Federal tax and spending reform

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The economic legacy of the 1970s has been the continuous upward spiral of inflation, unemployment, and interest rates. The federal government's inability to deal effectively with these problems has placed economic reform at the top of the nation's agenda for the 1980s.

In an effort to deal with these problems, the Congress has considered a wide variety of economic reform proposals in recent years. Several of these proposals have a common theme: the role of the federal government in the economy should be limited and/or reduced. Four of them—three proposed constitutional amendments and one tax reform bill—have received significant attention from prominent politicians and the press:

- The balanced budget amendment, which would require that federal expenditures not exceed federal revenues.

- The spending cap amendment, which would limit federal expenditures to some specified portion of GNP.

- The revenue cap amendment, which would limit federal revenues to some specified portion of GNP.

- The Kemp-Roth bill, which would reduce personal income taxes 30 percent over the next three years.

This article presents an overview of these proposals and discusses their implications for the nation's economic future.

The real sources of economic pain

The first rumblings of the taxpayers' revolt were heard in the late 1960s, as the "go-go" years drew to a close and, partly as a result of the deficit financing of the Vietnam War, inflation began to heat up. The focus of attention at the time was reform of the local property tax, but few of the organized initiatives met with success. However, the severity of inflation in the late 1970s undoubtedly added strength to the psychology of the taxpayers' revolt movement, which drew widespread attention in 1978 with the passage in California of Proposition 13. As a result of the national attention that was focused on Proposition 13 and its proponents, a number of other states considered and implemented fiscal reforms.[1]

In less than a decade, the taxpayers' revolt movement has been transformed from a small, ineffective lobby to a dominant force on the American political scene. What factors were primarily responsible for this change? Economist Lester Thurow has argued that popular support for policies that would bring about a dramatic shift in the distribution of economic resources arises only from intense economic pain.[2]

An obvious source of such pain was the *apparently* declining standard of living in America. Yet, in the six years (1972-78) of economic turbulence that gave rise to the widespread popularity of tax reform, real per capita disposable personal income rose just under 16 percent, almost as much as during the "go-go" years 1966-72. (See table 1.) To be sure, real hourly earnings in the private nonagricultural sector were slightly lower in 1978 than they had been in 1972, but the decline was more than offset by a sharp rise in the proportion of the total population that is

[1]At least 15 states have adopted fiscal limitations since the passage of Proposition 13. The recent recession, however, has apparently reversed this trend, as tax-limitation proposals were defeated in six states in 1980. For an argument that Proposition 13 was not the result of a basic shift in taxpayer attitudes, see James M. Buchanan, "The Potential for Taxpayer Revolt in American Democracy," *Social Science Quarterly*, vol. 59 (March 1979), p. 691.

[2]Lester Thurow, "The Real Sources of Economic Pain," *Wall Street Journal*, July 6, 1978.

Table 1

Growth in real per capita disposable income

Year	Real per capita disposable income	Percent change
	(1972 dollars)	
1966	3,290	
1968	3,493	6.2
1970	3,668	5.0
1972	3,880	5.8
1974	4,050	4.4
1976	4,216	4.1
1978	4,487	6.4
1980*	4,567	1.8

*Estimated.

SOURCE: *Economic Report of the President*, January 1981.

employed. However, to many households the loss of leisure may have constituted a decline in their standard of living.

In any case, the 16 percent rise in real per capita disposable income might conceal large disparities between groups within the population; it might reflect substantial real gains made by some while many others suffered real economic losses. "Not so," Thurow concludes. "In the six years from 1972 to 1978 there have been no significant shifts in the distribution of income. The gap between rich and poor, black and white, male and female has remained unchanged."[3] Since relative incomes have not changed significantly, all groups have benefited from the real economic growth. Of course, it is still possible that there were large differences between individuals within each of these broad groups.

Another frequently mentioned source of economic pain is that the government has taken an ever-increasing share of the average citizen's earnings. Again, the economic evidence does not support the popular assumption. While the ratio of total tax revenue at all levels of government to personal income increased from 17.7 percent in 1950 to 30.1 percent in 1980, most of this increase took place during the 1950s and 1960s.[4] (See table 2.) Government expenditures exhibit almost the same growth pattern. Table 3 shows that while the ratio of total expenditures at all levels of government to GNP has risen from 23 percent in 1950 to 33 percent in 1980, virtually all of the increase took place during the 1950s and 1960s. There has been little growth in the ratio of government expenditures to GNP during the 1970s.

Still another possibility has been suggested by Lester Thurow. He argues that the primary source of pain is the so-called "money illusion" created by the enormous gap between the growth of real and money incomes that has resulted from inflation. While real income grew 16 percent from 1972 to 1978, money income grew 72 percent. People think what life would be like if their incomes had risen by 72 percent with no inflation. Some people may even convince themselves that their real standard of living has fallen.[5]

Most people forget, however, that inflation raises income as well as prices. Every price increase is a reduction in the real living standard of some purchaser of a good or service, but it is also a real income increase for some provider of that good or service. More importantly, most people suffering from the "money illusion" do not realize that if there had been no inflation from 1972 to 1978, real incomes would have grown by 16 percent, not 72 percent.

It is not easy to identify clearcut reasons for the widespread perception of economic stress. It may have resulted in part from a

[3]Ibid.

[4]Richard A. Musgrave has argued that this evidence counters the widely held belief that inflation has resulted in an increasing tax burden. See "The Tax Revolt: Causes and Cure," *Social Science Quarterly*, vol. 59 (March 1979), p. 699.

[5]This is clearly not the type of "money illusion" that is so familiar in the literature of monetary economics. There "money illusion" refers to the temporary failure of people to realize that their real incomes have not kept pace with their nominal wages. In Thurow's use of the term it is precisely the public's awareness, perhaps belated, that their real incomes lag behind their nominal incomes that is the source of pain. The illusion consists in their belief that somehow their real incomes could be made to rise as rapidly as their nominal incomes.

Table 2

Tax revenue as a percentage of personal income (all levels of government)

	1950	1960	1970	1980*
Income tax	6.6	10.5	12.4	13.0
Corporation tax	3.1	3.6	3.3	3.1
Payroll tax	1.5	2.8	4.9	7.4
Property tax	2.5	4.2	4.5	3.1
Other	4.0	3.4	3.9	3.5
Total	17.7	24.5	29.0	30.1

*Estimated.

SOURCE: U.S. Bureau of the Census, *Government Finance*, various years. *Economic Report of the President*, January 1981.

"money illusion" that confuses nominal and real measures of economic performance. Nevertheless, *despite* evidence that the government sector did not continue to grow in the 1970s at the rapid rates of the 1950s and 1960s, many people feel that reducing the role of government in the economy provides a prescription for relief from the economic problems facing the nation in the 1980s.

Balanced budget amendment

Of the proposed reforms, the balanced budget amendment is probably the most popular with the general electorate. In a spring 1979 *CBS-New York Times* poll, 73 percent of the respondents favored a constitutional amendment to require the Congress to balance the budget every year. Legislators in 30 of the necessary 34 states have approved resolutions asking the Congress to call a constitutional convention to consider such an amendment. Three other states have adopted resolutions that urge the Congress to adopt a balanced budget amendment, but do not call for a convention. The convention movement, however, has met with significant opposition from several key political figures who fear a "runaway" convention that would attempt to adopt amendments on other issues such as busing and abortion.

Table 3

Public expenditures as a percent of GNP

	1950	1960	1970	1980*
Federal	13.4	17.1	18.2	19.5
State and local	7.9	9.8	13.4	13.5
Total	21.3	26.9	31.6	33.0

*Estimated.

NOTE: Federal grants-in-aid to state and local governments are included at the level of the recipient.

SOURCE: *Economic Report of the President*, January 1981.

The balanced budget amendment is something of a misnomer, because the proposal would bar the federal government from incurring deficits, but not from attaining surpluses. Of course, surpluses have been few and far between in recent years. A more substantive shortcoming of the amendment is that, even if it achieved the goal of eliminating deficits, it would not necessarily limit or reduce the role of the federal government. The government could continue to increase spending, in absolute terms and in relation to GNP, as long as it increased tax revenues to keep the budget balanced.

Aside from its inappropriateness as a means to achieve the goals of some of its proponents, the balanced budget amendment might severely impair the government's ability to influence the economy. Prior to the Depression the government pursued the "fiscally responsible" policy of balancing the federal budget. This "old-fashioned doctrine," according to economist Robert J. Gordon, "did considerable harm to the economy and has since been abandoned by all economists, monetarists and nonmonetarists alike."[6] Why? During a recession GNP declines along with personal and corporate taxable incomes. If tax rates and government expenditures remain constant, and the budget was in balance just before the recession, the budget will now

[6]Robert J. Gordon, *Macroeconomics* (Little, Brown and Company, 1978), p. 480.

show a deficit. To rebalance the budget, the federal government must either raise tax rates or reduce government expenditures, either of which will exacerbate both the recession and the deficit.

Attempting to balance the actual budget during a recession ignores the fact that while the budget affects the economy, the economy has a feedback effect on the budget. Although, in principle, the government could stimulate the economy by raising both expenditures and tax rates during a period of slack private demand, thereby maintaining the budget in balance, the administrative and political difficulties of doing so probably preclude such an approach.

The balanced budget amendment, in and of itself, is unlikely to enhance the government's ability to control inflation. Although government deficits have some short-run impact on demand, they are not inflationary in the long run unless they are financed by increases in monetary growth in an attempt to hold down interest rates. Other things being equal, a government deficit financed by the sale of Treasury securities, accompanied by rising interest rates and no increases in money supply, would not add to inflationary pressures. In this context the balanced budget amendment appears to be neutral in its expected impact on inflation.

Even with such an amendment in place, the Congress and the President would have many ways of maintaining expenditures. Off-budget outlays could be increased. The federal government in fiscal 1980 allocated $12 billion to off-budget entities and $19.1 billion to government-sponsored agencies, roughly 6 percent of the total budget. Loan guarantees, another method of avoiding the budgetary process, amounted to $284 billion in 1980.

In sum, the available evidence suggests that a balanced budget amendment may create as many problems as it solves. While it might, in a nominal sense, eliminate future federal deficits, it is not unequivocally clear that this is a desirable goal. Even if it were, there is no assurance the government would not circumvent the intent of the proposal. Moreover, the amendment would take away an important recession-fighting tool of the federal government and, in fact, might deepen any future recessions.

Spending cap amendment

This proposed constitutional amendment would limit spending by the federal government to a certain percentage of GNP. The specific percentage varies with alternative proposals, but virtually all have fallen into the 18 percent to 21 percent range. The spending cap amendment has been advocated most strongly by economist Milton Friedman and the National Tax Limitation Committee. Their amendment includes provisions that would limit off-budget outlays, allow the spending limit to be exceeded in national emergencies, and protect grants to state and local governments. It would limit the growth of the federal government's share of economic activity, but is silent on the question of deficits.

By limiting government spending, the amendment would tend to weaken the government's recession-fighting capabilities. This effect would not be as serious as under the balanced budget amendment, however, since the government would retain the authority to cut taxes during recessionary periods. In the long run the amendment might be helpful in fighting inflation caused by monetization of deficits because it would hold the growth of government expenditures below that of nominal GNP. Over the past decade federal expenditures grew at an annual rate of 10.5 percent, well above the 9.5 percent growth rate of GNP.

The amendment has other disadvantages. First, since certain expenditures rise automatically (for example, unemployment insurance benefits during a recession), other expenditures would presumably have to be reduced. This would create a great deal of uncertainty with regard to the planning of certain expenditure programs. Second, it would limit the ability of the government to target expenditures during a recession toward certain hard-hit or disadvantaged areas, industries, or individuals since any increased expenditures in these areas would have to be offset by decreases elsewhere.

Revenue cap amendment

A third proposal, less frequently discussed, is the revenue cap amendment, which would limit federal revenues to a certain percentage of GNP. This amendment would not eliminate deficits as it controls only government revenues, not government spending. Although it would weaken the government's ability to fight recession to a lesser extent than the balanced budget amendment, the revenue cap amendment would somewhat inhibit the government's range of inflation-fighting strategies. One consequence of our tax structure is that federal revenues tend to grow faster than the general economy during inflationary periods. The amendment would force the government to cut tax rates to hold down tax revenues during inflationary times. As a result, fiscal policy would be of little use in attenuating inflationary trends.

Implementation of the proposal would be relatively easy, unless the cap were set at a much lower level than present tax collections. As noted earlier, federal taxes did not rise dramatically during the 1970s; had the amendment been adopted in 1970, with the cap set at the then-prevailing level, it would not have been exceeded to date. While the economy and federal spending grew at annual rates of roughly 9.5 percent and 10.5 percent, respectively, over the past decade, federal revenues grew at roughly 8.5 percent. Thus, unless the cap were lowered to a pre-1970 share of the GNP, the revenue cap amendment is not likely to reduce significantly the government's share of economic activity. On the other hand, it should prevent that share from growing significantly in the future.

Kemp-Roth bill

A fourth reform proposal, and the one which has received the most political attention, is the Kemp-Roth bill, which calls for a 30 percent reduction in federal income taxes over the next three years. Proponents of the bill have argued that reducing personal income taxes will increase incentives to work and will expand the tax base so that, even at the lower rates, no tax revenues are lost. The theory behind this argument is summarized by the Laffer Curve, named for its originator, economist Arthur Laffer (see box).

Prior tax cuts. Many proponents of the bill have argued that prior tax cuts, particularly the Kennedy tax cut, provide empirical confirmation of the Laffer Curve hypothesis. Walter Heller, the key architect of the Kennedy tax cut, has responded that the supply-siders' arguments are flawed. Taxes were cut by about $12 billion ($10 billion individual and $2 billion corporate) in 1962-64; Heller notes that "the record is crystal clear that it was its stimulus to *demand* . . . that powered the 1964-65 expansion and restored a good part of the initial revenue loss."[7] Unemployment was reduced from 5.6 percent in January 1964 to 4.5 percent in July 1965, and utilization rates in manufacturing increased, drawing on existing excess capacity. Since inflation rose only slightly over the same period, from 1.4 percent to 1.6 percent, most of the increase in demand was converted into more output, not higher prices.

However, the premise that any change in economic activity after a tax cut is a result of the tax cut ignores the multiple causal relations in a complex economy. Other fiscal factors playing a critical role in the 1963-68 expansion, for example, were the huge (over) stimulus of Vietnam expenditures, the four increases in payroll tax rates and base in those years, and the $6 billion of revenues from the 1966 Tax Act. Moreover, monetary policy also played some role in the expansion. After slowing in 1962, money supply growth accelerated in 1963 and 1964. Similar difficulties in isolating the effects of tax cuts from other influences plague the other historical exam-

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[7]Walter W. Heller, "The Kemp-Roth-Laffer Free Lunch," *Wall Street Journal*, July 12, 1978.

ples, the Mellon tax cuts in the 1920s and the West German cuts in 1948, which the Kemp-Roth proponents use to support their theory.

Economic evidence. The economics profession has been studying questions related to the Laffer hypothesis for several years. There is little economic evidence, however, to support the conclusion that current levels of tax rates create disincentives to work and save. Studies of worker response to changes in take-home pay have yielded ambiguous results. Some people will work harder if a tax cut or some other change makes each hour of work worth more; others choose to take additional time off and enjoy more leisure while earning the same income.

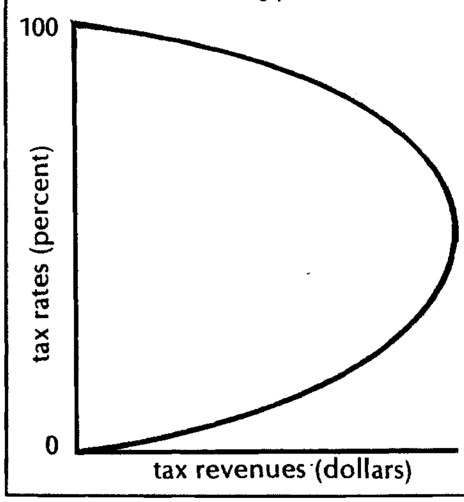
After reviewing the available evidence, the Congressional Budget Office concluded that hours worked would increase if after-tax real wages rose, largely because of the impact of married women entering the labor market. The net effect, however, would be small—perhaps a 1 percent to 3 percent increase in the labor supply as a result of a 10 percent rise in disposable income.[8] This estimate falls short of the minimum 10 percent increase in the labor supply which would be necessary for the Kemp-Roth cuts to be self-financing.[9]

The effect of changes in the after-tax rate of return on savings is also an empirical question, and available evidence is also ambiguous.[10] Some people will save more if they earn a higher rate of return; others will save less and maintain a constant level of assets. Many economists have long accepted what has become known as Denison's Law, that the saving rate is virtually constant and unaffected by changes in the tax structure or the real after-tax rate of return on capital.[11] Proponents of Kemp-Roth respond with the recent findings of Stanford's Michael Boskin that the total elasticity of private saving with

The Laffer Curve

Laffer argues that taxes create a "wedge" between salary and take-home pay and between pre-tax and after-tax investment profits. As the tax rate rises, people begin shifting out of productive activities (which are taxed) into less productive, frequently leisure, activities (which are not taxed) and tax revenue drops. If the government were to tax 100 percent of all earnings, Laffer argues, no one would work and there would be no revenue from taxes.

Due, in part, to its intuitive appeal, the Laffer Curve has enjoyed a modicum of success in political circles. Most economists, however, have argued that the theory does not necessarily support the conclusion that tax cuts will be self-financing. The true shape of the Laffer Curve is an empirical question. There is little evidence available to show that the curve ever bends backwards, much less that it is symmetrical. Moreover, there is virtually no evidence which demonstrates that our present tax structure is anywhere near the backward bending portion of the curve.



[8]Congressional Budget Office, *An Analysis of the Roth-Kemp Tax Cut Proposal* (Government Printing Office, 1978), pp. 14-16.

[9]This conclusion is based on the liberal assumptions that actual output is currently 4 to 5 percent below potential production and that capital-output and labor-output ratios are constant. Ibid., pp. 8-9.

[10]Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (McGraw-Hill Book Company, 1973), p. 478.

[11]Edward F. Denison, "A Note on Private Saving," *Review of Economics and Statistics*, vol. 40 (August 1958), pp. 261-7.

respect to income is 0.3 to 0.4.[12] The methodology of the study, however, has been strongly criticized.[13] Moreover, even if Boskin's findings are accepted, the resulting increase in saving falls far short of the minimum 10 percent increase necessary for the Kemp-Roth cuts to be self-financing.[14]

Econometric studies. Laffer and his supporters criticized the major macroeconomic forecasting models for excluding the economic responses which they describe. Arguing that no present model could accurately capture the economic impact of the Kemp-Roth proposal, Laffer constructed his own model that demonstrates the revenue feedback effects of his curve. The report describing the model has been quoted as acknowledging that "the task of quantifying the theoretical Laffer Curve is unachievable." Moreover, the only group that responds in accord with Laffer's theory is the working poor. For all other groups, the model suggests that the government should *increase* tax rates to increase revenue.[15]

Other models, specifically reformulated to include the Laffer hypothesis, have concluded that the revenue feedback effects anticipated by Laffer would not occur. Congressional committees commissioned two consulting firms, Data Resources, Inc. and Evans Economics, to build models to test the Laffer theory. The models, although quite different in construction, reached similar conclusions: implementation of a 30 percent across-the-board cut in tax rates, without significant expenditure reductions, would add between $85 billion and $135 billion to the *annual* budget deficit by 1985 and would add at least 2 percentage points to the inflation rate.[16]

While Kemp-Roth may have more political support than any of the proposed constitutional amendments, it also has the most potential for economic harm. While it will unquestionably reduce tax rates, there is little evidence to support the conclusion that it will pay for itself in the short run. In fact, most of the econometric models, including those that make Laffer Curve assumptions, forecast that the bill will simply produce larger deficits and increased inflation unless accompanied by significant spending cuts.

Summary

The Congress has considered a variety of proposals for economic reform over the past few years, several of which seek to limit and/or reduce the role of the federal government in the economy. Of the four plans analyzed here, the spending cap amendment appears to be the one best-suited to achieve these ends. However, economic evidence suggests that reducing and/or limiting the federal government's role may not eliminate the true sources of economic pain. Similarly, available evidence casts some doubt on the reasonableness of the income and revenue effects predicted by proponents of the Kemp-Roth bill. But a real test must await the tax cut's actual adoption and implementation. Any determination as to which of the four proposals is "best" is ultimately a value judgement and will vary with the social, political, and economic predilections of each individual. The purpose of this article has been simply to synthesize some of the economic information necessary to determine the tradeoffs.

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[12]Michael J. Boskin, "Taxation, Savings, and the Rate of Interest," *Journal of Political Economy*, vol. 86 (March/April, 1978), pp. S3-S27.

[13]Boskin defines personal saving to include consumer durables; thus, increased saving does not necessarily mean that more funds are available for investment. His omission of the inflation rate from the estimating equation and the particular time period studied may have strongly influenced his results. Finally, the presence of substantial serial correlation may affect the statistical significance of his findings. See Congressional Budget Office, p. 18.

[14]Congressional Budget Office, p. 9.

[15]"The Impact of a Reagan-Style Tax Cut," *Business Week* (June 9, 1980), pp. 90, 95.

[16]Ibid. See also Stephen Brooks and Otto Eckstein, "Economic Analysis of the Kemp-Roth Proposal," *Data Resources U.S. Review* (August 1978), pp. 1.12-1.15.