Taxes, Myths, and Cons: Facts about the Federal Budget and the Deficit

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Myth #1: The Government Just Keeps Getting Bigger and Bigger
The nominal numbers are misleading

- Price Inflation (3.6% average since 1952)
- Population Growth (1.2% avg. since 1952)
- Real Per-Capita Income Growth (2.0% average since 1952)

We can either adjust for these factors or we can consider other measures of the size of government.

One Alternative Measure: Government Employment

- In 1955, Federal Civilian Employment was about 4.3% of total civilian employment.
- This has fallen in relative terms to about 2.0%.
- In absolute numbers, this continued to rise through 1990.
- During the Clinton Administration, Federal Civilian Employment actually fell (by 6.5%). By 2000, federal employment was less than it was in 1980.
- State and local government employment makes up the lion’s share – currently 14.3% of the total. In absolute numbers this continues to rise. As a percentage of total employment, this peaked at 15.5% in 1975.
Adjusting for Inflation and Population Growth

Real Federal Government Budget Per Capita

Adjusting for Economic Growth

Federal Budget as a Share of GDP
Smoothing Out the Business Cycle requires calculation of “Trend GDP”

Federal Budget as a Share of Trend GDP

Why Did Taxes Go Up?

The answer is economic growth (revenue elasticity ~ 1.6)
What about State and Local Spending? Hasn’t that grown?

Myth #2: The Deficit Results from Rising Government Expenditures

- Receipts normally rise during economic expansions. Won’t government just spend the money if they get it?
- But if government spending – relative to GDP or in real per-capita terms – did not rise in the 1990s, then does this argument make sense?
- This begs two questions:
  - What did cause the deficit?
  - How can we get rid of the deficit?
What does the Federal Government spend its money on?

- **Biggest Items in FY2003:**
  - Largest items are Social Security – though it takes in more than it pays out – National Defense, Income Security, Medicare, and Health.
  - Everything else, including international affairs, was $326 billion, less than the deficit itself.

What changed?

- **From FY 2000 to FY 2004:**
  - Personal Income Tax Receipts and Corporate Income Taxes fell by 15-18%.
  - Defense Spending rose significantly, along with spending on International Affairs and health.
  - Medicare spending rose due to higher health care costs. Income security and social security also rose, by less, but social security receipts rose too.
  - Interest on the national debt fell by 20%, even though national debt held by public now $3.9 trillion and rising.
Outlays since 1952

Federal Government Outlays

Myth #3: Lower Taxes lead to Faster Growth

- In *The Elusive Quest for Growth*, William Easterly sums up a number of studies comparing different economies. Neither average nor marginal tax rates are correlated with economic growth rates.
- In the U.S., there is no consistent evidence that lower tax rates lead to faster growth.
- The problem is how the tax cuts are financed, how they affect savings and investment, and how efficiently the government spends its tax revenues.
Myth #4: Republican Administrations are Better at Managing the Economy

Most of this data is available back to 1929, but it is a more fair comparison to exclude the Great Depression and World War II:

- **Price Inflation** ~ 3.6% average since 1952
  - Republican Average = 3.8%
  - Democratic Average = 3.2%

- **Real Per-Capita Income Growth** ~ 2.0% average since 1952
  - Republican Average = 1.5%
  - Democratic Average = 2.8%

- **Government Deficits** ~ 1.4% of GDP since 1953
  - Republican Average = 1.8%
  - Democratic Average = 0.6%

- **Civilian Unemployment Rate** ~ 5.8% average since 1953
  - Republican Average = 6.1%
  - Democratic Average = 5.3%

- **Stock Market:** Average Real Growth Rate of Dow Jones Industrial Index ~ 3.5% per year since 1952 (*exponential method*)
  - Republican Average = 3.0%
  - Democratic Average = 4.3%

Myth #5: The Democrats Can Win by Focusing on the Recession

- The economy is not officially in a three-year recession, it is just slower than usual growth.
- The economy will recover eventually, and in a recovery growth is faster than average, especially when the recession has been deeper or longer.
- The tax cuts probably helped the recovery a little, at least in the short term. But could the economy have recovered at a cheaper long-run price?
Paul Krugman: the Tax-Cut Con

Krugman argues that the Bush Administration’s argument for tax cuts – like its argument for going to war in Iraq – is intentionally misleading. Consider the major arguments for a tax cut…

The Supply-side Argument

- Tax cuts stimulate long-run growth rates. This acceleration in growth is enough to increase tax revenues.
  - Evidence on stimulus effect is mixed:
    - Efficiency of investment should improve, and this should lead to faster growth in the long run.
    - It is not clear that tax cuts make people choose to work more.
    - Again, there is no consistent evidence that lower marginal or average tax rates lead to faster growth rates.
  - Few economists believe this is large enough to offset revenue loss:
    - Taxes will eventually rise again as the economy grows, but much of that growth may have occurred even without the tax cut.
The Demand-side Argument

- Classic Keynesian approach that tax cuts increase domestic consumption in short-run and stimulate demand.
  - In short-run, this should push the interest rate up since government is borrowing more, and leads to “crowding out” of investment and exports.
    - During a recession, investment demand is already low and this temporarily reduces interest rates. Once investment recovers, however, real interest rates will rise unless the deficits are temporary.
  - If consumers expect future tax increases, then effect on consumption may be small.
  - Most of the current tax cuts are back-loaded, so current stimulus effect is small.

What’s the Con?

Most tax-cuts advocates do not believe in either the supply-side or demand-side arguments. Instead, there are two reasons for it:

- Starve the beast: government deficits prevent the introduction of new programs and may force the reduction of existing programs.
- As Molly Ivins says, you have to “dance with them what brung you.”
  - Recipients of most tax cuts are major contributors to the Republican Party. What a surprise!
  - The “sweet spot” for the middle class – e.g., the child tax credit – was a Democratic idea and is a small part of the total.
So what about the Deficit?

- When the economy recovers, investment demand will increase and interest rates will rise. Interest on the National Debt will then rise unless private savings miraculously rise to compensate.
- Foreigners have been willing to buy U.S. Treasury Bonds and other assets instead of U.S. goods. When they start to worry about the future, or if we turn protectionist, then interest rates will rise and the Dollar will fall.
- The deficit is much larger than it appears, because social security is currently taking in more than it is spending. What happens when the baby boom starts to retire?

Thank you!

- My website is at http://unr.edu/homepage/elliottp.

I will make this presentation available there.
Notes on Sources and Data

All data used in this presentation come from either:

- Economic Report of the President
  [http://w3.access.gpo.gov/eop/](http://w3.access.gpo.gov/eop/)
- St. Louis Federal Reserve Bank’s Federal Reserve Economic Data
  [http://research.stlouisfed.org/fred2/](http://research.stlouisfed.org/fred2/)

Figures for 2003 are estimated using available data for the first three quarters. Some data is currently only available through 2001.

Real GDP was calculated using the GDP deflator, which usually measures a lower rate of inflation than the CPI, which many economists believe may overestimate inflation.

Real GDP per capita was derived by first calculating an average growth rate of 2.0% between 1952 and 2000, and then carrying that forward from 1952. In effect, this draws an exponential line between the two points. Multiplying by the population gets us Trended Real GDP, and multiplying by the GDP Deflator gets us Trended Nominal GDP.