JOINT ECONOMIC COMMITTEE

CONGRESSMAN JIM SAXTON
RANKING REPUBLICAN MEMBER

RESEARCH REPORT #110-9
July 2007

TAXES AND DEFICITS: AN OBSERVATION ON THE RELATIONSHIP BETWEEN TAXES AND SPENDING

The historical evidence suggests that future tax increases would likely be used to finance additional federal spending, not deficit reduction. According to a new study, each $1.00 of additional taxes in the 1947-2006 period was associated with $1.07 in additional federal spending. This finding indicates that federal tax increases have been an ineffective and self-defeating approach to reducing budget deficits. This research report summarizes the results of the study, *Taxes and Deficits: An Observation on the Relationship between Taxes and Spending* by Professor Richard Vedder and Jonathan Leirer. The study contains five key findings.

First, the historical evidence from the first administration of President George Washington to the present shows that the Federal propensity to spend new tax revenues has increased, as the political advantages of new spending have grown. At one time, new taxes were associated with very significant deficit reduction, but not in recent decades.

Second, there is a statistically significant tendency for spending to rise more than one dollar ($1.07) for each one dollar increase in tax revenue, based on the evidence for the past six decades. The data suggest that reducing budget deficits through higher taxation is typically unsuccessful.

Third, the findings are better understood by use of a simple cost-benefit theoretical framework of fiscal behavior developed by Dwight Lee of the University of Georgia and Richard Vedder of Ohio University, which draws on the laws of demand and supply. In the context of the findings reported here, the framework reveals that in the postwar era there has been a pronounced increase in the marginal political benefits to spend; put differently, "the political demand for spending has increased."

Fourth, the modestly positive relationship between taxation and deficits observed at the Federal level is not obtained at the state and local level, suggesting that different institutional arrangements constraining state governments, including balanced budget constitutional amendments, spending limitation amendments, line-item vetoes, etc., have a real impact on political and thus fiscal behavior. This suggests that those interested in constraining the amount of federal spending growth to or below the growth in revenues might learn from the experience of the states.

Fifth, the findings cast grave doubt on the efficacy of raising taxes as a means of eliminating fiscal imbalances. Instead, moderation in expenditure growth through greater fiscal discipline is desirable.

The Tax, Spending, and Deficit Relationship, 1947-2006.

Taking data on Federal expenditures and Federal revenues from the national income accounts for the calendar years 1947 through 2006, the study regressed Federal tax levels (largely tax receipts) against Federal spending levels. The statistical results indicate that there is a significant relationship between revenues and expenditure where each additional $1.00 in tax revenues was associated with $1.07 in expenditures.

It appears as though the brief period of fiscal restraint experienced throughout the 1990's led to a diminished propensity to spend, although that has reversed since 2000. Still the coefficient on the Tax variable is statistically significantly greater than unity, demonstrating that the Congress has a propensity to increase spending more than proportional to revenue. These results suggest that, contrary to political rhetoric, new tax revenues are associated with rising, not falling, budget deficits.

In the earliest years of the Republic, revenue increases were not associated with spending increases; indeed, spending fell slightly (the type of change envisioned in the 1990 budget agreement). Even as late as 1867 to 1913, tax increases seem to induce some spending increases, but also some deficit reduction (if spending rises 72 cents per dollar of new taxes, then the other 28 cents of that dollar goes for deficit reduction).

Over time, the Federal government's "marginal propensity to consume" has risen consistently. The political benefits of spending are on the rise. Whereas, in an earlier era, a tax increase could lead to some deficit reduction, this has not been the case since World War II (and was becoming less the case even before then).

Conclusions

Increases in Federal tax revenues continue to be associated with greater increases in Federal expenditures, leading to the conclusion that tax increases do not reduce budget deficits. The evidence suggests that higher tax revenues are associated with massive increases in income redistribution activity of various forms, especially transfer payments. Indeed, redistributionist activities seem to have crowded out some traditional expenditures of government services, particularly defense.

The cause of the deficit problem does not appear to be inadequate taxes, but rather the political gains from spending, gains that are rising over time, particularly to finance redistributionist activity. Historically, there was a time when tax increases meant deficit reduction, but that time passed in the early part of this century. State and local governments still are able to constrain spending increases to levels equal to or less than the taxes raised. Why? We would suggest that the answer may lie in different institutional constraints, such as balanced budget amendments, spending limitation amendments, line-item vetoes, etc., measures that lower the marginal political benefits of new spending to political decision makers. In any case, the Federal fiscal problem is not likely to be solved without significant behavioral change on the part of those decision makers, and those changes are not likely given the current system of political rewards and costs.