May 18, 1990

MR. PRESIDENT, KEEP YOUR PROMISE: NO NEW TAXES

Daniel J. Mitchell
John M. Olin Fellow

The policy most strongly associated with George Bush is best summarized in his now-famous statement, "Read my lips: No new taxes." Now, notwithstanding his 1988 election promise to oppose any tax increase, Bush has announced that he enters budget deficit reduction negotiations with congressional leaders with "no preconditions." Administration representatives have made it clear that a tax hike is "on the table."

It was not without reason that Bush won the 1988 election on a "no new taxes" platform. The American people understand that they are not undertaxed but, rather, that the federal government overspends and is unable to get its fiscal house in order. The federal government currently is collecting and spending record amounts of revenue. Herein lies the cause of the budget deficit. Yet rather than restraining the growth of government spending, many policy makers urge higher taxes. A tax increase, however, almost certainly would slow economic growth and could lead to a recession. This would mean less revenues for the federal government and a higher budget deficit. If he breaks his most solemn political pledge, Bush forgets the lessons of his own victory over tax hike advocates Walter Mondale in 1984 and Michael Dukakis in 1988.

Federal Spending Increase. Advocates of a tax hike insist that the additional revenue would go to reduce the budget deficit. But contrary to this contention, additional revenue almost certainly will mean dollar-for-dollar increases in federal spending. The Gramm-Rudman Deficit Reduction Act dictates that total federal spending can be no greater than the sum of projected tax revenues plus the allowable deficit. Since the deficit target is already determined by law, higher taxes simply would permit Congress to meet that target at a proportionately higher level of spending.

Some critics argue that deficit reduction is so important that the President should renege on his election pledge and accept higher taxes. Yet as a percentage of the Gross National Product, the budget deficit is less than half the size that it was just five years ago. In any case, if Congress and the White House are seriously interested in reducing government borrowing, Gramm-Rudman's deficit reduction mechanism known as sequestration will automatically reduce the deficit to the legally required level.

Damaging Concession. Other critics assert that the President should capitulate on taxes in order to win acceptance of a line-item veto, lower capital gains taxes, or some other budget reform. Yet the damage done to the economy as a result of higher taxes all but certainly would more than wipe out any gains from such concessions.

President Bush repeatedly promised the American people that he would not raise taxes. This was the economically and politically correct thing to do. The Bush Administration's integrity and commitment to economic prosperity are now on the line. The President should fulfill his pledge and refuse to raise taxes. Candidate Bush correctly promised to veto any tax increase; President Bush should follow through on that commitment.

THE PEOPLE SPEAK

Some political commentators maintain that the American people do not mind paying higher taxes. When policy makers propose tax hikes, some pundits instantly congratulate them for their "wisdom" and hail them for having the "courage" to come to the only "realistic" solution to the budget deficit problem. And, prior to his recent announcement opening the door for new taxes, President Bush was condemned for his "unrealistic" approach to fiscal matters.

Yet the current budget summit reflects an inside-the-Beltway perspective, not the beliefs of the vast majority of the American people. There should be no question concerning the public's attitude towards taxes. In election after election the American people unambiguously have said "no" to higher taxes. Bush's 1988 victory certainly is due in great part to his strong opposition to any tax increase. Polls indicate that the President's no-tax pledge is the most remembered feature of the campaign. Numerous states, including Michigan, Wisconsin, Washington, North Dakota, Oregon, Louisiana, and Pennsylvania have held referenda and initiatives on tax issues in the last two years. In every case, the voters rejected higher taxes. Tax revolts are currently under way in many states and localities, including the California, Illinois, Massachusetts, Michigan, Montana, Nebraska, Nevada, North Dakota, Oklahoma, and South Dakota.

Public opinion polls confirm the public's strong opposition to higher taxes. A comprehensive poll on fiscal policy released by the Roper Organization, Inc., last year found that, by a margin of more than six to one, Americans blame the deficit on higher spending rather than inadequate revenues. When asked about the best means to reduce the deficit, the same poll found that people prefer spending restraint over higher taxes by a margin of nearly fifteen to one. By a margin of nearly six to one, the public believes that if taxes are raised Congress will spend the additional money rather than use it to reduce the deficit. The Roper poll also found that people believe higher taxes will slow economic growth, make America less competitive, and reduce savings.

Polls conducted this year show that popular opinion has not changed. A poll by the Wirthlin Group asked the following question:

> Federal tax revenues are expected to rise by an average of 74 billion dollars a year through 1995. At the present rate, government spending will also increase about that fast, leaving the deficit above 100 billion dollars. What would you do to reduce the budget deficit – raise taxes so that they would equal spending, or hold down spending so that it fits tax revenues?

Only 6 percent of the respondents prefer higher taxes. Some 89 percent of the public, on the other hand, believe spending restraint is the best way to reduce the deficit. A *USA Today* poll of May 11 found that citizens opposed higher taxes by a margin of 62 percent to 31 percent. What the public wants concerning taxes is quite clear. If budget summit participants want to accommodate the wishes of the American people, they should say "no" to higher taxes.

FEDERAL TAX RECEIPTS: NOW AT RECORD LEVELS

Advocates of higher taxes often suggest that the federal government is starved of revenues. They maintain that the Reagan tax cuts deprived the U.S. Treasury of money, resulting in persistently large deficits. Since, they claim, federal spending has already been "cut to the bone," the only solution to the deficit is higher taxes.

These contentions in no way match the facts. As Table 1 illustrates, federal tax revenues doubled over the last decade, up from $517 billion in 1980 to an estimated $1.073.5 trillion this year. This was a 106 percent increase. Further, the Congressional Budget Office (CBO) predicts that federal tax revenues will jump by more than $370 billion over the next five years. Some tax-increase advocates argue that these figures are misleading. When the numbers are adjusted for inflation, they contend, actual tax revenues are seen to decline. Yet in constant, inflation-adjusted 1982 dollars, federal government tax receipts climbed from $612 billion in 1980 to approximately $820 billion this year, an increase of more than 34 percent.

Table 1

Annual Tax Increase During The 1980s
($ Billions)

Year	Taxes	Yearly $ Increase	Annual Growth Percent
1980	517.1	--	--
1981	599.3	82.2	15.9
1982	617.7	18.4	3.1
1983	600.6	-17.1	-2.8
1984	666.5	65.9	11.0
1985	734.1	67.6	10.1
1986	769.1	35.0	4.8
1987	854.1	85.0	11.1
1988	909.0	54.9	6.4
1989	990.7	81.7	9.0
1990 est.	1073.5	82.8	8.4

In both nominal and inflation-adjusted dollars, taxes are at the highest level in U.S. history. Had nominal tax revenues simply kept pace with inflation, tax collections this year would total only about $802 billion rather than $1.073.5 trillion. In other words, actual tax collections outstripped the amount needed to keep pace with inflation by more than $250 billion.

Other measures confirm that the tax burden is at a record high. The Tax Foundation, a Washington-based research organization, each year computes "Tax Freedom Day," the time of the year that citizens stop working to pay taxes and start earning money to support their families. Tax Freedom Day this year was May 5, the latest it has ever occurred. Put in other terms, the average American works two hours and forty-five minutes out of every eight hour day just to pay taxes. The American people clearly are not undertaxed.

Finally, federal taxes are consuming near-record amounts of the nation's Gross National Product (GNP). Tax revenues averaged 17.6 percent of GNP in the 1950s, 18.2 percent of GNP in the 1960s, 18.3 percent of GNP in the 1970s, and an all-time high of 19.0 percent in the 1980s. Tax revenues are expected to reach 19.6 percent of GNP this year, the fourth-highest single-year level in peacetime history. It is instructive to note that 1969 and 1981, when the tax burden reached peacetime highs of 20.1 percent of GNP, were followed by recessions in 1970 and 1982 respectively.

A DEFICIT DUE TO EXCESSIVE SPENDING

The all-time high levels of tax receipts suggests the real source of the budget deficit: Congress overspends. The dramatic growth in federal spending over the last ten years clearly makes this point. As Table 2 shows, federal spending doubled in the 1980s. Total federal spending increased well beyond the amounts needed to keep pace with inflation.

Table 2

Annual Federal Spending Increases During the 1980s
($ Billions)

Year	Spending	Yearly $ Increase	Annual Growth Percent
1980	590.9	--	--
1981	678.2	87.3	14.8
1982	745.7	67.5	10.0
1983	808.3	62.6	8.4
1984	851.8	43.5	5.4
1985	946.3	94.5	11.1
1986	990.3	44.0	4.6
1987	1003.8	13.5	1.6
1988	1064.0	60.2	6.0
1989	1142.6	78.6	7.4
1990 est.	1197.2	54.6	4.8

Thus, even though tax revenues have climbed $540 billion since 1980, the deficit is higher today than ten years ago because of the approximately $610 billion-plus increase in federal spending during that period. It is easy to see that the budget would be balanced today if Congress had simply limited total spending increases last decade. Rather than exercise even this modest level of fiscal responsibility, however, Congress is spending every penny of the $540 billion in additional tax revenue, borrowing and spending at least an extra $70 billion just for good measure.

In the area of spending, both Congress and the White House have failed to exercise leadership. The Bush Administration has not even bothered to list the tens of billions of dollars in wasteful government spending that should be cut, fearing perhaps to offend special interest groups. The White House has been overly generous in seeking new spending, for everything from the National Endowment for the Arts to a manned mission to Mars. Failure to attack wasteful spending gives the illusion that the budget has been cut to the bare bones and that a tax increase is the only way to deal with the deficit.

MORE TAXES MEAN MORE SPENDING

The current budget summit has many observers thinking, "This is *deja vu* all over again." The decade of the 1980s witnessed the collapse of a normal budget process. High-level negotiations between the executive and legislative branches replaced regular congressional procedures. The history of these summits does not bolster confidence that the current negotiations will produce a pro-growth deficit reduction package.

The most noted fiscal failure of the last decade was the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) which promised $3 of spending restraint for every $1 in higher taxes. The taxes materialized, but instead of reducing spending, legislators increased the budget. Tax increase packages in 1983 and 1984 also promised spending restraint. Once again, however, both taxes and spending continued their relentless rise. The budget summit of 1987 followed true to form. Taxes were raised with the promise that the deficit would be reduced by about $75 billion over the following two years. The deficit in 1987 was approximately $150 billion; two years later, it was still about $150 billion.

Proponents of higher taxes would like the American people to believe that times are different, that Congress would not use additional taxes for more spending. Yet the current budget situation in Congress virtually guarantees that any additional revenue raised by higher taxes will go towards more spending. The 1985 Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Reduction Act, better known as Gramm-Rudman, requires Congress to enact a budget each year with a projected deficit no greater than a specific mandated level.[1] If the projected deficit exceeds the legally required target, Gramm-Rudman has a spending restraint mechanism known as sequestration. This mechanism automatically reduces spending levels in each program in the budget by the percentage necessary to bring the projected deficit down to the target.

Less understood about Gramm-Rudman is the fact that placing a cap on each year's deficit also has the effect of placing a limit on each year's total spending. Congress can spend no more than the sum of projected tax revenues plus the allowable deficit target. Should legislators attempt to exceed that target, sequestration would occur, bringing total spending back down to the legally required level. The budget can be expressed as the following equation:

Total Spending = Projected Tax Revenue + Deficit Target

What happens if Congress wishes to spend more than the sum of projected tax revenues and the deficit target? There are three ways this can be accomplished. First, legislators could repeal the Gramm-Rudman law. Some policy makers have proposed this, but repeal appears unlikely. Second, legislators could change the deficit targets. If the 1991 deficit target were raised from $64 billion to $84 billion, for instance, Congress legally could spend an extra $20 billion. Since the targets were increased once already, in 1987, changing them a second time would subject lawmakers to charges of cheating on their own rules.

The third option left to lawmakers who want to increase spending is higher taxes. The oft-repeated claim that higher taxes would be used to reduce the deficit is not true. Higher taxes simply make it possible to meet the deficit target at a proportionately higher level of spending.

1 The maximum deficit for 1991 is $64 billion, falling to $28 billion in 1992, and $0 in 1993. For all years other than 1993, Congress is only actually required to come within a $10 billion "margin of error" of the deficit target.

Consider the following example. Tax revenues for fiscal year 1991 are projected to total $1.156 trillion. Since next year's deficit target is $64 billion, Congress can spend no more than $1.220 trillion. In other words:

Total Spending = Projected Tax Revenue + Deficit Target, or:

$1.220 trillion = $1.156 trillion + $64 billion.

What would happen if taxes were raised, say, by $20 billion? Allowing the improbable assumption that the economy continues to grow despite higher taxes, the budget formula changes to:

$1.240 trillion = $1.176 trillion + $64 billion.

Every dollar of higher taxes leads to a dollar of higher spending. The only way to dedicate a tax increase to deficit reduction is to require the Gramm-Rudman targets to be lowered by the same amount that taxes are raised. Therefore, if taxes are raised $20 billion next year, the $64 billion target would be reduced to $44 billion. Spending would remain the same while the deficit would fall. The budget formula changes to:

$1.220 trillion = $1.156 trillion + $44 billion.

If supporters of tax increases were truly serious about deficit reduction, they would support legislation tying higher taxes to lower deficit targets. The fact that no prominent tax increase advocates have adopted this position speaks volumes about their true intentions.

A DEFICIT PROBLEM, NOT A CRISIS

Advocates of higher taxes maintain that the U.S. budget deficit has reached crisis proportions, threatening the health of the economy. Recent estimates do suggest that the deficit this year and next will be somewhat higher than projected due in part to slower economic growth, the cost of bailing out the Savings and Loans, and higher interest rates. Yet the budget deficit is not out of control.

Even under a worse case scenario, the deficit for 1990 and 1991 would not climb much higher than $150 billion, where it has been stuck since 1987. Such a deficit certainly is too high and should be reduced. But policy makers should not be panicked into making decisions that would undermine economic growth and in the end lead to even higher deficits. A deficit of $150 billion would equal about 2.5 percent of GNP, around the 1979 level. As Table 3 shows, the deficit as a percent of GNP reached a high of 6.3 percent in 1983 and averaged more than 4.0 percent of GNP between 1980 and 1989.

Nor should policy makers be fooled into thinking a tax increase would result in lower interest rates. During the 1980s, as Table 4 shows, there was no strong correlation between budget deficits and high interest rates. Indeed, in six of the past eight years, deficits and interest rates moved in opposite directions.

Table 3

Deficits During the 1980s

Year	Deficit ($ billions)	Deficit as % of GNP
1980	73.8	2.8
1981	78.9	2.6
1982	127.9	4.1
1983	207.8	6.3
1984	185.3	5.0
1985	212.3	5.4
1986	221.2	5.3
1987	149.7	3.4
1988	155.1	3.2
1989	152.0	2.9
1990	123.8	2.3

Table 4

Interest Rates and the Deficit

Year	Prime Rate	Change	Deficit as % of GNP	Change
1981	18.87	—	2.6	—
1982	14.86	Down	4.1	Up
1983	10.79	Down	6.3	Up
1984	12.04	Up	5.0	Down
1985	9.93	Down	5.4	Up
1986	8.33	Down	5.3	Down
1987	8.22	Down	3.4	Down
1988	9.32	Up	3.2	Down
1989	10.50	Up	2.9	Down

Source: *Budget of the United States, FY 1991,* historical tables; Joint Economic Committee, *Economic Indicators,* January 1990.

If the deficit, in and of itself, prevents economic growth, advocates of higher taxes fail to explain why the economy was experiencing its longest period of peacetime economic growth during the 1980s. In reality, the budget deficit is just one of the many factors which inhibit economic growth. High taxes are another. The deficit is not a crisis. Policy makers should not replace a bad policy with a worse one; the cure would be worse than the disease.

HIGHER TAXES COULD MEAN RECESSION

Advocates of higher taxes often overlook the most probable result of their policy: An economic slowdown or a recession. The only two times since World War II that federal tax revenues surpassed 20 percent of GNP, the economy dipped into a recession the following year. This should give pause to policy makers considering a tax increase.

Even if a tax increase results in only slightly less economic growth, the budget deficit could rise rather than fall. The CBO projects that the deficit will increase by $26 billion next year if real economic growth is just one percentage point lower than currently projected. Further, CBO estimates that the deficit would jump by $52 billion next year if the unemployment rate rises by one percentage point.

A tax increase would remove from the pockets of Americans more of their money, the results of their hard work and productive efforts. As consumers, they would purchase less. As providers of goods and services, they would find fewer customers. Economic activity would slow. Unemployment would rise. The government would collect less revenue. The budget deficit would increase.

SEQUESTRATION: A VIABLE DEFICIT REDUCTION OPTION

Some policy makers state that they do not want to raise taxes, but that they have no choice since Congress refuses to enact a budget that meets the Gramm-Rudman target by restraining the growth of federal spending. They believe doing nothing would leave the deficit unchecked.

Fortunately, "doing nothing" is the one option that would result in the greatest deficit reduction. If the President and Congress fail to meet this year's deficit target by restraining spending, the automatic sequester of Gramm-Rudman would go into effect. The only way to prevent sequestration is to repeal the entire Gramm-Rudman law, repeal the sequester provision, raise the allowable level of the deficit, or enact a budget which would meet the current deficit targets.

Sequestration would not represent a high water mark in political responsibility. Politicians presumably are elected to make spending choices and to set priorities among various programs, not to have the budget determined by an automatic procedure. Nonetheless, there are benefits to sequestration. First and foremost, a sequester reduces the deficit without a tax increase. Rather than threatening the economy by raising taxes, a sequester promotes economic growth by slowing the rise of federal spending and leaving more resources in the productive sector of the economy.

Even though a sequester would not affect Social Security or programs designed to help the poor, critics charge that a sequester would be an arbitrary, "meat-ax" approach to the budget that might tear holes in the social "safety net." All programs would be cut by the same percentage, regardless of their merits.

Adjusting the Formula. Yet if legislators are unhappy with the distribution of the savings under a sequester, they have the power to adjust the formula that determines cuts. Alternatively, Gramm-Rudman allows Congress to rearrange spending priorities after a sequester goes into effect. Thus, if Congress is concerned about the sequester's effect on air traffic control or AIDS research, for instance, legislators can take money from less important programs and increase spending in those more important or politically sensitive parts of the budget.

Some critics point out that a Gramm-Rudman sequester falls disproportionately on the defense budget; 50 percent of the cuts must come out of defense even though defense accounts for only a quarter of federal spending. Yet, it is not entirely certain that the defense budget will be any worse off with a sequester than it would be otherwise. The budgets being considered in the House and Senate both reduce defense spending more over five years than would a sequester. Furthermore, since Congress is likely to focus defense cuts on weapons systems, a sequester might better protect defense preparedness by at least ensuring that a portion of the cuts come out of the manpower budget.

George Bush has the power to make real reductions in the deficit and fulfill his promise of no new taxes. He can simply inform Congress that he will take a sequester if legislators fail to produce an otherwise acceptable budget. And if Congress attempts to raise taxes, Bush can exercise his veto power. Never in the history of the United States has a tax increase become law over a presidential veto.[2] There is nothing to suggest that the current Congress would fail to sustain a veto today.

BEWARE THE DEAL

Tax hike advocates no doubt will try to give the White House some minor concession that would be used as an excuse for breaking the no-tax pledge. Among the likely candidates are a line-item veto, some sort of reduction in the capital gains tax, and an up-or-down vote on the balanced budget amendment.

2 President Franklin D. Roosevelt did veto a tax increase that he believed was *too small*. Rather than enact a larger tax increase, the Congress overrode his veto.

Positive Steps. Yet, the Bush Administration should avoid a political trap which requires surrender on the tax issue. As long as Gramm-Rudman is the law of the land, controlling taxes is the only sure way to control spending. Sticking to Gramm-Rudman and no-new taxes guarantees that tens of billions of dollars will be saved. A line-item veto and lower capital gains tax would be positive steps and could reduce the deficit by billions of dollars. A tax increase, however, would lead to increased spending that would wipe out such reductions. There is no face-saving gesture which can make up for a capitulation on the tax issue.

CONCLUSION

The importance of averting tax increases cannot be overstated. In 1988, Candidate Bush understood the importance of holding the line on taxes. He understood that higher taxes would open the floodgates for a torrent of new spending that could trigger an economic slowdown or recession, and in the end lead to higher rather than lower deficits. He understood that the American people already turn over entirely too much of their pay to the federal government, that if anything, the tax burden should be reduced further.

George Bush has distinguished himself first and foremost by his anti-tax hike policy. Now his credibility, integrity, commitment to principles, and political and economic wisdom are put to the test. Bush was not elected to adopt the policies of his losing opponents. This is a make-or-break decision for the Bush Administration. If Bush expects to keep the support of the people who put him in office, he must read their lips. They are saying: "Mr. President, keep your promise: No new taxes."