

# Taxes Aren't the Problem, Spending Is

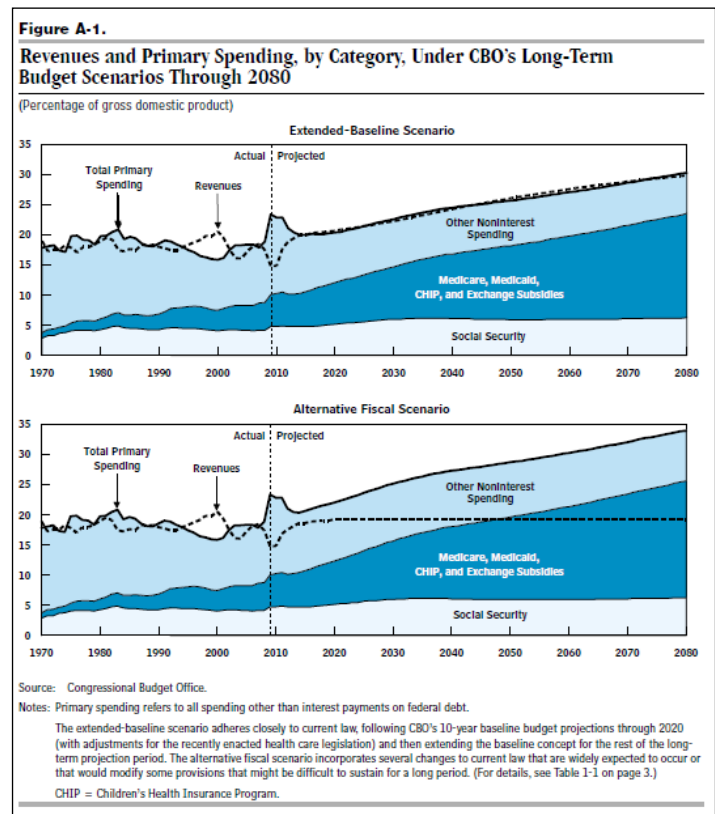
Jennifer Pollom | August 12, 2010

Fareed Zakaria had an interesting, but misguided piece, "Raise My Taxes, Mr. President!" in last week's edition of Newsweek echoing what has become a familiar line from the left. In it, Zakaria makes a claim that has become popular lately, stating that "The Bush tax cuts remain the single largest cause of America's structural deficit" and that in order to get deficits under control the 2001 and 2003 tax rates should all be allowed to expire. However, in claiming that current tax rates are most to blame for our disastrous fiscal condition, Zakaria is wrong.

This has been a familiar but sloppy argument surrounding the coming tax increases that will occur if the 2001 and 2003 rates are not extended. Recognizing the growing public ire over the exploding deficit, many on the left have been quick to offer up the expiring tax rates as a sacrificial lamb claiming implicitly that if the rates are allowed to expire for "the rich", all will be well again. Zakaria's proposal to let the rates expire for everybody (not just the top bracket) is admirably straightforward in contrast to most Democrats. Others claim to oppose deficits, but in the name of deficit reduction would extend the rates for everyone except the "rich" doing little to address the problem. Let's address this once and for all: the tax rates aren't the problem, spending is.

Zakaria and others in the pro-tax increase camp are unfortunately ignoring recent data by the Congressional Budget Office (CBO) presenting some rather stark scenarios of the budget picture and the effects revenues will have looking forward. In CBO's recent Long Term Budget Outlook, one scenario (the extended baseline scenario), estimates spending and revenue projections if no changes are made

to current law and all of the tax rates are allowed to expire. In the second scenario (the alternative fiscal scenario), CBO substitutes in some judgment about what is widely expected (though not certain) to happen moving forward including likely legislative changes. The alternative scenario includes the extension of current tax rates for everyone except high-income taxpayers through 2020 and likely spending increases such as the always-popular Medicare "doc fix".



As you can see above, the major difference in the scenarios is whether or not revenues balloon to keep pace with spending. In both cases, spending as a percentage of GDP remains well above historic

norms (18.5%) and quickly increases from there. According to CBO, if all of the tax rates are allowed to expire as Zakaria and some others suggest:

- Revenues as a share of GDP will increase to 20.7% of GDP in 2020 and 23.3% by 2035, well above the 17.8% historic norm. Even if rates increase for only the top bracket, revenues will still grow to 19.3% by 2020. To put this in perspective revenues collected would increase by almost 30% in 25 years.
- Rather than decreasing in response to the increased revenues, debt would still be 66% of GDP in 2020 and increase to 79% in 2035. Debt has only exceeded 50% of GDP during one other time period in history because of the spike in spending due to World War II. In contrast to the War era, the current debt is not projected to decrease but will continue to grow.
- Even with revenues growing to a much higher level than has been historically “comfortable”, the debt will still be dangerously high and keep growing. Why? Because of spending.

Revenues today remain near their historic norms despite changes in particular tax policies over the last several decades. Revenues have fluctuated over the last 50 years between 14.8% of GDP (during the crisis in 2009) and 20.6% of GDP (most recently in 2000) but have never approached the whopping 23.3% estimated for 2035. Specifically, revenues as a share of GDP have fluctuated a bit over the decades but have remained fairly constant as a share of the economy: an average of 17.9% in the 1960's, 18% in the 1970's, 18.3% in the 1980's, 18.5% in the 1990's, and 17.6% in the 2000's (including the very low 14.8% last year).

How has this history of rates affected the budget as

a whole? At the end of 2008, debt remained at 40% of GDP- relatively close to the 40-year average of 36%. At the end of 2010, debt will have increased to 62% of GDP primarily due to the massive spending of the last two years.

Those in favor of increasing taxes are quick to assert that the deficits of the last decade are the result of the “irresponsible” tax cuts of 2001 and 2003. Again, these advocates forget that spending was the real culprit. As we pointed out, tax revenues actually grew 18% more than GDP over the last decade, while spending continued to balloon. The resulting \$1.3 trillion deficit may not fall on the shoulders of the current Administration alone, but as Brian Riedl concluded, the tax cuts were responsible for a mere 14% of the swing from surplus to deficit. Runaway spending was really to blame.

What can be done? Even if the current rates expire and revenues swell from 18% of GDP to 23% in 2035 and beyond, the budget still gets worse. It is painfully clear that the problem facing our gloomy budget picture is not too little coming in, but too much going out. CBO projects that even if no further spending increases are enacted, primary spending (not including the increasing amount we'll pay in interest) will increase by 27% and rise incredibly from a historic average of 18.5% of GDP to 20% in 2014 and 24% by 2035. If the more likely scenario is used, including spending increases like “fixing” Medicare physician's payment rates which Congress was unwilling to forgo this year, spending explodes to 26% of GDP by 2035. What is responsible for the increase?:

- Most of the growth in spending is for the major health care programs: Medicare, Medicaid, the Children's Health Insurance Program, and insurance subsidies under the new health care

law. Spending on health care programs doubles by 2035 from 5% of GDP today to 10% in 2035, and will continue to increase after that.

- If you include the increase in social security spending due to the aging population, spending on these items alone will total 16% of GDP (dangerously close to the 40-year historic average of 18.5% in spending on ALL of the federal government's programs).
- Two factors are primarily responsible for this increase- the aging of the population, and the rapid growth of health care costs. Basically more old people will use increasingly expensive health care.
- In addition, these estimates include the dubious savings projected in Medicare due to some double counting taking place in the new health care legislation. See here for our previous discussion of how these health care spending numbers are likely to look much worse in the future.

To put these figures in perspective, it's helpful to discuss what would have to be done to close this widening budget gap. To close the gap between spending and taxes under the alternative (and more likely) CBO budget scenario, an immediate and permanent reduction in spending or increase in revenues equal to 4.8% of GDP – the equivalent of \$700 billion in this year's federal budget – would have to be enacted for the next 25 years. To put that into perspective, if the cuts were enacted this year, the gap is so wide that we would have to eliminate everything spent on national defense (roughly equal to 4.6% of GDP in 2009). Alternatively, we could leave defense and the major health entitlements alone, but eliminate every other discretionary program and ALMOST reach the goal (4.1% of GDP

in 2009). This would mean eliminating services most Americans have come to think of as second-nature including such things as the Department of Justice (including prisons), the Treasury Department, NASA, even the border patrol. Or we could do what seems most sensible and start curtailing the exploding entitlement spending now.

Politically popular proposals to curtail entitlement spending with significant results – primarily through savings to Medicare and Medicaid – are difficult to find. Changes to the popular programs are political kryptonite for the same reason they are budgetarily untenable: they provide increasingly generous benefits to an increasingly large population. However, it's clear that we must find somewhere to start.

For instance, recently Rep. Paul Ryan offered a proposal which has met with mixed reactions. Specifically, the proposal would gradually increase the eligibility age for Medicare up to 69, and by 2021, would transition new enrollees from the Medicare program to private insurance plans through exchange vouchers. Low income Medicare beneficiaries would also receive funding for medical savings accounts. In addition, after 2011, Medicaid spending per beneficiary would be limited to growth at a prescribed rate. CBO estimates of the Medicare and Medicaid spending in the Ryan roadmap indicate that the effects of such proposals would reduce Medicare spending to less than a quarter of the spending otherwise projected for the program over the very long term and reduce uncertainty about the long-term viability of the program itself.

Opinions differ over the particular policy reforms, however Ryan's efforts and the resulting estimates make clear that it's possible to fix our budget with serious entitlement reform and attention to the exploding spending problem.



Proponents of repealing the tax rates in the face of this budget disaster clearly think we can tax our way out of the problem. Many would use reasoning echoing Zakaria's claim that, "In fact, federal taxes as a percentage of the economy are at their lowest level since the presidency of Harry Truman" to justify increasing the rates. This claim is true, but misleading. Two things determine the amount of revenue the federal government collects in a year. The first is the federal tax policy legislators agree upon, and the second is the amount of income or output the economy produces to actually be taxed. The 2009 revenues Zakaria is referencing (an anemic 14.8% of GDP) appear artificially low not because the tax rates were too low, but rather because of the dramatic – and temporary – reduction in revenues due to the financial crisis. The pre-crisis years 2006 and 2007 under the same tax rates saw revenues of 18.2% and 18.5% respectively – slightly higher than the historic norm.

In fact, prior to the 2001 legislation, revenues as a share of GDP had grown to the highest level since the height of World War II- 20.6%. This is a direct result of real bracket creep and the increasing reach of the Alternative Minimum Tax, which we also discussed here. Because the tax code is indexed to inflation, without periodic tax relief Americans naturally "creep" into higher tax brackets and pay increasing amounts in income taxes.

This brings us to a sticky point: In recent history, Americans have become accustomed to tax rates that result in a revenue to GDP ratio of approximately 18%. How will Americans react if revenues skyrocket in order to keep pace with spending projections? Although the numbers are currently abstract (and will likely remain so for some time), increasing revenue as a share of GDP to 23% to keep pace with spending will result in sharply increased taxes

compared to the current tax burdens. Very simply, there aren't enough "rich" to shoulder this increase. In order to increase revenues by 30% as a share of the economy, higher tax rates will necessarily fall on families, investment, and businesses in much larger proportions than many are ready for or would be willing to sustain.

As the debate continues over how to solve the looming budget deficits, it's important to remember that growth will be key. Policies that stifle economic growth will only exacerbate the tax and spending gap if revenues remain depressed. Misguided tax policies could be a fast-track to that fate. While experts on both sides will continue to debate the merits of many pro-growth policies, there is significant data indicating that lower marginal rates (especially at the top) can in fact produce economic growth. Unfortunately, if our spending binge continues it won't be enough to save us from the looming budget disaster.