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Don P. Diffine Ph.D.
Harding University, ddiffine@harding.edu

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The Belden Center for Private Enterprise Education
Harding University School of Business
Searcy, Arkansas

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Why America Does Not Need More Taxes

by
Stephen Moore
Grover M. Hermann Fellow
in Federal Budgetary Affairs
Heritage Foundation

INTRODUCTION

During the presidential campaign, George Bush repeatedly assured Americans that he would not raise their taxes. He declared: "Read my lips: no new taxes." Just hours after Bush's victory, however, America's pro-tax lobby began an all-out offensive to convince him that, because of the federal budget deficit, he must ignore the American people's mandate and break his vow by accepting a steep tax increase. Yet the facts are on President Bush's side. They show that there is no reason for him to retreat from his pledge.

Indeed, there is good news concerning the federal budget deficit. Recently released forecasts from the Congressional Budget Office (CBO) indicate that the flow of red ink is subsiding.[1] From its peak level of $220 billion in fiscal 1986, the federal deficit in fiscal 1989 shrank to $148 billion. More important, as a share of total economic output — the best measure of the economic impact of federal borrowing — the deficit will fall to 2.9 percent of gross national product (GNP) in 1989. This is substantial progress, considering that the deficit consumed 6.3 percent of GNP in 1983.

Heartening Forecast. The forecast for the next five years is even more heartening than the statistics suggest. The CBO projects that, with moderate economic growth, the deficit will shrink to just 1.8 percent of GNP by 1993 — one-third its 1983 peak. Other forecasters, most notably the Office of Management and Budget, are more bullish on the economy in the near future and thus are anticipating a drop in the budget deficit to less than one-half of one percent of GNP by 1993.

Two factors are mainly responsible for this dramatic improvement in the federal fiscal outlook. First, the 1985 Gramm-Rudman-Hollings balanced budget law (GRH) has forced Congress to slice the growth rate of federal outlays in half. The federal government still is growing, of course, but at a slower pace.[2]

David Tucker Receives Leavey Award From Freedoms Foundation

Dr. David Tucker, associate professor of economics and director of the Walton Scholarship Program for Central American students, has been named recipient of the 1989 Leavey Award for Excellence in Private Enterprise Education.

Dr. Tucker's award was announced by the Freedoms Foundation on April 29 at a banquet held in his honor at the Beverly Hilton Hotel in Los Angeles, California. On that occasion, Tucker was presented with a $7,500 check and a plaque to commemorate the award.

The award was given to Dr. Tucker for his work promoting private enterprise to the students in the Walton Scholarship Program. Funded by Sam and Helen Walton of Bentonville, Arkansas, the program is designed to teach the principles of freedom, liberty and private enterprise to students from the seven countries of Central America (Nicaragua, Honduras, Costa Rica, Panama, Guatemala, El Salvador and Belize). More than 80 students have been a part of the Walton Program.

Tucker has taught at Harding for nine years. In addition to teaching classes and directing the Walton Program, he has published several scholarly articles and has been an invited speaker to many conferences and seminars.

Tucker is the second Harding faculty member to be honored with a Leavey Award. Dr. Don Diffine received a Leavey Award in 1980.

Second, the U.S. economy, which just entered its peacetime-record 72nd straight month of expansion, is outpacing the deficit. With more than 18 million more Americans working since the recovery began, family incomes up by over 10 percent, and corporate profits growing by about 5 percent per year, the federal treasury since 1982 has been enjoying an unprecedented $60 to $80 billion annual fiscal dividend through rising tax receipts.

As these growing revenues pour into the federal coffers, the federal budget can be balanced by the end of President Bush's first term, without raising new taxes and without deep program spending cuts. In fact, if Congress can simply hold the rate of spending growth to less than 4 percent per year, the deficit will be erased in 1993. With an aggressive budget-cutting strategy, the President could balance the budget even sooner.

Threats from Capitol Hill. There is, however, one dark cloud looming. Congress seems determined to halt this progress on the deficit by torpedoing the economic expansion with a tax hike and a surge of new spending. Such a double blow not only could halt further progress in deficit reduction; it could send the economy into a tailspin. Already this year, legislators have spent billions of dollars on new federal programs, including welfare reform, catastrophic health care, AIDS research expansions to the Food Stamp program and drug rehabilitation programs.

This year, the spending spree is expected to continue as Congress unleashes a huge catalog of new spending initiatives, which could add as much as $150 billion to the deficit over the next five years.[3] Included in this package are new federal commitments for child care, long-term health care, an infrastructure loan fund, and an estimated $60 billion bailout of the savings and loan industry.

Even more threatening is the mounting enthusiasm on Capitol Hill for a major tax increase in 1989. Ignoring all the data from their own budget experts and turning their backs on even modest spending restraint, many lawmakers insist that raising taxes is the only course of action for the President. Yet a tax hike in 1989 would not produce a balanced budget, and it would almost certainly disrupt the current economic expansion. The reasons:

1) Federal taxes are already at record high levels.

Taxes will consume 19.6 percent of GNP in 1990. In only five years of this century, most recently just prior to the 1981-1982 recession, have tax burdens been this heavy. Even without new taxes, federal revenues will rise to over $1 trillion for the first time in history in 1990.

2) Tax increases result in higher spending, not lower budget deficits.

A recent study finds that every dollar of taxes raised since 1948 has led to $1.58 in increased spending. New taxes just lead to a surge of new spending by lawmakers.[4] A tax increase in 1989 simply would be a green light for Congress to use the money to finance its $150 billion "wish list" of new spending programs.

3) A major tax hike would slow economic growth and could spark a recession.

Over the past quarter century, higher federal taxes have led to slower economic growth. Higher taxes increase business costs, discourage investment and reduce consumer demand, dampening or even halting economic growth. Some studies have concluded that every dollar of higher income taxes reduces economic activity by as much as 50 cents.[5]

A healthy, growing economy, combined with modest federal spending restraint, would afford the least painful and most promising route to reaching a balanced budget by 1993 as required by the Gramm-Rudman-Hollings legislation. This means that Congress must pursue only pro-growth fiscal policies over the next four years. Raising taxes is an anti-growth policy. It risks slamming the brakes on the current economic expansion and causing red budget ink to begin gushing again.

CONFOUNDING PREDICTIONS OF DOOM

Big budget deficits are clearly undesirable, but members of the pro-tax lobby have been consistently wrong in their predictions about the course of the economy during the Reagan Administration.[6] In 1982, they predicted that the Reagan tax cuts would cause high inflation; inflation declined.

In 1983, they claimed that big deficits would bring a rise in interest rates; rates fell sharply from 13.5 percent to 9.4 percent over the next four years. During the 1984 presidential campaign, they promised the electorate a recession unless taxes were raised substantially; taxes were not raised, but the economic expansion has continued uninterrupted. Most recently, they have insisted that the burden of federal debt would cause the loss of U.S. business and jobs to foreign competitors. Yet corporate profits and employment levels in the U.S. are now at all-time highs.

Concealing Good News. A primary reason for these consistently faulty forecasts is that, since 1983, the federal budget deficit gradually has been fading as an economic problem. One of Washington's best kept secrets is that the budget deficit is slowly declining in real dollar terms and falling rapidly as a percentage of gross national product. Next year the budget deficit will consume only one-half the proportion of GNP that it did in its peak year of 1983. And in 1992, according to CBO estimates, which do not assume any congressional actions to curb spending, this proportion will fall to about one-third the 1983 level.[7] Remarkably, this good news about the deficit has been almost completely concealed from the U.S. public.

The second reason that the catastrophic projections of Ronald Reagan's critics have proved false is that the impact of large federal deficits has been offset somewhat by annual state and local government budget surpluses. These have averaged approximately $50 billion in recent years. This means that current total public sector borrowing, the most accurate measure of the impact of government on the private credit market, in fact, is only about $100 billion a year. These figures also expose the fallacy of the argument that the U.S. budget deficit hampers the well-being of American firms as compared with that of corporations in other countries. Total public sector borrowing in the U.S. now consumes 2.3 percent of GNP.[8] The combined public sector deficit for the member countries of the Organization for Economic Cooperation and Development (OECD), which includes most of America's major European competitors, is 2.5 percent of GNP. Most U.S. trading rivals, in other words, face larger budget deficits.

To be sure, the budget deficit does have a negative influence on the economy, and a deficit of $100 billion to $150 billion is nothing to cheer about. But thanks to strong growth in the U.S. economy, the deficit is headed firmly downward. It is far smaller as a proportion of national output than just five years ago and slightly lower than in most industrialized countries. Panic action is unnecessary, and panic tax hikes could be a disaster.

IS AMERICA UNDERTAXED?

Proponents of tax increases repeatedly charge that Reagan tax cuts are responsible for the triple digit budget deficits of the 1980s. But the evidence refutes this claim. Federal revenues adjusted for inflation grew by 7.2. percent in 1984, 7.4 percent in 1985, 4.1 percent in 1986, and 8.7 percent in 1987.[9] Total federal tax receipts today are over $300 billion higher than the year Ronald Reagan became President, and in 1988, revenues were higher in real dollars than in any other year in history. The increase in tax receipts alone during the past eight years was enough to finance the entire Reagan defense buildup and still leave $175 billion of revenues for other purposes.

Rich Paying More Taxes. By encouraging faster economic activity, moreover, the carefully crafted tax-rate reductions of 1981 appear to have improved revenues for the Treasury. Several new studies indicate that, as a result of the new jobs and income growth spurred by the 1981 reductions in income tax rates, Americans are paying more taxes now than they would have under the old tax system. And it is the rich who are paying the fastest growing slice of these taxes. Harvard University economist Lawrence Lindsey, for instance, calculates that the nation's richest one percent of taxpayers could have been expected to pay $40 billion in 1985 taxes under the old tax code, but paid approximately $50 billion in taxes after top tax rates were slashed from 70 percent to 50 percent.[10]

Even more remarkable, Lindsey finds that the wealthiest 15 percent of Americans paid three times more in income taxes in 1985 than they would have under the old tax code — mainly because of the prosperous economy. These results should not be surprising. They mirror the historical experience of the 1922-1925 tax cuts and the 1963 Kennedy tax cuts. In both these cases the economy boomed, and tax receipts collected by the IRS mushroomed after tax rates were slashed.[11]

The fiscal outlook could have been better, had not Congress spent the past seven years working to reverse the impact of the 1981 income tax cuts. Congress has passed 14 separate tax increases since 1982. The tax reductions for Americans achieved by the 1981 tax law will have been eroded by 1989, thanks to this steady procession of tax hikes. Fortunately, the marginal rate reductions of 1981 and 1986, which boost risk taking and the incentive to work, will remain, but the total deduction from the family paycheck once again will be close to the level prevailing just before the last recession.

Greater Danger than the Deficit. The main culprit has been the regressive, anti-employment Social Security payroll tax, which consumes almost 15 percent of the paychecks of low-and middle-income families. Current law schedules another $7 billion Social Security payroll tax hike for 1990.

As a result of these increases, federal taxes will climb to 19.6 percent of GNP in 1990, far above the post-World War II average of 18.2 percent. Many economists believe that the current high level of taxation as a share of total output constitutes a far greater danger to the American economy than the budget deficit.

The reason that the U.S. has experienced big deficits despite rising federal revenues is that Congress has made only minimal progress in controlling spending. The $1 trillion federal budget is equal to about 23 percent of GNP. This is a higher percentage than in 1981 when Reagan entered the White House and is substantially above the postwar average of 19.5 percent.

WOULD TAX INCREASES REALLY LOWER BUDGET DEFICITS?

The recent call for higher taxes to trim the budget deficit is not the first time that this demand has been heard in Washington. In 1982, for instance, Congress convinced Reagan to accept a huge tax hike, the Tax Equity and Fiscal Responsibility Act (TEFRA), by pledging that the record $100 billion increase would be used to cut the deficit. Yet by 1986 the deficit had not fallen as the pro-tax lobby had promised, but had climbed by $100 billion. The reason: the tax increase triggered a $200 billion surge in new spending.[12] Similarly, a major tax increase in 1984 again was followed not by a deficit reduction, but by higher spending. It was only when the Gramm-Rudman-Hollings Deficit Reduction Act placed a statutory ceiling on spending that the deficit began to reverse its upward course.

Tax and Spend Relationship. Several academic studies confirm statistically that new taxes almost always stimulate higher federal spending, rather than lower budget deficits. Economists Neela Manage and Michael Marlow, for instance, report in the *Southern Economic Journal* that between 1929 and 1982 federal receipt growth fostered faster than expected increases in outlays.[13] They conclude that "a tax increase may not even offer a temporary solution to unacceptably large federal deficits." In a subsequent study the authors discovered that this same tax and spend relationship holds true statistically for state governments as well.[14]

More recently, members of the congressional Joint Economic Committee commissioned Ohio University econmists Richard Vedder, Lowell Galloway and Christopher Frenze to examine the impact of tax increases on the budget deficit over the last 40 years.[15] These experts have found that higher taxes do not lower budget deficits. On the contrary, they discovered that a dollar rise in taxes results in a 58-cent increase in the budget deficit because of resulting higher spending after the hike.

THE IMPACT OF ECONOMIC GROWTH ON THE FEDERAL BUDGET DEFICIT

Those who want to balance the budget by raising taxes ignore the essential link between economic growth and the budget deficit. Although there is honest disagreement as to whether the U.S. can "grow out of the deficit," virtually every economist agrees that without a strong economy, the budget cannot be balanced. Just as an expanding economy produces substantial increases in federal tax receipts as incomes, employment and business profits rise, so an economy in recession causes the federal deficit to mushroom.

In its February 1988 report, the Congressional Budget Office quantified this relationship between economic performance and the size of the budget deficit.[16] According to the CBO:

> Each one percentage point increase in the rate of economic growth would generate a $21 billion deficit reduction in 1989, a $41 billion reduction in 1990, a $64 billion reduction in 1991 and a $90 billion reduction in 1992.
>
> Each percentage point reduction in the unemployment rate would reduce the deficit by $42 billion.
>
> Each percentage point reduction in general interest rates would trim the budget deficit by $11 billion in 1989 and $26 billion in 1992.

To illustrate the importance of economic growth on the size of the budget deficit, consider the following scenarios. The CBO projects economic growth rates of between 2.5 percent and 3.0 percent over the next four years, leading to a 1993 budget deficit of $130 billion. But if the economy grows by just one percentage point faster than anticipated by CBO, the deficit plummets to about $10 billion in 1993.

Conversely, if the economy were to slow by only one percent per year, the budget deficit would be about $300 billion by the end of George Bush's first term. Strong economic growth is critical to deficit reduction. Yet proponents of tax increases practically ignore the potential impact of new taxes on the growth rate.

HOW FEDERAL TAXES AND SPENDING AFFECT U. S. ECONOMIC GROWTH

Several studies have examined the historical relationship between the level of federal taxes and the rate of economic growth. Most have discovered that, when Congress raises taxes, the economy grows at a slower pace, adding to deficit pressures. Other studies indicate, meanwhile, that the pattern is for increased taxes to fund more spending and for this tax-induced expansion of government to undermine growth. Examples:

1) John Skorburg, chief economist at Sears, Roebuck & Company, has analyzed the impact of federal tax receipts as a percentage of GNP (the "tax ratio") on changes in real GNP in the U.S. between 1960 and 1984.[17] Skorburg concludes that there is a statistically significant negative relationship between the tax ratio and U.S. economic performance over this period. Writes Skorburg: "Every year that we have had large increases in taxes as a percent of GNP, the next year showed a large deceleration in the growth of GNP. For every time we have had a large decline in taxes as a percent of GNP, the very next year it has been followed by a very large increase in the growth of GNP."

2) In a follow-up study, Skorburg and Purdue University economist William C. Dunkelberg found a direct inverse relationship between federal taxes and both GNP growth and job creation.[18] The authors conclude:

> Taxes are a key factor in measuring change in the U.S. economy. Using just the tax ratio we can account for more than three-fourths of the growth in real GNP, as well as more than two-thirds of the growth in jobs, in the entire U.S. economy over the past 26 years ... High taxes lead to low growth, and low taxes lead to high growth.

3) Hikes in federal taxes also impair U.S. productivity. Robert Genetski, chief economist at Harris Trust and Savings Bank in Chicago, has reviewed the impact of changes in marginal tax rates upon productivity (as measured by private nonfarm output per man hour), between 1950 and 1986.[19] Concludes Genetski:

> Our analysis suggests that tax rates have been particularly significant in influencing productivity in the past,

and all of the data subsequent to 1981 appears to support that conclusion. Whenever marginal tax rates have increased, productivity trends have deteriorated. Whenever these rates have fallen, productivity trends have improved.

Since the 1981 tax cuts, manufacturing productivity in the U.S. has grown at an average annual rate of 4.3 percent. This growth rate has been higher than that achieved by either Japan or West Germany, and much higher than the 1.5 percent rate in the U.S. in the five-year period prior to the 1981 tax cuts.[20]

4) In 1988, George Washington University economists James R. Barth and Michael Bradley conducted a U.S. Chamber Foundation study of the impact of federal fiscal policy on the performance of the U.S. economy.[21] Their results identify government spending as the main influence on national economic growth. Barth and Bradley examined total U.S. public sector spending at all levels of government as a percentage of GNP in 1930 and 1986 and compared it with the rates of national economic growth. They uncover a "clear and consistent finding that the impact of government spending on U.S. economic activity or growth is negative."

This finding indicates that it is not so much the method of financing government spending — direct taxation versus borrowing — that is critical to economic growth, but rather the percentage of productive goods and services in the economy consumed by the government. The trouble is, of course, that new taxes tend to unleash new spending. Hence, raising taxes weakens the economy.

THE MESSAGE FOR GEORGE BUSH

These studies of the impact that taxes have on economic growth and budget deficits show that, rather than focusing on the federal deficit which can be eliminated by maintaining growth and constraining spending, the new President — and the new Congress — should focus on the underlying causes of the deficit. Balancing the federal budget is a commendable and important goal. But a more imminent threat to the U.S. economy, says the almost unanimous evidence, is the rising tide of taxes and government spending. This means that balancing the budget will generate a stronger economy only if deficit reduction is achieved by controlling government spending. Conversely, a balanced budget at higher levels of taxes and spending will reduce the living standards of Americans.

JFK's Wise Words. Policy makers also should recognize that raising taxes is a self-defeating strategy to cut the deficit. In 1962, President John F. Kennedy promoted his historic tax reduction package by stating: "An economy hampered by restrictive tax rates will never produce enough revenue to balance the budget — just as it will never produce enough jobs or enough profit."[22] Four decades of U.S. experience confirm Kennedy's wise words. There is a very strong negative relationship between marginal tax rates and economic growth.

Other countries finally appear to be understanding this message. Most countries in the world today are cutting taxes, not raising them. In a review of this international tax revolt, *The Economist* notes: "Across the world in recent years, a reduction in top rates of taxes has quickly resulted in higher, not lower, yields to the exchequer."[23]

In this environment of falling international tax rates, the adverse economic implications of raising U.S. taxes would be magnified. Almost all of the empirical evidence indicates that countries with low tax burdens compete more effectively than their trade rivals burdened with heavy taxes. Furthermore, a recent study by Peat Marwick Main and Company economist J. Gregory Balentine reveals that the "current U.S. effective corporate tax rates on new investment tends to cluster around those of the highest tax group of countries, well above those of countries like South Korea, Taiwan, Hong Kong, Spain and Belgium."[24] By raising taxes, Congress would risk placing the United States at a significant competitive disadvantage against its major trading partners, who are in the process of lowering their taxes.

CONCLUSION

George Bush was elected President in the month marking the sixth anniversary of the current economic expansion. Over that period, 18 million jobs were created, the unemployment and inflation rate were cut roughly in half and real family incomes climbed by more than 10 percent. President Bush must remember that the economists and lawmakers who are now supporting a tax hike, and who have done so throughout the Reagan Administration, once claimed that the economic improvement of the past six years was impossible. They seem completely unable to learn from their mistakes.

Once again they insist that, without a major tax increase to balance the budget, the economy will slide into a deep recession. President Bush should ignore them. Their advice is as bad now as it has been during the past eight years.

Record Tax Receipts. President Bush should understand that, without a tax hike in 1989, federal tax collections are expected to climb by about $80 billion annually over the next four years, thanks mainly to economic growth. In 1990, federal tax receipts will top the $1 trillion mark for the first time. Surely this is enough money to fund the essential activities of the federal government.

Although many in Congress attempt to cloak their desire to raise America's taxes in the rhetoric of deficit reduction, their real purpose to use the money to embark on another $100 billion spending spree could not be more transparent. Dozens of spending bills are already awaiting the tax-hike green light. If President Bush permits a tax hike in 1989, he will lose both the war on the deficit and the war on wasteful spending.

[1] Congressional Budget Office, *The Economic and Budget Outlook: An Update,* August 1988.

[2] Much of this reduction in federal outlays is attributable to real cuts in defense spending since 1980.

[3] Stephen Moore, "A Budget Summit to End the $100 Billion Spending Spree," The Heritage Foundation *Executive Memorandum* No. 202, May 25, 1988.

[4] Richard Vedder, Lowell Gallaway 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, 1987.

[5] Charles L. Ballard, John B. Shoven and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the U.S.," *American Economic Review,* March 1985, pp. 128-138; and James L. Miller, Director of the Office of Management and Budget, Hearings before the House Republican Study Committee, on "Tax Increases and the Economy," April 1, 1987.

[6] For more details see Paul Craig Roberts, "Putting Stability At Risk," *The Washington Times,* September 16, 1988, p. F1.

[7] Congressional Budget Office, 1988, *op. cit.*

[8] Richard W. Rahn, "Do We Need a Tax Increase?" U.S. Chamber of Commerce, July 27, 1988, p. 4.

9 Office of Management and Budget, *Historical Tables: Budget of the United States Government,* Fiscal 1989.

[10] See Lawrence B. Lindsey, "Supply Side Lessons for Reducing the Deficit," *Business Economics,* October 1988, pp. 13-18; and "Laffer's Last Laugh," *The Economist,* March 19, 1988, p. 54.

[11] "The Classical Case for Cutting Marginal Income Tax Rates," working paper prepared for Representatives Bob Michel, Trent Lott and Jack Kemp, February 1981.

[12] For an assesssment of the impact of TEFRA on the budget deficit see Richard W. Rahn, Chamber of Commerce of the United States, hearings before the House Republican Study Committee, "Tax Increases and the Economy," April 1, 1987.

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

[14] Michael Marlow and Neela Manage, "Expenditures and Receipts: Testing for Casuality in State and Local Government Finances," *Public Choice,* 1987, pp. 243-255.

[15] Vedder, *op. cit.*

[16] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1989-1993,* February 1988.

[17] John Skorburg, "Taxes vs. Economic Growth: Compelling Evidence," in *The State Factor,* American Legislative Exchange Council, July 1985.

[18] William L. Dunkelberg and John W. Skorburg, "Taxes and Economic Growth: A Not So Complicated Look at the Issue, 1960-1985," unpublished manuscript, March 1986.

[19] Robert J. Genetski, *Taking the Voodoo Out of Economics* (Chicago: Regnery, 1986).

[20] Robert J. Genetski, Testimony before the National Economic Commission, August 3, 1988, p. 4.

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

[22] President John F. Kennedy, Speech before the Economic Club of New York, December 1982.

[23] "Laffer's Last Laugh," *op. cit.*, p. 54.

[24] J. Gregory Ballentine, "An International Comparison of Effective Tax Rates on New Investment," prepared for the American Council for Capital Formation, 1988, p. 2.

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The Belden Center for Private Enterprise Education
Harding University School of Business
Box 922, Station A
Searcy, Arkansas 72143

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