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THE IMPACT OF HIGHER TAXES: MORE SPENDING, ECONOMIC STAGNATION, FEWER JOBS, AND HIGHER DEFICITS

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Many Washington lawmakers and interest groups are urging President Bill Clinton to impose higher taxes on the American economy. They say such taxes will reduce the deficit and provide funds for new programs. Unfortunately, the former Arkansas Governor seems to need little convincing. Although he already has broken several promises made during the presidential campaign, there is no indication that Clinton will backtrack on his promise to raise taxes by $150 billion over the next four years. Indeed, evidence is mounting that Clinton will propose even more taxes.[1] Moreover, after telling Americans to examine the fine print in his campaign statements, it appears the new President also will violate his promise to raise taxes only on those families with annual incomes of more than $200,000.[2]

Proponents of raising taxes argue that the federal budget cannot be balanced without a tax hike. They argue, too, that tax increases will make the tax code "fairer." Some even claim that tax increases will encourage economic growth by reducing the need for federal borrowing.

Raising taxes, however, would be a political and economic mistake, regardless of who pays and what taxes are increased. If history is any guide:

- ✘ **Higher taxes will fuel additional federal spending.** For every dollar of higher taxes since 1947, spending has increased by $1.59.

1 *White House Bulletin*, Alexandria, Virginia, January 25, 1993, p. 5.
2 "Clinton to Consider Consumption Tax," *The Washington Post*, January 25, 1993, p. A1.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

- ✗ **Higher taxes will hinder economic growth.** Large tax increases under Herbert Hoover, Jimmy Carter, and George Bush slowed the economy, while tax cuts under John F. Kennedy and Ronald Reagan led to record economic expansions.

- ✗ **Higher taxes will shrink the tax base and reduce tax revenues.** The record tax increase in 1990, for instance, was meant to bring in billions of dollars to the Treasury and spur growth. Instead, the increase in the tax burden helped throw the economy into a recession and lost $3.25 of tax revenue for every dollar it was supposed to raise.

- ✗ **Higher taxes will result in larger federal budget deficits.** Taxes were raised in 1982, 1984, 1987, and 1990. In each case, proponents of the hike claimed that the deficit would decline. But in each case, the deficit rose the following year.

Advocates of higher taxes have resorted to promoting general myths in an effort to derail opposition. Among the dishonest statements now being used:

Myth #1: The 1981 tax cuts caused the deficit.
Reality: Tax revenues this year are $630 billion higher than they were in 1980, an increase of 26 percent *after* adjusting for inflation.

Myth #2: The federal government is suffering a revenue shortfall.
Reality: Federal tax revenues are expected to increase by an average of $67.8 billion each year between 1993 and 1998.

Myth #3: The rich are not paying their "fair share."
Reality: The wealthiest 10 percent of taxpayers are paying a larger share of the income tax burden today than they were in 1980.

Myth #4: The rich got richer and the poor got poorer during the 1980s.
Reality: All income groups enjoyed higher real earnings during the Reagan years.

The only beneficiaries of tax increases are those who gain from the new programs that taxes finance. By contrast, typical American families suffer when higher taxes consume a larger percentage of their income. American workers suffer when tax increases reduce employment opportunities and upward mobility. American businesses suffer when tax hikes make new investment unprofitable and hinder their international competitiveness.

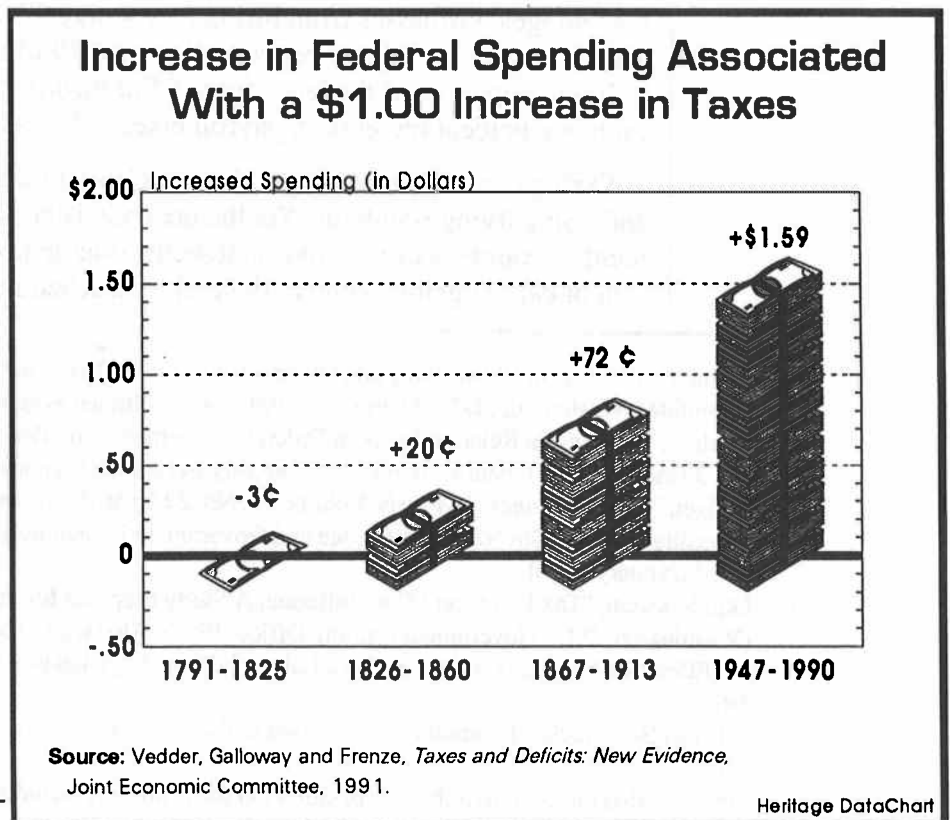
If policy makers are concerned about economic growth, they should cut taxes instead of raising them. Presidents from Calvin Coolidge to John Kennedy to Ronald Reagan triggered strong economic expansions by cutting tax rates; that policy increased incentives to work, save, and invest. Presidents Herbert Hoover, Jimmy Carter, and George Bush, on the other hand, imposed substantial tax increases and the economy suffered in each case. This does not mean, of course, that tax policy is the sole determinant of economic growth. Herbert Hoover's protectionist trade policy, for instance, clearly contributed to the economy's poor performance in the 1930s while John Kennedy's free trade

policies helped boost economic growth in the 1960s. But tax policy is a major factor in U.S. economic performance.

Lawmakers thus should be wary of proposals to reduce the deficit by increasing tax rates or raising taxes on savings and investment. The record is unambiguous. Raising taxes fuels spending and widens the deficit. And raising taxes slows the economy by directly reducing incentives to engage in productive economic activity. No lawmaker familiar with this record can support a tax increase while genuinely wishing to protect the economic interests of the average American.

HOW MORE TAXES MEAN MORE SPENDING

Politicians routinely claim that higher taxes mean deficit reduction. But in reality, additional tax revenues are consumed by more spending. In the 1970s, for instance, tax revenues grew by $324.3 billion, but spending rose by $395.3 billion. In other words, for every dollar of higher taxes, spending rose by $1.22. In the 1980s, tax revenues rose by $514.2 billion. Rather than use the new money for deficit reduction, however, lawmakers increased spending between 1980 and 1990 by $661.7 billion, a spending increase of $1.29 for each dollar of new tax revenue. The pattern has become even more pronounced since 1990. In the last three years, federal spending has increased by $1.91 for every dollar of additional tax revenue.[3]



Source: Vedder, Galloway and Frenze, *Taxes and Deficits: New Evidence*, Joint Economic Committee, 1991.

The relationship between taxes and spending is confirmed by scholarly research. A 1991 study by Congress's Joint Economic Committee, for instance, measured the budgetary impact of tax increases. The study found that every dollar of higher taxes between 1947 and

3 *Budget Baselines, Historical Data, and Alternatives for the Future*, Office of Management and Budget, Washington, D.C., January 1993.

1990 was associated with $1.59 of new spending.[4] To make matters worse, the propensity of Congress to spend new revenues has increased. As the chart on the previous page indicates, the bulk of new tax revenues went to deficit reduction in the early years of the Republic. But over time lawmakers steadily have increased the amount of new spending associated with higher taxes.

Given the persuasive historical evidence that tax increases result in higher spending, it is incumbent upon proponents of higher taxes to explain why the pattern would be different in 1993—why tax increases today will produce any different result than tax increases in the past. In theory, the budget deficit could be solved with higher taxes. In reality, however, lawmakers seem more concerned with reaping political benefits by increasing spending. Until this political relationship is changed, higher taxes will undermine rather than promote the goal of deficit reduction.

WHY HIGHER TAXES ARE A RECIPE FOR RECESSION

Higher taxes lead not only to higher spending, but also to a deterioration in the economy's performance. Taxing labor income (payroll and income taxes), for instance, drives a tax wedge between the employer's cost of hiring a worker and the after-tax income a worker receives. This wedge reduces the incentive for Americans to work. And it discourages businesses from hiring new workers by raising the cost of attracting labor. The increased tax burden between 1965 and 1980, for instance, drove an estimated 1.9 million people out of the labor force.[5] For businesses, statistical research has found that each one percent increase in payroll taxes reduces hiring by approximately 1.4 percent.[6]

Taxing capital is equally pernicious. Capital formation is the key to economic growth and rising living standards. Yet the tax code is heavily biased against savings and investment.[7] Examples of this bias include the double taxation of dividend income, the taxation of capital gains, punitive depreciation schedules, the taxation of interest income, es-

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4 Richard Vedder, Lowell Gallaway and Christopher Frenze, "Taxes and Deficits: New Evidence," Joint Economic Committee, Washington, D.C., October 30, 1991. For additional evidence, see Neela Manage and Michael L. Marlow, "The Causal Relation between Federal Expenditures and Receipts,"*Southern Economic Journal*, Volume 52, No. 3 (January 1986); Paul R. Blackley, "Causality Between Revenues and Expenditures and the Size of the Federal Budget," *Public Finance Quarterly*, Volume 14, No. 2 (April 1986); and Rati Ram, "Additional Evidence on Causality between Government Revenue and Government Expenditure," *Southern Economic Journal*, Volume 54, No. 3 (January 1986).

5 Otto Eckstein, "Tax Policy and Core Inflation, A Study Prepared for the Use of the Joint Economic Committee," (Washington, D.C.: Government Printing Office, 1980). Also see L. Godfrey, "Theoretical and Empirical Aspects of the Effects of Taxation on the Supply of Labour" (Paris: Organization for Economic Cooperation and Development, 1975).

6 Michael Beenstock, "Taxation and Incentives in the U.K.," *Lloyds Bank Review*, Number 134, October 1979, pp. 1-15.

7 For a detailed discussion of the role of capital in the economy, including quotes from liberal economist Paul Samuelson and the Democrat-controlled Joint Committee on Taxation, see Daniel J. Mitchell, "An Action Plan to Create Jobs," Heritage Foundation *Memo to President-Elect Clinton* No. 1, December 14, 1992. Also see Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth" National Center for Policy Analysis, Report No. 169, January, 1992); and Arthur P. Hall, II, "Big Government or Economic Prosperity? A Primer on Taxation, Regulation, and Economic Growth" (Washington, D.C.: Citizens for a Sound Economy Foundation, June 1992).

tate taxes, and the corporate income tax. These taxes combine to discourage savings and investment, biasing economic choices in favor of consumption rather than investment, and creating a preference for short-term rather than long-term investment.[8]

Other levies, such as excise taxes and property taxes, may not impose quite as much economic damage as taxes on capital and labor, but their impact still is negative. Energy taxes, for instance, increase the cost of producing and transporting almost every good produced in the economy.[9] So-called luxury taxes can devastate particular industries. The luxury taxes imposed as part of the disastrous 1990 budget deal, for example, are widely credited with destroying jobs and businesses in the light aircraft and boat-building industries.[10]

Major tax increases almost always have a significant impact on the economy's performance. Herbert Hoover's decision in 1930 to increase the top tax rate from 25 percent to 63 percent doubtless contributed to the Depression. Lyndon Johnson's surtax on income tax liabilities enacted in 1968, together with an increase in the capital gains tax, helped choke the expansion triggered by the Kennedy tax cut. The economy's dismal performance during the Presidency of Jimmy Carter was associated with large tax increases, including inflation-induced bracket creep. And George Bush's record tax increase in 1990 was a principal cause of the recent recession and subsequent anemic recovery.

The inverse relationship between taxes and economic growth is confirmed by academic research. A 1983 World Bank study of twenty countries found that low-tax nations experience faster growth, generate more investment, enjoy faster productivity growth, and experience more rapid increases in living standards than high-tax nations.[11] A more recent study of taxes in the United States found that each 1.0 percent increase in the federal tax burden reduces economic growth by 1.8 percent and lowers national employment by 1.14 percent.[12]

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8 For empirical evidence on the relationship between taxes, capital formation, and economic growth, see Eckstein, *op. cit.*; Roger H. Gordon and Dale Jorgenson, "The Investment Tax Credit and Countercyclical Policy" (Cambridge: Harvard Institute of Economic Research, Discussion Paper No. 373, June 1974); James M. Poturba and Lawrence Summers, "Dividend Taxes, Corporate Investment and 'Q'" (National Bureau of Economic Research, Working Paper No. 829, December 1981); Martin Feldstein, "Inflation, Tax Rules and the Accumulation of Residential and Non-residential Capital" (Seminar Paper No. 186, Institute for International Economic Studies, University of Stockholm, November 1981); Dale W. Jorgenson, "Taxation and Technical Change" in Ralph Landau and N. Bruce Hannay, eds., *Taxation, Technology and the U.S. Economy* (New York: Pergamon Press, 1981); Robert E. Hall and Dale W. Jorgenson, "Tax Policy and Investment Behavior," *American Economic Review*, 58:3, pp. 391-414; and Charles W. Bischoff, "The Effect of Alternative Lag Distributions," in Gary Fromm, ed., *Tax Incentives and Capital Spending* (Washington, D.C.: The Brookings Institution, 1971).

9 "Jobs-At-Risk: Short-Term And Transitional Employment Impacts of Global Climate Policy Options, Final Report" CONSAD Research Corporation, Pittsburgh, PA, May 12, 1992.

10 "The 1992 Joint Economic Report" Joint Economic Committee, Washington, D.C., Government Printing Office, 1992, pp. 159-164.

11 Keith Marsden, "Links Between Taxes and Economic Growth: Some Empirical Evidence" (World Bank Staff Working Paper Number 605, Washington, 1983).

12 William C. Dunkelberg and John Skorburg "How Rising Tax Burdens Can Produce Recession" Cato Institute *Policy Analysis*, No. 148, February 21, 1991.

The direct economic cost of taxation is compounded by a tax code that is unnecessarily complex and burdensome. In fact, tax experts have discovered that the tax system as a whole imposes $1.65 of cost on the private sector for every $1 that the government receives.[13] This cost to the economy includes the time, money, and resources that are used to comply with the tax law, and the economic output lost because of the tax code's impact on incentives to work, save, and invest. Thus elected officials deciding whether to create or expand government programs should ask themselves the following question: What will benefit people more, one dollar of additional federal spending or $1.65 of spending in the productive sector of the economy? Many government programs today would fail this test.

HOW TAX INCREASES LEAD TO HIGHER DEFICITS

When the economy slows, the impact on the tax base is often dramatic. Workers without jobs do not pay income and payroll taxes. Businesses losing money do not pay corporate income taxes. A reduction in disposable income means fewer purchases of gasoline, imported goods, alcohol, cigarettes, and other items subject to excise taxes. It is because tax increases cause the tax base to shrink in this way, compared with what would have happened if economic policy had remained constant, that new taxes never raise as much money as originally forecast.

A major reason why projected revenues from tax increases routinely exceed the amount of money actually generated is that lawmakers rely on static economic models. Incredibly, these models assume that higher taxes will have no impact on the economy. As a result, even though taxes have a well-documented harmful effect on economic activity, Congress uses revenue estimates that simply pretend the real world does not exist. The absurdity of this system was exposed in 1989 by Senator Robert Packwood of Oregon, the ranking Republican on the Finance Committee. Senator Packwood asked Congress's revenue estimating body, the Joint Committee on Taxation (JCT), to estimate what would happen to tax revenues if the government confiscated all income over $200,000 per year. The JCT replied that such a tax would generate $104 billion the first year, $204 billion the second year, $232 billion in the third year, $263 billion in the fourth year, and $299 billion in the fifth year.

The notion that such a tax would raise higher amounts of revenue each year is of course preposterous. As Senator Packwood pointed out, "[The JCT estimate] assumes people will work if they have to pay all their money to the Government. They will work forever and pay all the money to the Government when clearly anyone in their right mind will not. Of course, there will be a behavioral response."[14]

Despite the theoretical models used by the JCT, in the real world higher taxes do affect the economy. Individuals and businesses change their behavior in an effort to reduce their tax liability.[15] As a result, tax increases never increase revenues as much as congres-

13 James L. Payne, "Unhappy Return: The $600-Billion Tax Ripoff," *Policy Review*, Winter 1992.

14 *Congressional Record*, November 14, 1989, p. S 15534.

15 Many citizens already are taking action to protect their earnings from excessive taxation. Executives at major

sional forecasts predict. This revenue shortfall, combined with lawmakers' propensity to spend projected new tax revenues (which do not materialize), explains why tax increases almost always increase the budget deficit.

America's recent fiscal history illustrates the counterproductive effect of tax increases. Major tax hikes were imposed on the American economy four times in the last twelve years, but not once did the deficit fall:

- ✘ **The 1982 Tax Equity and Fiscal Responsibility Act was supposed to reduce the budget deficit, but the deficit climbed the following year.**
- ✘ **The 1984 Deficit Reduction Act was supposed to reduce the budget deficit, yet the deficit rose in 1985.**
- ✘ **The 1987 Omnibus Budget Reconciliation Act was supposed to reduce the budget deficit. Once again, the deficit was higher the following year.**
- ✘ **The budget deal of 1990 saddled the economy with the largest single-year tax increase in American history, as Congress allegedly sought to reduce the deficit. Since then the budget deficit has risen to record highs.**

The 1990 budget deal exemplifies why tax increases are such an ill-conceived policy. Not only did the agreement unleash a record increase in domestic spending, but the massive tax hike also helped cause a large decline in tax revenue. The table below compares five-year baseline revenue projections made in the Summer of 1990—before the budget deal was enacted—with the revenue numbers and estimates released in January 1993. Rather than rising by an additional $175 billion over the five-year period, tax revenues actually fell by $569.7 billion compared with the Summer 1990 estimates. This means the tax increase produced a revenue loss of $3.25 for every dollar it was supposed to generate.[16]

The 1990 Budget Agreement: More Taxes Equals Less Revenue

Billions of Dollars	1991	1992	1993	1994	1995
1990 Mid-Session	$1121.7	$1194.5	$1278.7	$1363.1	$1441.1
1993 Baseline	1054.3	1091.6	1147.6	1230.3	1305.6
Difference	**-67.4**	**-102.9**	**-131.1**	**-132.8**	**-135.5**

Source: *Mid-Session Review of the Budget* and *Budget Baselines, Historical Data and Alternatives for the Future,* Office of Management and Budget, 1990 and 1993.

corporations, including General Dynamics and Disney to name just a few, arranged to take bonuses and exercise stock options in 1992 because of fears that tax rates would be raised this year. Similarly, many major league baseball players, such as Detroit Tigers outfielder Cecil Fielder and Kansas City Royals pitcher David Cone, have signed contracts taking a substantial portion of their remuneration in lump-sum amounts in 1992 because of expected increases in tax rates.

16 The tax increase is not responsible for the entire drop in tax revenues. Other misguided policies, such as the

Tax increases have failed to reduce the deficit in the past and they are not likely to work now for President Clinton. Indeed, if tax increases were to reduce projected economic growth by just one percentage point over the next five years, the deficit almost certainly would grow rather than fall. A one percentage point reduction in growth causes a small increase in spending and a large drop in projected tax revenues. And the projected spending increase, it should be noted, only includes higher outlays caused by heavier demands on existing entitlement programs, such as food stamps and unemployment insurance. It does not include any spending increases accompanying a tax increase.

Deficit Impact of Economic Growth 1% Less Than Predicted

Billions of Dollars	1993	1994	1995	1996	1997	1998
Receipts	-$5.8	-$19.1	-$35.5	-$52.4	-70.8	-$90.9
Outlays	+1.3	+4.8	+9.7	+16.4	+24.8	+33.2
Deficit Increase	+7.1	+24.0	+45.0	+68.8	+95.6	+124.1

Source: *Budget Baselines, Historical Data and Alternatives for the Future,* Office of Management and Budget, 1993.

If tax increases could eliminate the deficit, the budget would have been balanced long ago. Between 1962 and 1991, Congress approved at least 47 pieces of legislation increasing the burden of taxes.[17] Yet the budget has never been balanced since 1969. In the 24 years since then, an unbroken string of budget deficits has added more than $3 trillion to the national debt, and annual budgets have climbed from $183.6 billion to $1.475 trillion, an increase of more than 700 percent.

FEDERAL SPENDING IS REAL PROBLEM

Even if tax increases could reduce the budget deficit, higher taxes still would be the wrong choice. The reason for this is that budget deficits are only a symptom of a greater problem—excessive federal spending.[18] It is the total level of spending, regardless of whether it is financed by taxing or borrowing, that is the fiscal burden imposed on the economy by government. Both taxes and borrowing hinder economic growth by reducing the amount of resources available to the productive sector of the economy. Simply replacing government borrowing with taxes—even assuming the taxes do not of themselves harm the economy or induce additional spending—leaves the overall fiscal burden of government unchanged.

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minimum wage increase, the Americans with Disabilities Act, the Clean Air Amendments, and the record increase in domestic spending have contributed to the economy's problems and helped shrink the tax base.

17 "Listing of Tax Laws Which Increased Revenues from 1962 to the Present" *Memorandum*, Congressional Research Service, Washington, D.C., May 11, 1992.

18 For an excellent discussion of this issue, see Lawrence Kudlow, "The Deficit Obsession," *The Wall Street Journal*, January 25, 1993, p. A16.

As in the case of taxes, scholars have discovered a strong inverse relationship between government spending and economic growth. A 1983 study in the *Southern Economic Journal*, for instance, discovered that a one percentage point increase in government consumption spending as a percent of gross domestic product causes real economic growth to fall by .33 percentage points.[19] A 1989 study in the *Journal of Monetary Economics* came up with similar results. The authors found that every percentage point increase in government consumption spending as a share of national output reduces the economy's inflation-adjusted growth by .35 percentage points.[20] Numerous other studies also confirm the inverse relationship between economic growth and government spending.[21]

One reason for this inverse relationship is that politicians and bureaucrats do not have the incentive to spend money in ways that promote economic growth. Instead, government decision makers spend money in response to political pressures. Workers, consumers, investors, and businesses in the private sector, on the other hand, have strong financial incentives to use resources as efficiently and productively as possible. Thus a dollar taken from the private sector and spent in the public sector almost always means a net economic loss.

THE PHONY FAIRNESS ISSUE

Even though higher taxes encourage more spending, undermine economic growth, and increase the budget deficit, some policy makers still argue that the tax burden on upper-income citizens should be increased in order to restore "equity" to the tax code. Proponents of this "fairness" argument maintain that tax changes during the 1980s allowed upper-income Americans to avoid paying their fair share.

This ideologically driven assertion is factually flawed and economically bankrupt.

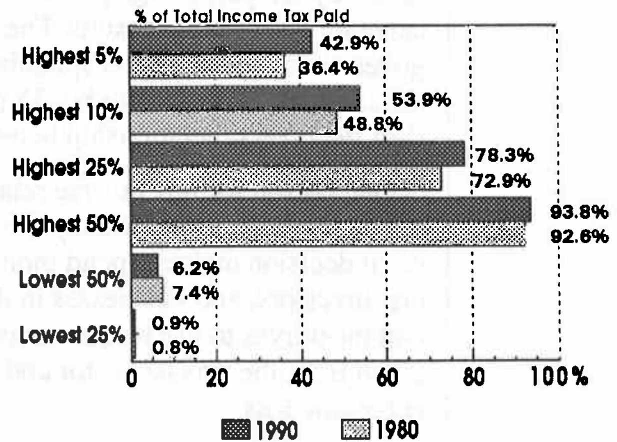
Indeed, wealthier Americans in fact are paying a larger share of the income tax burden than they were in 1980. The top ten percent of income earners, for instance, paid 53.9 percent of federal income taxes in 1990—compared with 48.6 percent in 1980. The bottom 50 percent of income earners, on the other hand, saw their portion of the income tax burden drop from 7.4 percent to 6.2 percent.

19 Daniel Landau, "Government Expenditures and Economic Growth: A Cross-Country Study," *Southern Economic Journal* 49 (1983), pp. 783-792.

20 Kevin B. Grier and Gordon Tullock, "An Empirical Analysis of Cross-National Economic Growth, 1951-1980," *Journal of Monetary Economics* 24 (1989), pp. 259-276.

21 For example, see R.C. Kormendi and P.G. Mequire, "Macroeconomic Determinants of Growth: Cross-Country Evidence," *Journal of Monetary Economics* 16 (1985), pp. 141-163; Michael Marlow, "Private Sector Shrinkage and the Growth of Industrialized Economies," *Public Choice* 49 (1986), pp. 143-154; John McCallum and Andre Blais, "Government Special Interest Groups and Economic Growth," *Public Choice* 54 (1987), pp. 3-18; James R. Barth and Michael D. Bradley, "The Impact of Government Spending on Economic Activity," The National Chamber Foundation, 1988; Robert J. Barro, "A Cross-Country Study of Growth, Saving, and Government," National Bureau of Economic Research, Working Paper No. 2855, February 1989; and Robert J. Barro, "Economic Growth in a Cross-Section of Countries," *Quarterly Journal of Economics* 56 (1991), pp. 407-443.

Presented with these data, proponents of "tax fairness" respond that the only reason that upper-income taxpayers are paying a larger share of the income tax burden is because the rich got richer and the poor got poorer during the last decade. In other words, the rich paid compar atively more in taxes because their incomes skyrocketed, leaving the poor farther behind.



Once again, the assertion is incorrect. The rich did report significant income gains during the 1980s, just as tax-cutters predicted would happen once lower tax rates reduced incentives to shelter and under-report income. But every other income class in America also experienced substantial gains in income during the Reagan expansion. Income fell for every income class during the high-tax Carter years, rose for every income class once the Reagan tax cuts took effect, and fell again when President Bush returned to high-tax policies.

Household Income Growth By Quintile: 1977-1991

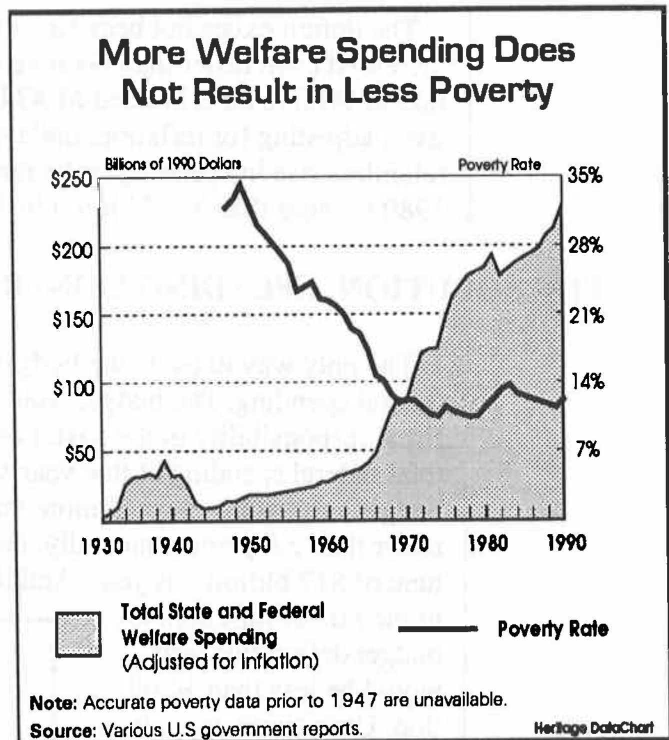
Income Growth in Constant Dollars	Bottom Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Top Fifth	Top 5%
1977-1981	-3.2	-2.0	-1.9	-0.2	-0.0	-2.9
1981-1989	10.4	10.3	10.7	12.3	22.9	33.6
1982-1989	**12.6**	**10.7**	**11.1**	**13.0**	**20.5**	**28.8**
1989-1991	-6.5	-5.0	-5.1	-4.4	-6.2	-9.4

Note: 1982-1989 represents the period between Reagan's tax cuts and Bush's tax increase.
Source: *Budget Baselines, Historical Data and Alternatives for the Future* , Office of Management and Budget, 1993.

Even these figures understate the error of the rich-got-richer, poor-got-poorer argument. Research has demonstrated that there is substantial mobility between income classes from one year to the next, so the poor and rich in 1980 are not the same people as the poor and rich in 1985. Similarly, the poor and rich in 1985 represent different people than those who are poor and rich in 1990.[22]

22 For further information, see: Christopher Frenze,"Income Mobility and Economic Opportunity" (Joint Economic Committee, Washington, D.C., June 1992); "Household Income Mobility During the 1980s: A Statistical Assessment Based on Tax Return Data" (U.S. Department of the Treasury, Washington, D.C., June 1992); Ed Gillespie and Christopher Frenze, "Income Mobility and the U.S. Economy: Open Society or Caste System" (Joint Economic Committee, Washington, D.C., January 1992); Isabel Sawhill and Mark Condon, "Is U.S. Inequality Really Growing" (*Policy Bites*, Urban Institute, Washington, D.C., June 1992); and, Christopher Frenze, "Family Income Growth and Income Equality: Progress or Punishment?" (Joint Economic Committee, Washington, D.C., July 1992).

As the preceding table indicates, policies encouraging economic growth are the best way to increase the living standards for all income classes, including the poor. Income growth was especially strong during the years when the Reagan tax cuts were in effect. During the high-tax periods of the Carter and Bush presidencies, by contrast, all income classes experienced a decline in living standards. Nor will raising taxes for the purpose of income redistribution address the poverty problem. The adjacent chart illustrates how rising welfare expenditures have had no effect on the poverty rate. Indeed, the poverty rate was falling at a steady rate before the War on Poverty began. Once federal anti-poverty programs took effect, the decline in poverty ceased.[23]



TAX RATE REDUCTIONS DID NOT CAUSE THE DEFICIT

Many politicians argue that tax cuts caused the deficit, and so higher taxes are needed to balance the budget. Nothing could be further from the truth. The 1981 Economic Recovery Tax Act did indeed reduce marginal tax rates, as did the 1986 Tax Reform Act, but lower rates do not mean less tax revenue. Tax revenues today are more than $630 billion higher than they were in 1980, an increase of 122 percent. Even after adjusting for inflation, tax revenues jumped by more than 26 percent.

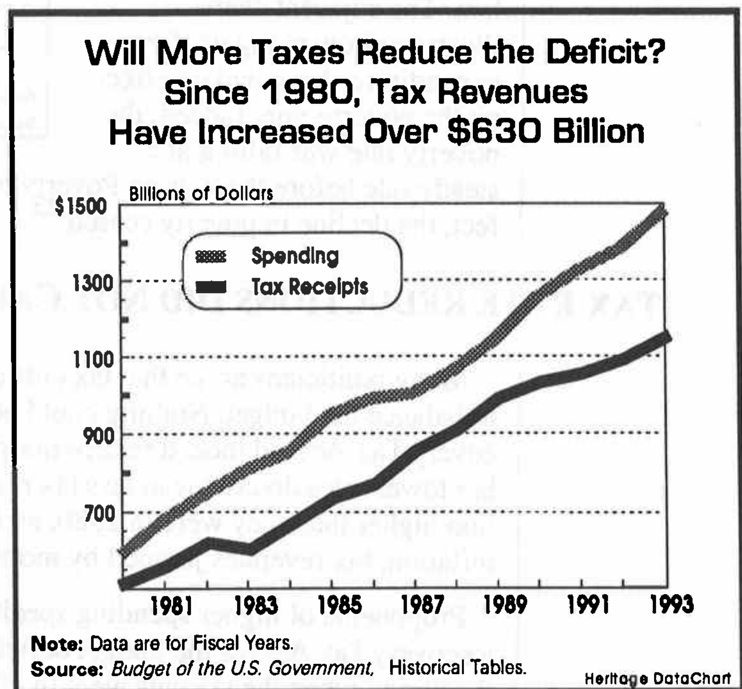
Proponents of higher spending specifically blame President Reagan's 1981 Economic Recovery Tax Act for the budget deficit. But tax revenue growth was more impressive in the period when the tax cuts were in effect than in other years since 1980. From 1983, when the tax rate reductions enacted in 1981 became effective, until 1990, when Bush agreed to the infamous budget deal, tax revenues grew by an average of more than $61 billion per year. But in the three years since taxes were raised by a record amount, as part of the 1990 budget deal, revenue growth has averaged less than $39 billion annually.

23 For further details on the harmful effects of government welfare programs, see Robert Rector, "The Paradox of Poverty: How We Spent $3.5 Trillion Without Changing the Poverty Rate," *Heritage Lecture* No. 410, September 3, 1992.

The deficit exists not because of tax rate reductions but because federal spending has increased even faster than tax revenues. Federal outlays have climbed from $590.9 billion in 1980 to an estimated $1,474.9 billion in 1993, an increase of nearly 150 percent. Even adjusting for inflation, outlays have risen by almost 42 percent since 1980.[24] This relentless rise in spending is the reason that the deficit has jumped from $73.8 billion in 1980 to more than $327 billion in 1993.

THE SOLUTION: SPENDING CONTROLS, NOT TAXES

The only way to solve the budget crisis is to tackle its root cause—the growth of federal spending. The budget would be balanced today had lawmakers chosen to exercise fiscal responsibility in the past. For example, if lawmakers had decided in 1989 to freeze total federal spending at that year's level of $1,143.2 billion, there would have been a budget surplus this year of more than $4 billion. If they had permitted spending to rise no faster than 2.0 percent annually, beginning in 1987, the budget would be in surplus to the tune of $17 billion this year. And if federal spending growth since 1983 had been limited to the rate of inflation, the budget deficit this year would be less than $4 billion. Unfortunately, policy makers did not choose these prudent and reasonable options. Instead, they continued to vote for rapid increases in spending, pushing the deficit to record levels.



Note: Data are for Fiscal Years.
Source: *Budget of the U.S. Government,* Historical Tables.

On the few occasions when policy makers have adopted policies to slow the growth of federal spending, the results have been dramatic. In 1987, for example, the overall growth of federal spending was held to 1.37 percent. As a result of this fiscal restraint, the budget deficit fell by a record $71.4 billion. And significantly, taxes did not increase that year.

The Gramm-Rudman-Hollings Deficit Reduction Act is another example of just how successful spending control can be in reducing the deficit. Enacted in 1985 and amended in 1987, the law created fixed deficit targets designed to balance the budget by 1993.

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24 Another prevalent myth is that higher defense spending caused the deficit. While it is true that defense spending did climb, non-defense spending grew at a faster rate. Inflation-adjusted defense spending rose by 27.7 percent between 1980 and 1993, compared with a 45.8 percent increase in non-defense spending. Moreover, defense spending has fallen from 22.7 percent of total spending in 1980 to 19.6 percent of outlays in 1993.

Gramm-Rudman was far from perfect, and lawmakers regularly engaged in budget gimmicks to avoid some of the fiscal discipline the law demanded, but the Act significantly slowed the growth of federal spending. The budget deficit, which consumed 5.4 percent of gross domestic product (GDP) when the law was enacted, fell to 2.9 percent of GDP by the time Reagan left office just four years later. Unfortunately, the Bush Administration and Congress conspired to evade the Gramm-Rudman law in 1989, and effectively repealed the law in 1990 as part of the budget deal. The result? The repeal of Gramm-Rudman unleashed a torrent of domestic spending.

Annual Average Domestic Spending Growth: The 1990 Budget Agreement Unleased a Massive Spending Binge

Billions of 1987 Dollars	1985-1990	1990-1993
Discretionary	$1.52	$8.98
Entitlements	4.97	38.83
Total Domestic	6.49	47.81

Source: *Budget Baselines, Historical Data and Alternatives for the Future,* Office of Management and Budget, 1993.

President Bill Clinton had the opportunity, on January 21 of this year, to return to Gramm-Rudman by using his executive authority to mandate fixed deficit targets.[25] Unfortunately, Clinton chose to continue the current practice of allowing the deficit targets to expand, thus permitting more spending and higher deficits.

In the absence of a tax limitation/balanced budget amendment, returning to Gramm-Rudman would be a significant move toward a more responsible fiscal policy. Indeed, lawmakers could make a good bill even better by closing some of the loopholes used to skirt the law between 1985 and 1990. In particular, replacing deficit targets with spending targets would focus the law on the real problem—uncontrolled federal spending.

WASHINGTON'S WELL-KEPT SECRET: TAX REVENUES ALREADY ARE RISING

Listening to the rhetoric about "revenue shortfalls" in Washington, one would think that tax revenues were plummeting and conclude that a tax increase was a necessary response. Once again, however, proponents of higher taxes either do not know the numbers or they are being dishonest. According to the Congressional Budget Office (CBO), tax revenues are expected to climb by an average of $67.8 billion annually between 1993 and 1998—without any additional increase in the tax burden. All told, according to CBO, tax revenues are projected to be $339 billion higher in 1998 than they are estimated to be in 1993.[26]

25 Daniel J. Mitchell, "Clinton's Real Deficit Test," *The Wall Street Journal*, January 12, 1993.

26 *The Economic and Budget Outlook: Fiscal Years 1994-1998*, Congressional Budget Office, Washington, D.C., January 1993.

Office of Management and Budget (OMB) estimates confirm the CBO numbers. According to OMB's projections, tax revenues under current law are supposed to be $376 billion higher in 1998 than they are this year, an average annual increase of more than $75 billion. Regardless of which estimate is more accurate, reducing the deficit should be a relatively simple exercise—use the new revenues for deficit reduction, not more spending.

Unfortunately, when advocates of higher taxes assert that additional tax revenues must be part of any deficit-reduction package, they are not referring to the revenue windfall the government already is projected to receive. They mean that American taxpayers must sacrifice even more of their incomes to feed a rapidly growing government.

WHAT DO VOTERS REALLY WANT?

Many Washington insiders argue that the American people really favor higher taxes. But there is little support for this claim in polling data. Voters on election day were asked, for instance, whether they would rather have government provide more services but cost more in taxes, or government cost less in taxes but provide fewer services. By a 55 to 36 margin, voters chose smaller government and lower taxes.[27]

Since the three major candidates had records or platforms supporting tax hikes, voters did not have much choice when voting for President last November. But several state initiatives and referenda did give voters a chance to support or reject higher taxes at the ballot box. A ballot initiative in California, for instance, would have raised state taxes on individuals earning more than $250,000 annually, and on corporations, and would have used the money to cut taxes paid by lower income residents. California voters defeated the initiative by a 58 percent to 42 percent margin.

Similarly, voters in South Dakota rejected a proposal to impose state-wide personal and corporate income taxes by nearly a three-to-one margin. Some 78 percent of Ohio voters rejected a proposal to levy a tax on toxic chemicals. Voters in New York were given the opportunity to approve an $800 million bond package to finance additional state spending on "job-creating" infrastructure. They rejected it by a 56 percent to 44 percent margin. Colorado had an initiative to increase the state sales tax by one cent, to fund more education spending. Voters said no by a 54 percent to 46 percent margin.

Overall, voters rejected eleven of the twelve tax and/or spending increases on state ballots. By contrast, voters approved three-fourths of the tax and/or spending reduction initiatives. Connecticut, Colorado, and Rhode Island voters approved limits on state spending. Arizona voters approved a measure requiring that tax increases receive two-thirds support from the legislature. Colorado voters passed a measure mandating that all state and local tax increases must be approved by voters.

27 "Public Opinion and Demographic Report," *The American Enterprise*, Vol. 4, No. 1 (January/February 1993), p. 94.

CONCLUSION

Higher taxes are neither necessary nor desirable. If taxes are increased, the results will be easy to predict. Federal spending will increase, the economy will weaken, jobs will be destroyed, and the deficit will rise. Rather than promote income equality, higher taxes will have an especially negative impact on the poor and others who are most dependent on economic growth for advancement. Tax increases also will undermine American competitiveness and hinder the capital formation that is so necessary to rising wages and higher living standards.

Americans who will benefit from new or expanded programs are clamoring for higher taxes. Feigning concern for the economy as a whole, they say that raising taxes will reduce federal red ink and spur economic growth. Yet the record shows exactly the opposite. No honest lawmaker familiar with this record can vote for a tax increase while claiming to be acting in the interests of ordinary Americans.

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