress in paring federal spending — due mainly to the tightening noose of the Gramm-Rudman-Hollings budget law. Federal spending as a percent of GNP has declined from its peak of 24 percent in 1983 to 21 percent next year.

Yet even this progress masks the full extent of the government's spending patterns, because it does not capture the spending that is hidden through various budgetary schemes. One of these is to move programs off-budget, which is how a major portion of the multibillion-dollar savings and loan debacle is being financed. Another is for the government to make future obligations to spend through contingent liabilities, such as issuing loan guarantees.[8]

DO BUDGET SUMMITS LEAD TO LOWER DEFICITS?

Congress and the President have pledged that any new taxes raised at the budget summit will be dedicated to solving the budget deficit crisis, not to new spending. Yet Congress has broken similar pledges following virtually every budget agreement leading to a tax increase during the last decade.

"Every budget summit agreement has led to a higher federal deficit."

The notorious 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) is a dramatic case in point. TEFRA raised $100 billion in new taxes to cut the deficit and was supposed to cut spending by $3 for every dollar of new taxes. Instead, by 1986 the deficit had climbed by an additional $100 billion and spending had climbed by $200 billion. Indeed, the deficit was no lower in 1986 with TEFRA than it had been projected to be without it. This was by no means an isolated incident.

In six of the past eight years, the federal budget has been set by budget summit agreements between the President and the Congress:[9]

- In all six budget summit years, new taxes were agreed to in return for an agreement on a lower federal deficit.
- Despite the agreement and despite the higher taxes, in five of the six years the deficit rose.
- In all six cases, the actual deficit produced was higher than the deficit that had been agreed to.

For example, President Reagan agreed to $29 billion in new revenues for fiscal years 1988 and 1989 in return for a $76 billion deficit reduction. Instead, the 1988 deficit was $11 billion higher than agreed to and the 1989 deficit was $15 billion higher. By contrast:

"In the two years not governed by a budget summit agreement, the deficit fell."

- There were two years (1984 and 1987) with no summit agreement and no new taxes.

- In those years the deficit fell by $22.5 billion and $71.5 billion, respectively.

DO HIGHER TAXES LEAD TO LOWER DEFICITS?

This question has been the subject of several recent studies. On balance, the studies cast considerable doubt on the proposition that another tax hike would reduce the federal deficit.

The Manage/Marlow Study. In 1986 economists Neela Manage and Michael Marlow reported in the *Southern Economic Journal* that, "between 1929 and 1982, the growth in federal taxes produced faster than expected increases in federal spending. The authors found statistical evidence of "one-way causality from tax receipts to spending, suggesting that tax increases result in higher spending levels — and possibly larger deficits."[10]

The Vedder/Galloway/Frenze Study. Economists Richard Vedder and Lowell Galloway (Ohio University) and Chris Frenze (Joint Economic Committee of Congress), in a 1987 report issued by the Republican members of the JEC, discovered that:[11]

"Each $1.00 of new taxes leads to $1.58 of new spending — increasing the deficit by 58 cents."

- Between 1948 and 1986, every dollar in increased taxes did not lead to lower subsequent deficits, but to 58 cents in *higher* levels of red ink.

- This was because spending tended to rise by roughly $1.58 in response to each new $1.00 of taxes.

"Even the CBO could not confirm that higher taxes will reduce the deficit."

The CBO Study. The Republican study came under immediate attack from the Democrats in Congress, who asked the Congressional Budget Office (CBO) to rerun the numbers and discredit the JEC staffers' findings. The subsequent CBO report was released with great fanfare. It concluded that the Vedder, et al. study was "extremely sensitive to the time period" and provided "no persuasive evidence in favor of the tax-and-spend hypothesis." Yet the CBO made four statistical tests of its own, using various assumptions. In only one of them could the tax-and-spend hypothesis be rejected outright. The CBO found that an extra dollar of taxes led to $1.55 in new spending (adding 55 cents to the deficit) in its first test; $1.05 in new spending (adding 5 cents to the deficit) in its second test; $0.83 in higher spending (reducing the deficit by

17 cents) in its third test; and $0.08 in higher spending (reducing the deficit by 92 cents) in its final test. Despite the best efforts of the CBO's top economists and statisticians, the CBO report failed to make a persuasive case that higher taxes will reduce deficits.[12]

Recent Actions of Congress. After George Bush reversed his "no new taxes" position, members of the Appropriations Committees apparently embarked on a new spending spree. According to a July 1990 Heritage Foundation report, the House of Representatives has already spent the budget summit revenues. The report found that:[13]

"Since George Bush changed his position on taxes, the House has already spent the new budget summit revenues."

- The eight appropriations bills recently approved by the House of Representatives would lift spending by 11.4 percent over last year's levels.

- If the remaining legislation contains these spending increases, next year's outlays will be $110 billion above 1990 levels.

WHAT EFFECT WILL HIGHER TAXES HAVE ON THE U.S. ECONOMY?

The stated objective of raising taxes at the budget summit is to reduce federal borrowing and lower interest rates to generate improved economic performance in the long term. But given the current state of the sputtering U.S. economy, a tax hike is the worst fiscal prescription that Congress could deliver.

Taxes and Growth. Most research concludes that higher federal taxes lead to lower economic growth. A Temple University study found that:[14]

"Tax increases reduce economic growth, while spending reductions increase growth."

> Taxes are a key factor in measuring changes in the U.S. economy. Using [tax policy alone] we can account for over three-fourths of the growth in real GNP, as well as over two-thirds of the growth in jobs in the U.S. economy over the past 26 years .... High taxes lead to low growth and low taxes lead to high growth.

Conversely, cutting spending would have a positive economic effect. In a 1988 study, George Washington University researchers found that total public sector spending as a percentage of GNP between 1930 and 1986 had "a clear and consistent negative impact on U.S. economic growth."[15]

Taxes and Productivity. The reason tax increases impair economic performance is not the standard explanation — that tax increases depress aggregate demand. Rather, research shows that higher income taxes affect output on the supply side by stifling work incentives and productivity growth. For instance, Robert Genetski, chief economist of the Harris Trust and Savings Bank in Chicago, has uncovered convincing evidence that higher marginal income tax rates reduce productivity.[16]

"High marginal tax rates reduce productivity."

Taxes and the Deficit. If a tax hike triggered a recession, as the evidence suggests it might, then the new taxes would cause the government's total tax collections to plummet and the deficit to soar back to its mid-1980s levels. The main reason for this is that the deficit is driven primarily by the condition of the economy:[17]

- Each 1 percent rise in unemployment raises the deficit by roughly $25 billion, and each percentage point decline in GNP raises the deficit by $6 billion.

""A recession would cause the deficit to be higher."

- Hence, even a modest recession, raising unemployment by 2 percent and slowing growth by 2 percent, would raise the deficit by $62 billion — or far more than the $50 billion the budget summit agreed to trim from the deficit this year.

Taxes and Saving. There is some debate about whether Americans save too little. But to the extent that a low level of savings is an economic problem, there are good reasons to suppose that a tax increase would make the problem worse. A 1987 study by U.S. Department of the Treasury economists found that, in the first few years of a tax increase, 80 percent comes from private savings and only about 20 percent from reduced consumption. Even a consumption-based tax reduces private savings, according to the authors. The study also discovered that reducing government spending is a far better way to stimulate higher national savings than raising taxes.[18]

"Even consumption taxes cause savings to be lower."

CONCLUSION

The economic evidence suggests that a tax increase could produce an economic and fiscal crisis much worse than the persistent deficit problem the nation now confronts. A tax increase probably would not reduce federal red ink, and it would lower our national savings and investment. The bulk of the increased burden would fall on middle-income taxpayers, who are already paying record high levels of taxes. At a time when the national economy is teetering on a precipice of recession, federal policymakers would be wise to concentrate on pro-growth policies — by selectively cutting taxes rather than raising them.

Stephen Moore
Adjunct Fellow
Hudson Institute

- 30 -

NOTE: Nothing written here should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress.

Footnotes

[1]Unless otherwise noted, the data for the analysis of federal tax receipts and spending in this paper comes from: Office of Management and Budget, "Historical Tables of the U.S. Budget," February 1990; and Office of Management and Budget, "Midsession Budget Review," June 1990.

[2]Federal tax receipts climbed from $517 billion in 1980 to $1,044 billion in 1990.

[3]The two highest tax burden years on record were 1969 and 1981 when taxes consumed 20.1 percent of GNP.

[4]Tax Foundation, *Tax Features*, March 1989, p. 2.

[5]Tax Foundation, "1989 Tax Increases Have Arrived," *Federal Tax Policy Memo*, March 1989, p. 4.

[6]Lawrence Lindsey, *The Growth Experiment* (New York: Basic Books, 1990).

[7]The loss of capital gains revenue was more than three times greater than the increase in revenue from wealthy taxpayers due to increased wage and salary income and business income.

[8]The National Taxpayers Union estimates that taxpayer liabilities reached $14 trillion in 1988 — having doubled since 1977. These liabilities are like small FSLIC time bombs waiting to explode in the taxpayers' laps. See: National Taxpayers Union, "U.S. Government Liabilities Now Exceed $14 Trillion," 1989.

[9]Tax Foundation, "A Decade of Budget Summitry," 1990.

[10]Neela Manage and Michael Marlow, "The Causal Relationship between Federal Expenditures and Receipts," *Southern Economic Journal*, January 1986, pp. 617-629.

[11]Richard Vedder, Lowell Galloway and Christopher Frenze, "Federal Tax Increases and the Budget Deficit, 1947-1986: Some Empirical Evidence," Report to the Republican Members of the Joint Economic Committee of Congress, 1987.

[12]Congressional Budget Office, 1987.

[13]Scott Hodge, "What Deficit Crisis? Congress Continues Its Pork-Laden Spending Spree," Heritage Foundation *Backgrounder Update*, July 1990.

[14]William L. Dunkelberg and John W. Skorburg, "Taxes and Economic Growth: A Not So Complicated Look at the Issue, 1960-1988," *Temple University Working Paper*, 1989.

[15]James R. Barth and Michael Bradley, "The Impact of Government Spending on Economic Activity," National Chamber Foundation, 1988.

[16]Robert J. Genetski, *Taking the Voodoo Out of Economics* (Chicago: Regnery, 1986). This finding suggests that, of all the tax options available to Congress, the most economically destructive would be to raise income tax rates to 33 percent, as is now under discussion.

[17]Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1990-1993," 1989.

[18]Michael Darby, Robert Gillingham and John Greenlees, "The Impact of Government Deficits on Personal and National Savings Rates," U.S. Department of the Treasury, Research Paper No. 8702, August 1987.

ECONOMIC EXPERTS

1. Stephen Moore (Adjunct Fellow)
   Hudson Institute
   703-824-2742

2. John Goodman (President)
   National Center for Policy Analysis
   214-386-6272

3. Gary Robbins (NCPA Senior Fellow)
   (President) Fiscal Associates
   703-979-1371

4. Aldona Robbins (NCPA Senior Fellow)
   (Vice President) Fiscal Associates
   703-979-1371

5. Lawrence Lindsey (Economist)
   Harvard University; White House Office of Policy Development
   202-456-6402

THE NATIONAL CENTER FOR POLICY ANALYSIS

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute, funded exclusively by private contributions. The NCPA originated the concept of the Medical IRA (which has bipartisan support in Congress) and merit pay for school districts (adopted in South Carolina and Texas). Many credit NCPA studies of the Medicare surtax as the main factor leading to the the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, a capital gains tax cut would increase federal revenue, and the federal government gets virtually all the money back from the current child care tax credit. These forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free-enterprise health care task force report, representing the views of 40 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. According to NCPA reports:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

What Others Say About the NCPA

"... influencing the national debate with studies, reports and seminars."

TIME

"... steadily thrusting such ideas as 'privatization' of social services into the intellectual marketplace."

CHRISTIAN SCIENCE MONITOR

"Increasingly influential."

EVANS AND NOVAK