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The Limit of Tax Revenues

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The Greeks have always been trendsetters for the West. Washington has repudiated two centuries of U.S. fiscal prudence as prescribed by the Founding Fathers in favor of the modern Greek model of debt, dependency, devaluation and default. Prospects for restraining runaway U.S. debt are even poorer than they appear.

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Deficits and Public Debt. U.S. fiscal policy has been going in the wrong direction for a very long time. But this year the federal government declined to lay out any plan to balance its budget ever again. Based on President Obama's fiscal 2011 budget, the Congressional Budget Office (CBO) estimates:

- The federal budget deficit will be 10.3 percent of gross domestic product (GDP) in 2010.
- The deficit will narrow as the economy recovers but will still be 5.6 percent of GDP in 2020.
- As a result, the net national debt (debt held by the public) will more than double from 40 percent of GDP in 2008 to 90 percent by 2020.

By contrast, the Greek public debt of 115 percent of GDP in 2009 is projected to rise to 133 percent in 2010**,** and the current Greek deficit is now thought to be 13.6 percent. Of course, Greek GDP is far smaller than the United States' — and unlike ours, the Greek insolvency is not too large for an international rescue.

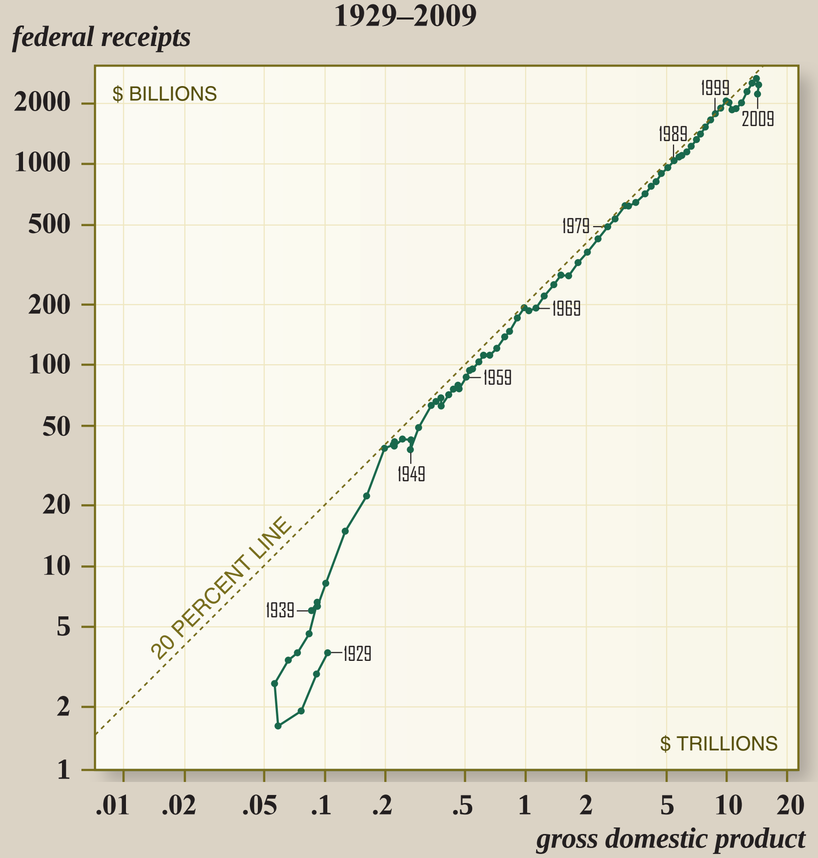
As sobering as the U.S. debt estimates are, they are incomplete and optimistic. They do not include deficit spending resulting from the new health insurance legislation. The revenue numbers rely on increased tax rates beginning next year resulting from the scheduled expiration of the Bush tax cuts. And, as usual, they ignore the unfunded liabilities of social insurance programs, even though these benefits are officially recognized as "mandatory spending" when the time comes to pay them out.

"Hauser's Law." The federal government assumes a relationship between the economy and tax revenue that is divorced from reality. Six decades of history have established one far-reaching fact that needs to be built into fiscal calculations: Increases in federal tax rates, particularly marginal rate increases targeted at higher income taxpayers, produce no additional revenue. For politicians this is truly an inconvenient truth.

The figure shows how tax revenue has grown over the past eight decades along with the size of the economy. It illustrates the empirical relationship first introduced in the *Wall Street Journal* 20 years ago by W. Kurt Hauser of the Hoover Institution: There has been a close proportionality between revenue and GDP since World War II, despite big changes in marginal tax rates in both directions. "Hauser's Law," as I call this formula, reveals a kind of capacity ceiling for federal tax receipts at about 19 percent of GDP.

The Limit of Tax Revenues

Hauser's Law: Federal Tax Receipts Will Always Fall Short of 20 Percent of Gross Domestic Product 1929–2009



Note: These data derive from the national income accounting (NIA) system, which is quite different from the cash-based system used by the Congressional Budget Office and the Office of Management and Budget. NIA receipts generally exceed budget revenues by two to three percent.

Source: Calendar-year gross domestic product and current receipts of the federal government from the Bureau of Economic Analysis.

What is the origin of this limit beyond which it is impossible to extract any more revenue from taxpayers? The tax base is not something that the government can kick around at will. It represents a living economic system that makes its own collective choices. In a tax code of 70,000 pages there are innumerable ways for high-income earners to seek out and use ambiguities and loopholes. The more they are incentivized to make an effort to game the system, the less the federal government will collect. That would explain why, as Hauser has shown, conventional methods of forecasting tax receipts from increases in future tax rates are prone to over-predict revenue.

Like other empirical "laws," Hauser's Law predicts within a range of approximation. Changes in marginal tax rates do not make a perceptible difference to the ratio of revenue to GDP, but recessions do. When GDP falls relative to its potential, tax revenue falls even more. History shows that, in an economy with no "output gap" between GDP and potential GDP, a ratio of federal revenue to GDP of no more than 18.3 percent would be realistic.

Recessions Matter. In these circumstances, Hauser's Law provides a simple basis for testing the validity of any government's revenue projections. Today, since the economy already suffers from a large output gap that is expected to take many years to close, 18.3 percent must be a realistic upper limit on the ratio of budget revenues to GDP for years to come. Any major tax increase will reduce GDP and therefore revenues too.

How long does it take to fire up the economy once capital is more readily available? The answer is: longer than it takes to close it down.

But CBO projections based on the current budget show the revenue-to-GDP ratio reaching 18.3 percent as early as 2013 and rising to 19.6 percent in 2020. Such numbers implicitly assume that the U.S. labor market will get back to sustainable "full employment" by 2013 and that GDP will exceed its potential thereafter. Not likely. When the projections are tempered by the constraints of Hauser's Law, it is clear that deficit spending will grow faster than the official estimates show.

Conclusion. For budget planning, it is wiser and safer to assume that tax receipts will remain at a historically realistic ratio to GDP no matter how tax rates are manipulated. That leads to the conclusion that current projections of federal revenue are, once again, unrealistically high.

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