The Tax Mirage

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Political campaigns these days are shot through with contentions on the desirable level of tax rates in coming years. In broad-brush overview, there are two major positions: one defending the Bush administration’s tax cuts and seeks to extend them, the other presses the need to restore fiscal balance by allowing the tax cuts to lapse. Proponents of the former position often espouse a “supply-side” approach to tax policy. For the most part, however, this approach is a mirage. Let me explain.

Along with some dubious notions—among them, the occasional claim that lower taxes increase government revenues—supply-side economics does rest on a valid idea: lower taxes are more conducive to economic growth than higher taxes. The supply-side dogma on taxation, however, is clouded by a misconception. Simply put, most supply-side economists don’t know (or affect not to know) what taxes are. In identifying the level of taxation in the economy, supply-siders point to the amount and distribution of compulsory transfers made to governments under the label “taxes.” But that is not the whole of it. The real tax over any significant period is the level of government spending in relation to national output. The higher public spending as a percentage of GDP, the higher the real tax. The periodic payments we call “taxes” as we make them are only the current portion of the real tax. The full tax consists of the current part and, in times of budget deficits, a deferred part in the form of claims against the public payable in the future. During the odd period of budget surplus there is an accrued portion, reducing claims against the public in the future. Together, the current tax and the deferred tax (or, rarely, an accrued tax) make up the real tax.

The level of future taxes is a direct function of current taxes. A current tax lower than the real tax implies higher current taxes in the future, while a current tax higher than the real tax implies lower current taxes in the future. These relations do not arise from any policy or ideology, but areas a simple matter of arithmetic. A tax cut today, all else equal, spells higher taxes tomorrow. There are two ways to meet the claims implied by deferred taxes: 1) higher current taxes in some future time or 2) inflating the claims away. Inflation—which entails a mandatory shift of wealth from private to public hands—is the functional equivalent of a tax increase. There is, of course, a third way to pacify deferred taxes: reduce spending to the level of the current tax, or below. That, nearly always, has proven impossible—and no less during supply-side administrations, which use tax cuts to reward their allies but have little stomach to ask anyone to give up anything, for fear of unmasking the supply-side illusion.

Real taxes (federal spending as a percentage of GDP) reached a peacetime high during the Reagan administration (23.5 percent in 1983) and maintained nearly that level through the first (GHW) Bush administration. Real taxes fell considerably during the Clinton years (to a low of 18.4 percent in 2000), then rose again in the second (GW) Bush administration. In real effect, therefore, taxes were reduced during the Clinton administration and were raised in both Bush administrations, especially Bush II.

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The fiscal policy habitually associated with social democratic political orientation is tax-and-spend. Considering the true nature of taxation, supply-side fiscal policy as practiced in the past 25 years boils down to spend-and-tax. In the bigger picture there is little or no functional difference between them. The spend level in those patterns drives the tax level either way. Both resolve into old-style fiscal stimulus.

In sum, the Bush II administration has raised future taxes. We will therefore have higher current taxes in the next administration, be it McCain, Obama, or even Clinton II. Against the inexorable arithmetic of real taxes, it won’t matter who is in the White House.

Plus ça change …