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NEW TAXES TO CUT THE DEFICIT: ANOTHER CONGRESS BAIT-AND-SWITCH RUSE

INTRODUCTION

Congress recently passed a fiscal 1988 Budget Resolution that would raise federal taxes by $73 billion over the next three years. The $29 billion of additional revenue in 1988 would be the largest single-year peacetime tax hike in United States history. This same resolution, meanwhile, proposes to raise domestic spending by approximately $50 billion next year. And for the second straight year, the only agency to feel the budget knife is the Pentagon. Defense programs would be cut by at least 2 percent in fiscal 1988. Remarkably, despite raising taxes and cutting military spending, the Budget Resolution's bottom line deficit figure still misses the Gramm-Rudman-Hollings deficit targets enacted by Congress less than two years ago by almost $30 billion.

In an attempt to win public support for the budget, especially for the tax increase contained in it, Democratic congressional leaders are trying to resuscitate three false but common myths about fiscal policy under the Reagan Administration. Falling for these myths would allow the liberals in Congress once again to pull their shabby bait-and-switch ruse--using fear of a deficit to get a tax hike and then using the new revenues not for deficit reduction but for new spending.

The bait-and-switch myths are:

Myth 1: Reagan's tax cuts launched the country into an era of $200 billion federal budget deficits.

Fact: Despite the 1981 cut in marginal tax rates, federal revenues have not fallen. To the contrary. As predicted by the Administration, lower rates can generate higher revenues. Between 1981 and 1987, federal tax revenues have grown by $160 billion in current dollars and $70 billion in constant dollars, adjusted for inflation.[1] Thanks to tax increases legislated during the Carter Administration, however, taxes as a percentage of Gross National Product (GNP) under Ronald Reagan have been higher than under any of the last eight presidents, with the exception of Jimmy Carter. Moreover, legislated Social Security tax increases will push the percentage to record levels by 1990, even without the new taxes proposed by Congress. What this means is 1) America is not undertaxed and 2) the Reagan tax cuts have not caused the deficits.

Myth 2: Reagan's rebuilding of the U.S. arsenal has been excessive and unaffordable.

Fact: The average U.S. spending on defense as a percentage of GNP between 1950 and 1980 was 8.4 percent. Today, the U.S. spends only 6.4 percent of GNP on defense. The new federal revenues generated since 1981 could have paid for the entire defense hike with $55 billion left over to combat federal red ink.

Myth 3: The Reagan Administration has sliced domestic programs to the bone, leaving no more room for further budget cuts.

Fact: Domestic spending has not been cut at all. Jimmy Carter's last budget spent $450 billion on domestic programs. Ronald Reagan's latest budget will spend $600 billion on domestic programs. Reagan has curtailed only the rate of growth in domestic spending; he has not stopped domestic spending growth.

Why did federal deficits erupt during the 1980s? Despite the claims by many lawmakers on Capitol Hill that the deficit is due to deep tax cuts, the facts show otherwise. As Figure 1 shows clearly, the cause of the deficit has been runaway spending. Until Congress acts to curb the escalation in federal spending, tax hikes will make no dent in the deficit. The new taxes proposed by Congress will merely add more fuel to the spending fire.

IS AMERICA UNDERTAXED?

The conventional wisdom in Congress that Reagan tax cuts have contributed to the budget deficit is contradicted by all the evidence. By every meaningful measure, the tax burden on Americans is heavier today than in any other period since World War II.

◆◆ In constant dollars, federal taxes have grown steadily between 1950 and 1987 (see Figure 2). Since 1981 annual federal revenues in constant dollars will have risen by $70 billion by the end of this fiscal year.

◆◆ Federal tax revenues as a share of gross national product (GNP) are also at near record highs (see Figure 3). Of the last nine presidential terms, only

1. Unless otherwise noted, the source of all numbers in this paper is: Office of Management and Budget, Historical Tables, Budget of the United States Government: Fiscal Year 1988. All dates in this paper refer to fiscal years.

Jimmy Carter's tenure has seen federal taxes that exceeded those under Ronald Reagan.

CONGRESS'S HIDDEN TAX HIKES

Washington's best kept secret is that, whether or not Congress raises taxes this year, the tax burden on Americans, as a percentage of GNP as well as in constant dollar terms, will continue to mount at least through 1992. The reason for this is that previously enacted tax hikes have yet to kick in. Next year, for instance, businesses and workers will be hit with a 5.8 percent hike in the Social Security payroll taxes. This will take $14 billion out of the pockets of Americans in 1988 alone.[2]

Thus even if Congress left the federal tax structure on automatic pilot, rather than pushing for even more taxes, federal taxes as a percentage of GNP would climb to 19.4 percent by 1990 (see Figure 4). By that time, Americans will be carrying a heavier tax load than during even the Carter years, which hold the record for taxing the nation. Figure 4 also shows projected taxes as a percentage of GNP between 1988 and 1991, assuming that the tax hike in the congressional Budget Resolution becomes law. By 1991 tax revenues would reach 20.2 percent of GNP. Never in peacetime have taxes been so high.

HOW CONGRESS USES SOCIAL SECURITY TO UNDERSTATE THE BUDGET DEFICIT

The federal budget contains over dozen programs whose bills are paid for out of separate trust funds. The most important of these is Social Security, but these programs also include highway, airport, and retirement trust funds. Most Americans believe--erroneously--that tax contributions to these funds are set aside for these programs. Hence, gasoline tax money can only be used for road building, and Social Security for retirement. In fact, the funds are diverted immediately to other government programs, in return for government bonds which can later be cashed--funds permitting--from general revenues. The trust funds are simply blended into the unified budget, and thus any surplus in the funds serves to "cut" the deficit (see Figure 7). By 1990, for instance, trust fund surpluses will reach $135 billion; this revenue will help offset the budget deficit, making it appear to be only a projected $134 billion when the deficit in that year actually would be about $270 billion.

This accounting slight-of-hand could have serious implications for the Social Security trust fund. The temporary large surplus in the trust fund eventually will be needed to pay off huge future liabilities as the baby-boom generation enters retirement. But Congress spends the surplus money to fund today's excessive spending on non-Social Security programs. This could bankrupt the national pension program when the federal government's IOUs eventually come due. The Congressional Research Service has estimated that by the year 2020, the Social

2. For a detailed explanation, see: Statement of Representative Harris Fawell, Congressional Record, March 12, 1987, pp. H1285, H1286.

Security Trust fund will have an accumulated paper surplus of about $10 trillion dollars.[3] But if those past surpluses have been spent by Congress, there will be no money for the Social Security Administration to draw on to pay retirees. The CRS projects that if Congress at that time has to pay obligations directly out of payroll taxes, lawmakers would have to raise Social Security taxes by about 60 percent over today's level.[4]

HOW LOWER MARGINAL TAX RATES HAVE INCREASED TAX REVENUE

How is it possible that federal tax receipts have reached record levels despite the 1981 Kemp-Roth tax cuts, which reduced the average American's tax bill by about 30 percent? The reason: "supply side" economists were correct. Reductions in marginal tax rates, the percentage paid on the last dollar earned, have stimulated business expansion and job creation. This increased the tax base so much that even at lower rates the Treasury took in more revenue.

Figure 5 shows the steady decline in the marginal tax rates on various income groups between 1975 and 1988, when the tax rate reductions from the Tax Reform Act of 1986 will be fully in effect. The figure also reveals that Kemp-Roth cut tax rates across the board for all income groups.

Most economists agree that these marginal tax reductions have been at least partially responsible for the 1982-1987 economic expansion--the longest sustained growth in U.S. peacetime history. Thanks to this expansion, over 13 million more Americans have jobs and are paying taxes than when Jimmy Carter was President. This is creating an enormous revenue windfall for the federal Treasury.

The 1981 tax cuts had not even taken full effect when Congress in 1982 passed the so-called Tax Equity and Fiscal Responsibility Act or TEFRA. This raised taxes by $150 billion over four years. This and two other major income tax hikes since 1982 have altogether eroded almost 40 percent of the 1981 Kemp-Roth cuts.[5]

Because Reagan has warned Congress that tampering with income tax marginal rates is off limits, legislators have relied on hikes in the Social Security payroll tax to fuel the federal spending binge. In 1980, wage earners and businesses paid a combined $158 billion into the Social Security trust fund; this year that figure will rise to $302 billion (Figure 6). By 1990 the Social Security tax will consume over three and a half times more of GNP than it did as recently as 1960, adding to labor costs, decreasing U.S. competitiveness and slowing down job creation.

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3. David Koitz, "Social Security: Its Funding Outlook and Significance for Government Finance," Congressional Research Service, June 1, 1986, p. CRS-18.

4. Ibid., p. CRS-16.

5. Bruce Bartlett, "A Tax Hike Is No Cure for the Deficit," Heritage Foundation Backgrounder, No. 491, March 3, 1986.

DO THE AFFLUENT PAY A FAIR SHARE OF TAXES?

While the House of Representatives leadership long has made the argument that the 1981 marginal tax cuts were a boon only to the rich, Figure 7 reveals that, although the tax rates were made less progressive by the 1981 tax cuts, the affluent now pay a larger share of total taxes than they did before the new tax rates were instituted. The wealthiest 5 percent of Americans now carry 5.5 percent more of the tax load than they did in 1981, while middle and lower income Americans have had their tax burden eased by over 5 percent.

WOULD A TAX INCREASE HIKE CURB THE DEFICIT?

The House and Senate leadership claims that the $70 billion tax hike proposed in the Budget Resolution is an act of fiscal responsibility. Legislators sing the usual refrain--the new revenue will be used to trim the budget deficit.

But the tax lobby in Congress has little credibility when it comes to budget deficits. In 1982, Congress promised that the record $100 billion TEFRA tax increase would be used to cut the deficit. Three years later the deficit had risen by another $100 billion. Congress again raised taxes in 1984, citing the need to raise revenue to cut the deficit. And once again spending and the deficit rose. The lesson is clear: Congress normally regards additional federal revenues as an invitation to spend. A 1987 Joint Economic Committee study commissioned by Senator William Roth, the Delaware Republican, investigated the impact of tax hikes on the deficit since 1947.[6] Its conclusion:

> Increases in taxes, other things equal, are associated with higher deficits, with the results statistically significant....A one dollar increase in taxes, other factors held constant, is estimated to lead to a 58 cent increase in the deficit, meaning a $1.58 cent increase in spending.

THE REAL CAUSE OF THE BUDGET DEFICIT: SPENDING

The notion promoted by Congress that the Reagan Administration has slashed domestic spending programs has no basis in fact. All but a handful of domestic programs survived intact the assaults of Reagan's first budget director, David Stockman. In fact, the vast majority of federal programs have much fatter budgets today than in 1981.

Figure 8 compares the growth in domestic versus defense spending since 1950 in constant dollars. The domestic spending build-up has dramatically outpaced defense spending over this period. Domestic programs have grown fivefold in size since 1960 and have more than doubled in size since 1970. Over this period, defense spending has grown only modestly. Though virtually every domestic program

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6. Richard Vedder, Lowell Gallaway, and Christopher Frenze, "Federal Tax Increases and the Budget Deficit, 1947 - 1986: Some Empirical Evidence," Joint Economic Committee, 1987.

consumes a larger percentage of GNP today than in 1960, defense programs consume about 3 percent less.

Figure 9 shows how defense spending as a share of GNP would plummet through 1990 if the Congressional Budget Resolution became law. By 1990 the defense budget would resemble the defense spending levels of the Carter years, which threatened America's preparedness and undermined Washington's ability to negotiate with the Soviets. Senator Phil Gramm, the Texas Republican, correctly has criticized this deficit reduction path as one that moves the country's national security "from vulnerability to vulnerability."

CONCLUSION

Ronald Reagan vows that "any tax-hike bill that makes it into the Oval Office won't make it out alive." He is correct in challenging the pro-tax lobby on Capitol Hill. A tax hike would not reduce the deficit. Federal revenues long have climbed steeply--in constant dollars and as a share of GNP--yet lawmakers have made sure that spending stays one jump ahead.

The chief architects of the 1988 Congressional Budget Resolution tout it as an act of fiscal responsibility. But these "responsible" lawmakers behind the proposed $70 billion tax hike are the same members who:

◆◆ Voted within the last six months to override presidential vetos of two pork barrel spending measures--the Highway bill and the water bill--with a combined price tag $20 billion over the President's request.

◆◆ Voted in 1986 against the balanced budget amendment in the Senate and prevented the issue from being taken up in the House--despite the fact that about 70 percent of Americans support this amendment.

◆◆ Refused to restore the enforcement mechanism to the Gramm-Rudman-Hollings deficit reduction law, even though this legislation has been the only successful tool to pare down the budget deficit.

The record indicates that lawmakers do not want new taxes out of any born-again concern over budget deficits that they themselves enacted. They want new taxes to allow them to spend more on domestic programs--indeed, spending would rise 4.5 percent under their plan.

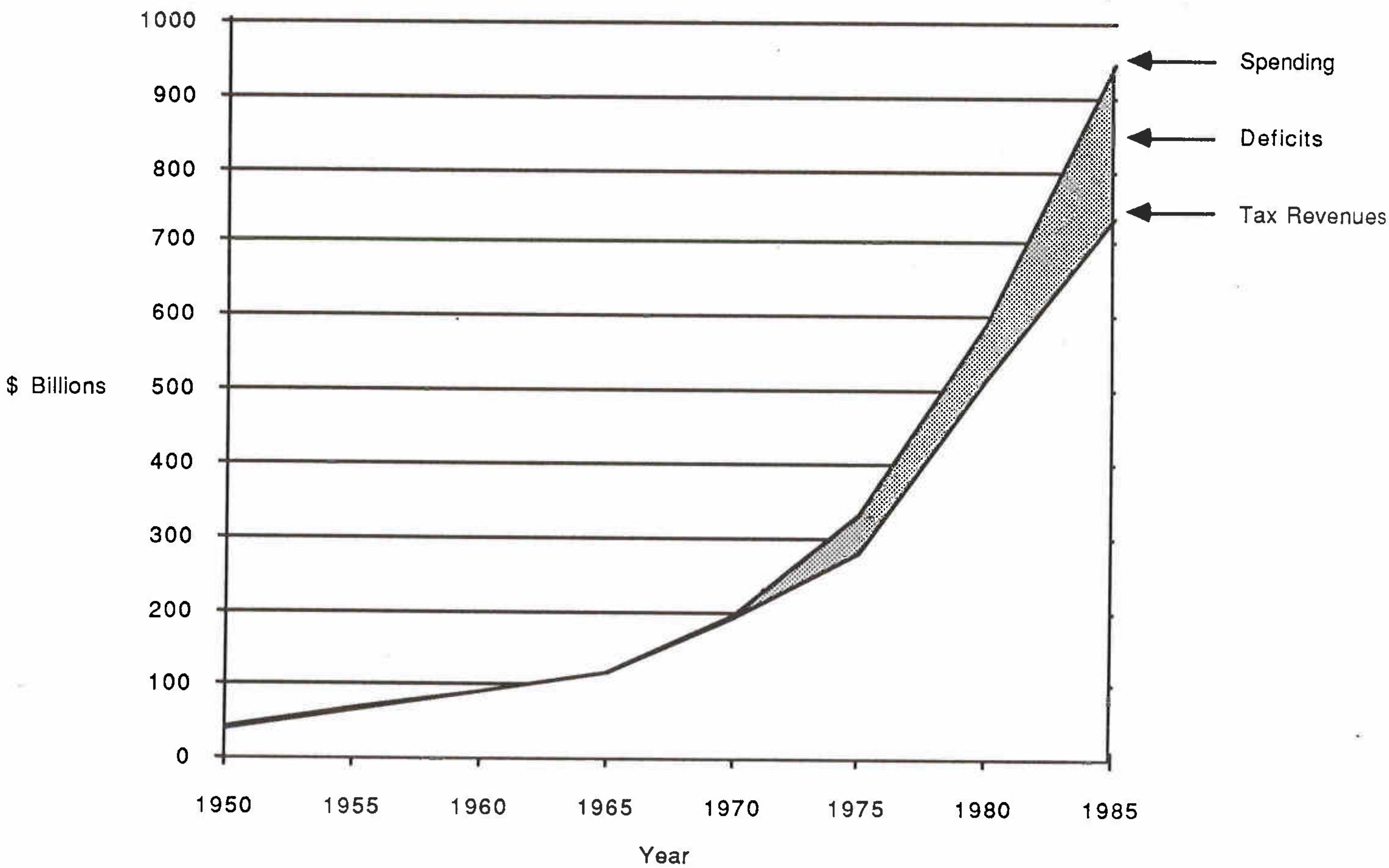
The U.S. public has been duped twice already in this decade by hollow promises from Congress that a tax hike would be used to finance deficit reduction. Both times taxpayers got the new taxes, but not the deficit reduction. This is not the time for Americans to learn another costly bait-and-switch lesson.

Stephen Moore
Policy Analyst

Figure 1

Growth in Federal Spending, Taxes, and Deficits

(Current Dollars)



NOTE: The federal budget deficits between 1950 and 1970 are too small to accurately represent on a graph of this scale. The largest deficit between 1950 and 1960 was $13 billion in 1959. The largest deficit between 1960 and 1970 was $25 billion in 1968.

Figure 2

The Growth in Total Federal Tax Revenues

(Constant 1982 Dollars)

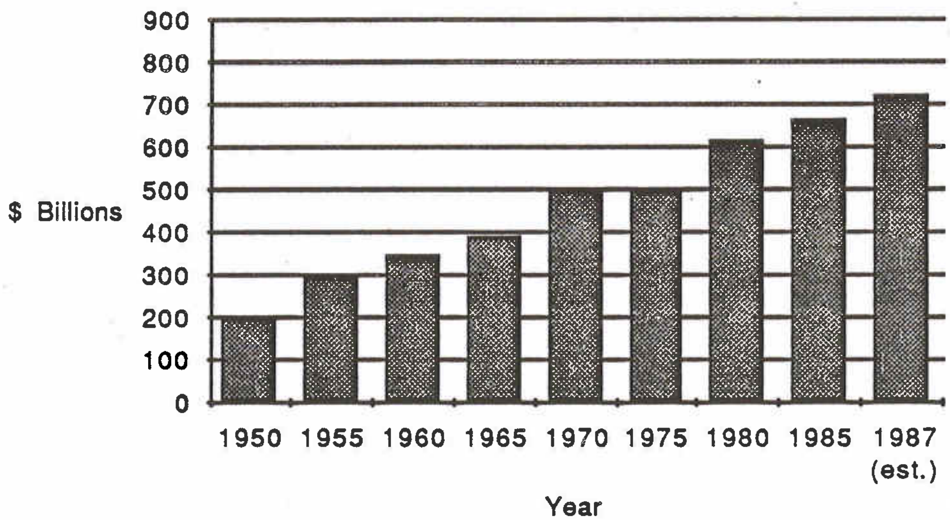
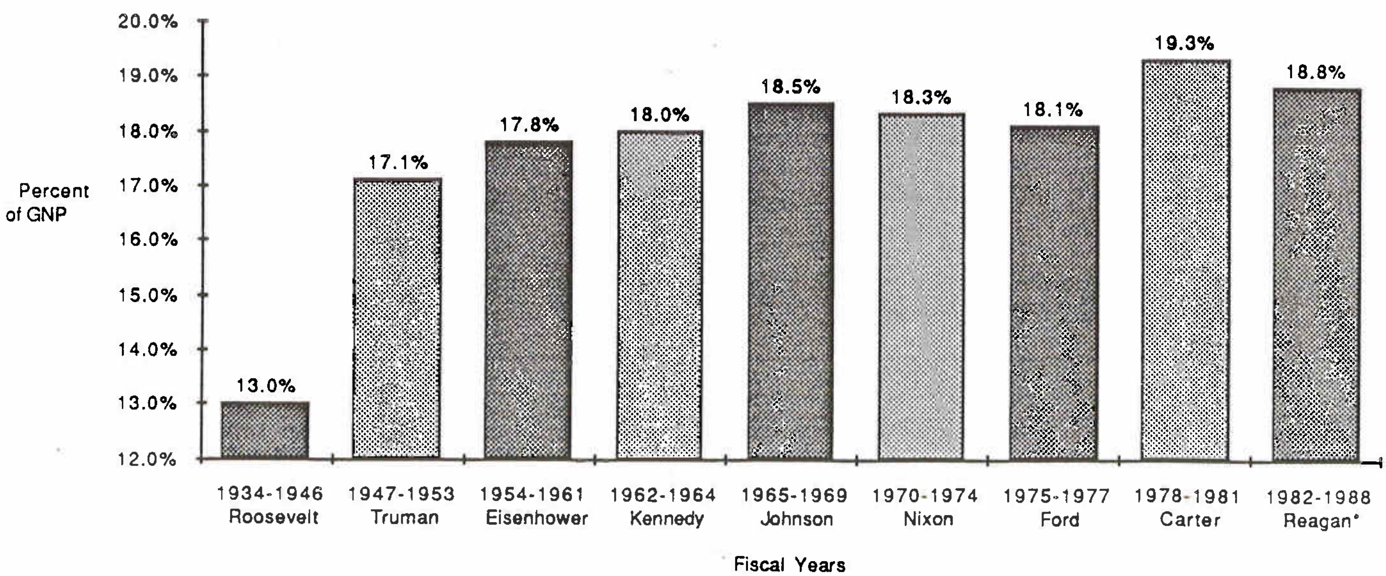


Figure 3

Federal Taxes as a Percentage of GNP During the Past Nine Presidencies

(By Fiscal Years)



* Data for Fiscal Years 1987 and 1988 are OMB estimates.

Figure 4

Growth in Taxation Through 1990: Under Current Law and Under FY 1988 Congressional Budget Resolution

(Federal tax revenues as a share of GNP)

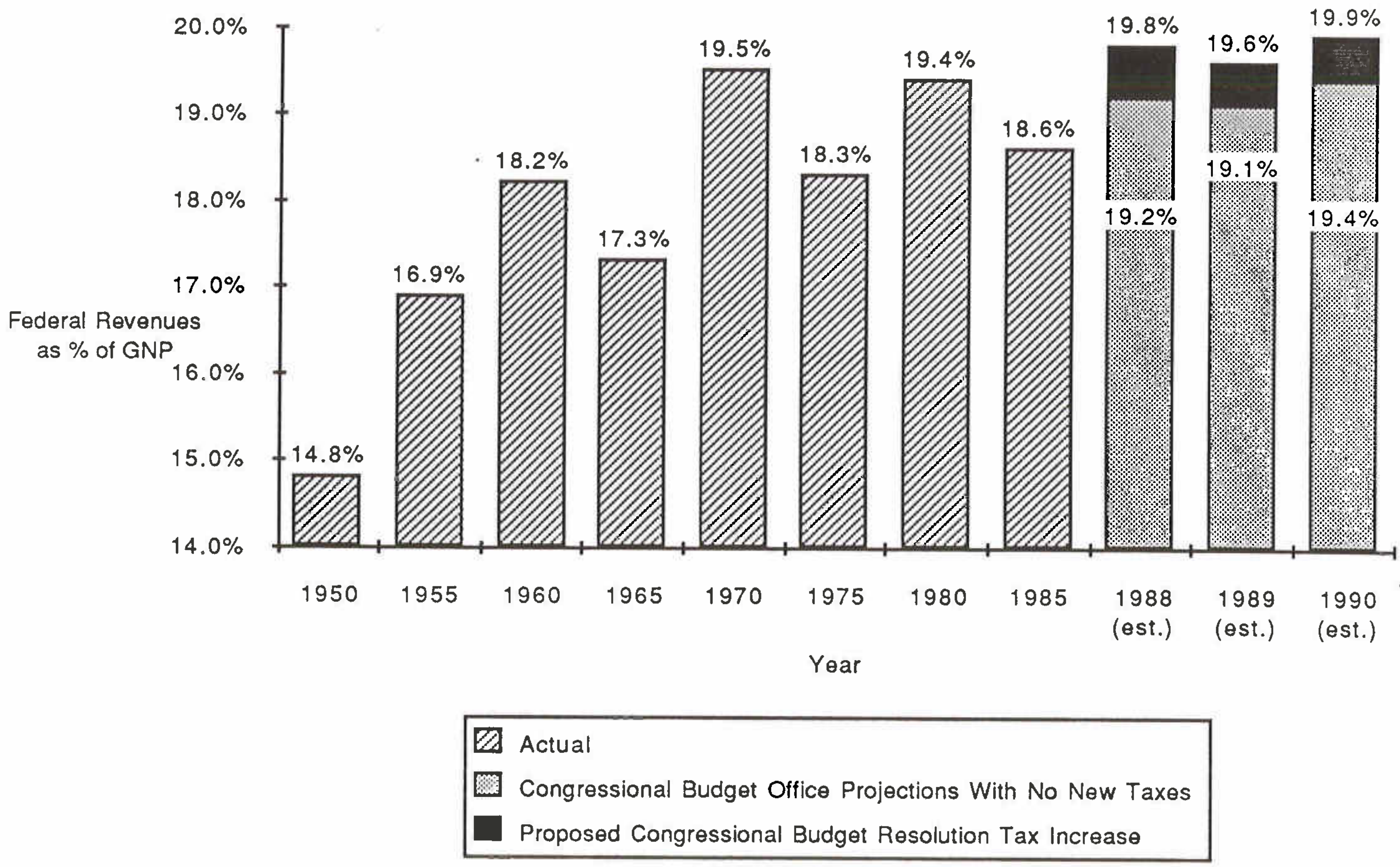
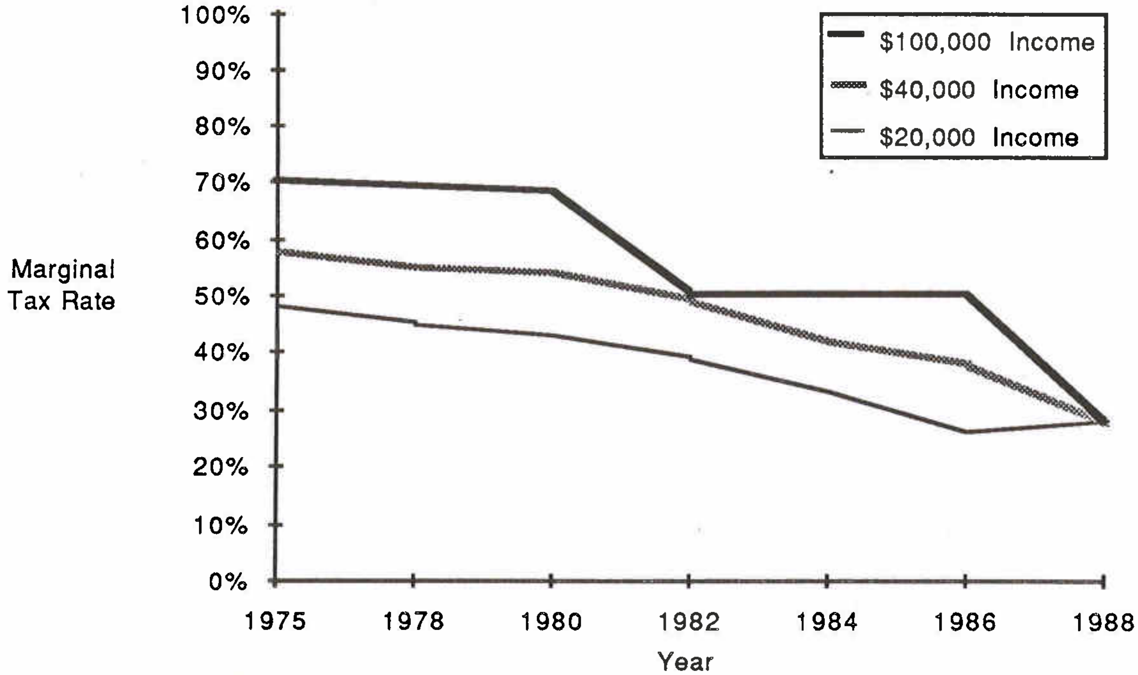


Figure 5

Decline in Marginal Tax Rates Since 1975
(Selected Years)



Source: Tax Foundation, Incorporated, "Facts and Figures on Government Finance," 1986, table C-36.

Figure 6

The Increasing Burden Of Social Security Taxes

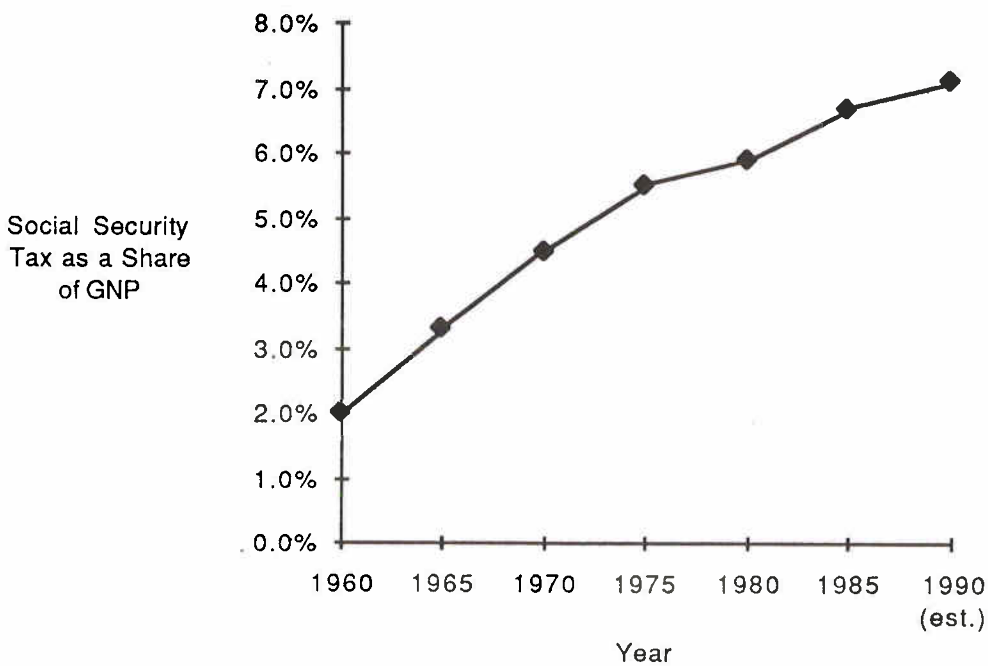


Figure 7

Annual Federal Deficits: Reported Versus Actual

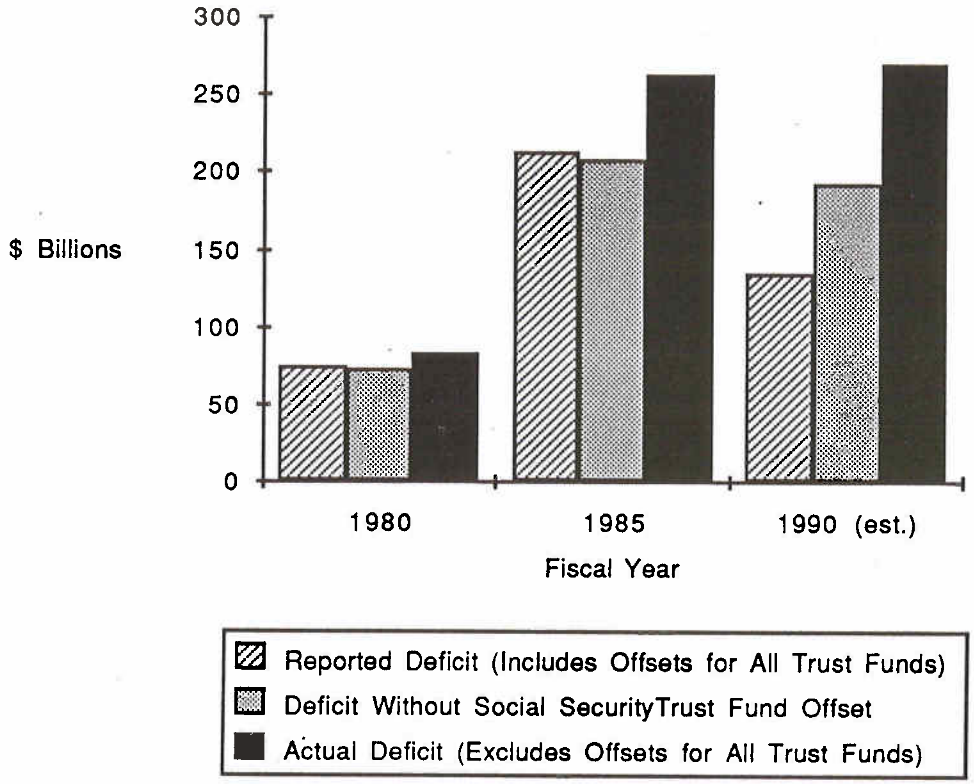
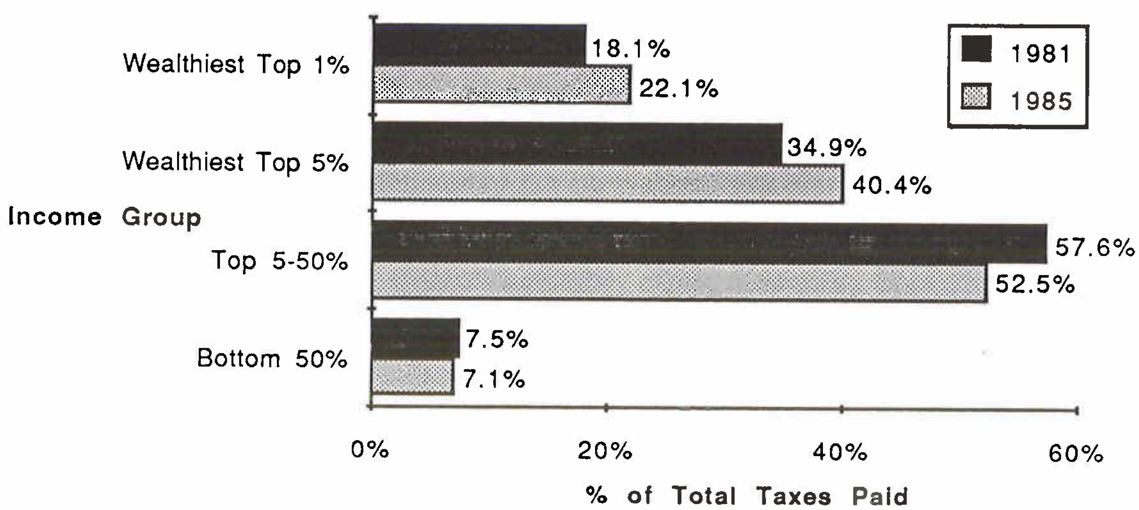


Figure 8

Share of Tax Burden by Income Group Before and After Reagan Tax Cuts.

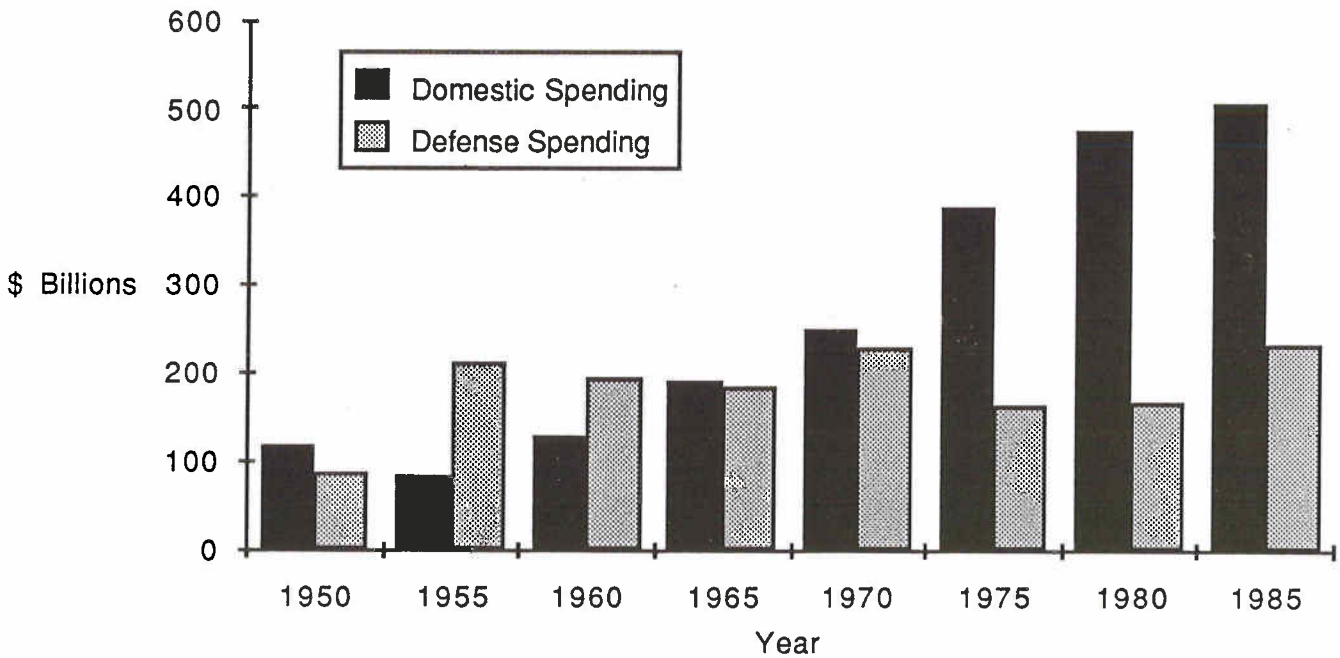


Source: Internal Revenue Service, 1987 Data.

Figure 9

Federal Domestic Spending Versus Defense Spending 1950-1985*

(Constant 1982 Dollars)

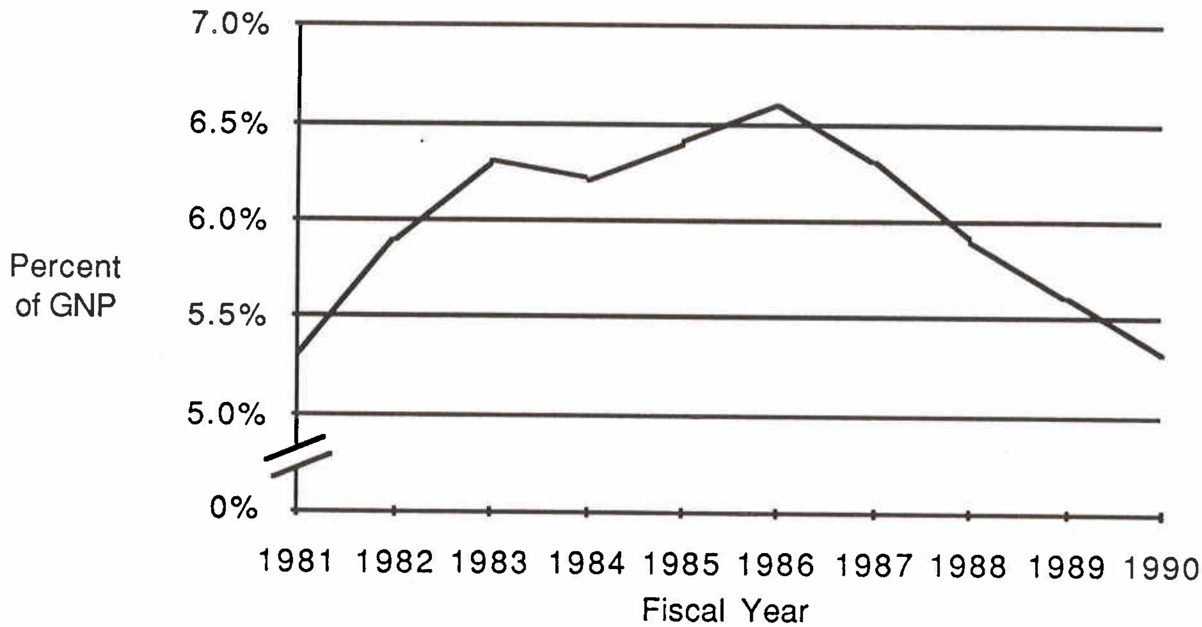


* Domestic Spending is defined as total federal spending minus defense and interest on the national debt.

Figure 10

A Return to The Carter Era in Defense Spending

(Defense Spending as a Percentage of GNP)



* Defense spending figures for 1988 through1990 assume adoption of 1988 Congressional Budget Resolution.