LICENSE TO SPEND

BY STEPHEN MOORE

Now that George Bush has explicitly renounced his campaign pledge, the prescription for budget deficits is the same in Washington as in Albany, Boston, and Trenton: higher taxes. Such prominent Americans as Nobel laureate in economics Franco Modigliani of MIT and Citicorp Chairman John Reed believe that a tax hike is just the remedy needed to jump-start a sluggish American economy. The process is supposed to work as follows: Higher taxes will cause the deficit to fall, which will raise the national savings rate, which will lower interest rates, which will spur investment and ultimately generate economic expansion.

The proponents of higher taxes accept as a matter of faith that deficits will fall if taxes are raised. But recent historical experience at both the state and the federal levels demonstrates convincingly that there is no such iron law of politics. Indeed, a sizable body of statistical and anecdotal evidence shows that trying to reduce deficits by increasing taxes is an exercise in futility: Lawmakers invariably respond to higher taxes principally by raising spending by an amount about equal to the additional revenue, thereby leaving the deficit fundamentally unchanged.

The description of this effect is often called the "tax-and-spend hypothesis." Many years ago Milton Friedman stated the point this way: "You can't reduce the deficit with higher taxes. Political rule number one is: government spends what government receives plus as much as it can get away with." Not surprisingly, the Washington establishment dismisses Friedman's "rule."

Nonetheless, several studies have verified the tax-and-spend hypothesis. In 1986 economist Paul Blackley published a study in *Public Finance Quarterly* that examined the relationship between federal taxes and deficits during the period 1929 to 1982. Blackley found that revenue increases led to spending increases, not to

smaller deficits. A subsequent study by Neela Manage and Michael Marlow, formerly with the U.S. Treasury Department, supported this finding. The authors found statistical evidence of "one-way causality from tax receipts to spending, suggesting that tax increases result in higher spending levels—and possibly larger deficits."

Perhaps most controversial was a 1987 paper published by the Republican members of the Joint Economic Committee (later disavowed by the Democrats), which examined federal revenues and deficits from 1947 to 1986. The authors—JEC staff members Richard Vedder, Lowell Galloway, and Chris Frenze—concluded that each dollar of new taxes had triggered $1.58 in new spending. In other words, the deficit has tended to *rise*, not fall, after a tax hike.

Predictably, this report came under immediate and intensive attack from the Democrats in Congress, who asked the Congressional Budget Office to rerun the numbers and discredit the report. The CBO found that the Vedder et al. study was "extremely sensitive to the time period" and "provides no persuasive evidence in favor of the tax-and-spend hypothesis."

Yet the CBO made four statistical tests of its own, using various assumptions. In its first test, it found that an extra dollar of taxes led to $1.55 in new spending; in its second test, the result was $1.05 in new spending; in its third test, 83 cents; and in its final test, 8 cents. Only the last test supported outright rejection of the tax-and-spend hypothesis. The CBO economists failed to make a strong case that increased taxes reduce deficits, even though they put forth their best effort to validate that conclusion.

The most recent case of a large federal tax hike expressly intended to reduce the deficit was the $100-billion tax package called the Tax Equity and Fiscal Responsibility Act (TEFRA). This was the 1982 grand compromise that Ronald Reagan was talked into supporting because he had received assurances from Congress that "every one dollar in new taxes will be matched with three dollars in spending cuts." But Congress reneged on the deal. Americans got the dollar of new taxes without the spending cuts.

In fact, spending skyrocketed by $200 billion over the next four years. An analysis of TEFRA by Richard Rahn of the U.S. Chamber of Commerce revealed that the deficit in 1986 was no smaller than it had been projected to be by the CBO without the passage of TEFRA. In other words, the largest tax hike in history failed to reduce the budget deficit at all.

Despite this experience, the tax-and-spend lobby has succeeded in convincing Bush that another grand-compromise budget deal is the only way to stifle deficit spending.

The fiscal experiences of the states also confirm the tax-and-spend hypoth-

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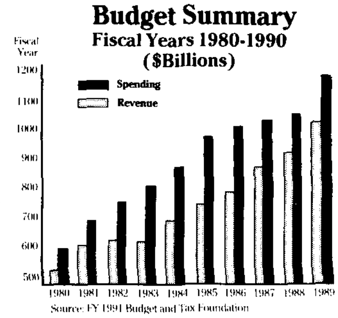

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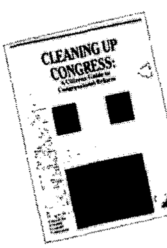

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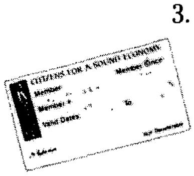

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esis. The relationship is slightly harder to detect at the state level because 18 states have statutory tax and expenditure limitations, which place constitutional restraints on legislators who might wish to spend away additional revenue resulting from economic growth or tax increases.

For example, in 1989 California had a windfall of $2.5 billion in state revenue, but the legislature was prohibited by law from spending the funds on new or most existing programs. The law limited expenditures to the 1978 level plus an adjustment for inflation and population growth. This kind of constitutional limit is an effective deterrent to runaway spending during periods of rapid revenue growth.

But even with the widespread adoption of such limitations in the states, studies have uncovered a statistically significant positive relationship between tax receipts and subsequent spending levels. Former Treasury Department economists Manage and Marlow followed up their study of the federal tax-and-spend relationship with a similar investigation of the 50 states, covering the 30-year period 1952 to 1982. Their overall conclusion was that "tax receipts cause expenditures at the state level of government."

Perhaps even more powerful evidence from the states that taxes invite higher spending is the fiscal crisis that confronts the Northeast. The national economic expansion of 1983-88 produced unprecedented revenue windfalls for the treasuries of most state governments—and nowhere was this more true than in the eight northeastern states. Income in the region grew roughly four times faster than in the nation as a whole between 1978 and 1987. The region's unemployment rate dipped to 2.5 percent in 1987—less than half the national average. In short, these states are precisely the ones that we would expect to be the most fiscally sound in the nation.

Yet precisely the opposite is true; each is sinking under a sea of red ink. New York, New Jersey, and Massachusetts are each running deficits of nearly $1 billion this year. The fiscal outlook is only slightly less gloomy in Maine, New Hampshire, Rhode Island, and Vermont. Governors Mario Cuomo of New York, Michael Dukakis of Massachusetts, and James Florio of New Jersey have endorsed tax hikes of $1.4 billion, $1.2 billion, and $1.4 billion, respectively. Steven Gold, former budget director for the National Council of State Legislatures, says 1990 could see $10 billion in new state taxes—an all-time record.

Although revenues in the Northeast have grown 25 percent faster, these states' year-end reserves have plummeted, while reserves in the less revenue-rich states have climbed. The evidence flatly contradicts the notion that the recipe for fiscal balance is higher taxes.

State legislators in the region have blamed their budget ills on a variety of factors beyond their control. They say that the regional economy has cooled off unexpectedly, that the federal government is mandating new spending, and that the 1986 Tax Reform Act has caused a loss of revenue.

None of these explanations is plausible. Seven of the eight states in the region have experienced faster revenue growth from 1987 through this year than the average for all other states. Although revenues in the region have grown 25 percent faster, these states' year-end reserves have plummeted, while reserves in the less revenue-rich states have climbed. The evidence flatly contradicts the notion that the recipe for fiscal balance is higher taxes.

Even the most liberal of commentators have correctly assessed the problem of the Northeast, which is not insufficient revenues but unbridled growth in new spending programs. The *Washington Post* reported last year: "The main reason for budget shortfalls from Connecticut to Maine has been...mushrooming spending programs that doubled and even tripled budget outlays in these prosperous states." To substantiate the point, the *Post* cited figures for spending growth between 1987 and 1989: Outlays escalated 37 percent in New Hampshire, 31 percent in Connecticut, 20 percent in New Jersey, 18 percent in New York, and 13 percent in Massachusetts.

The plight of the Northeast has been a classic case of the ratchet effect of government spending, which might be called a corollary to the tax-and-spend hypothesis. Higher revenue triggers new spending that quickly becomes an indispensable fixture of the government. When revenue is expanding at a healthy pace, the legislature feels free to find new and creative ways to spend the funds on government services. When the budget situation turns sour, as now in the Northeast, the prescription is inevitably to pass tax bills to support the new higher level of spending—hence, the ratchet effect.

New Hampshire state Rep. Donna P. Sytek, the Republican chairman of the state Ways and Means Committee, explained how the process works when she said: "We did a lot of good things in the years we had the money. But there's a constituency that now perceives these programs as essential, and we can't take them away. We should have known the boom wouldn't last forever."

What are the lessons, then, from the fiscal crisis in the Northeast and the failure of deficit-reduction schemes such as TEFRA? The first is that a new plate of federal or state taxes may in the short term provide fiscal relief, but over the long term it will usher in budget crises worse than the one we now face. The second is that if, as the evidence suggests, the tax-and-spend hypothesis is correct, then Congress and the state legislatures should be cutting taxes, not raising them.

Stephen Moore is an adjunct fellow with the Indianapolis-based Hudson Institute.

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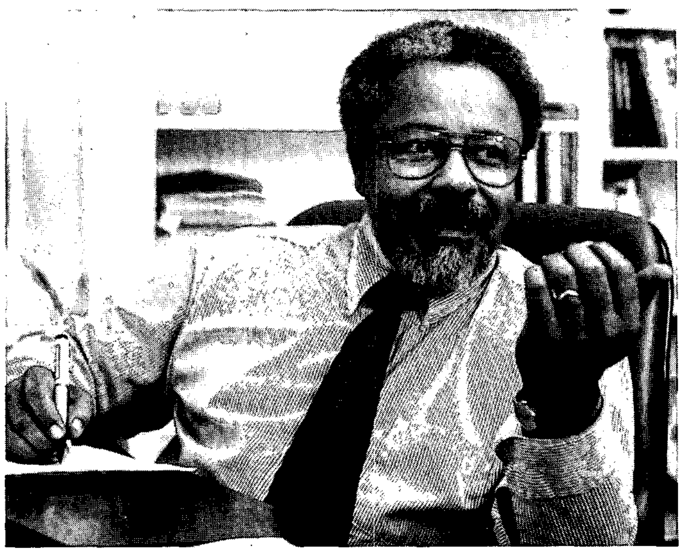
POLITICAL THEATER

BY ERIC FELTEN

The number of those who claim to have won the Cold War single-handedly grows every day. First, conservatives claimed to have intimidated the Soviets with their unflinching commitment to an arms buildup. Then liberals argued it was their devotion to peace and diplomacy that eased the Soviets' fears. Now members of the National Endowment for the Arts executive council claim the victory.


NEA council member Lloyd Richards compares the chocolate-covered Karen Finley to Vaclav Havel.

GERRY GOODSTEIN

At the NEA's August meeting in Washington, D.C., council member Lloyd Richards, dean of the Yale School of Drama, said "the revolutions of the last year would not have been possible without the ideal of artists from the United States." Thus, he argued, the NEA should support controversial performance artists like Karen Finley—known for lathering herself with chocolate—and Holly Hughes, the "tough girl" lesbian eroticist. They challenge the government, he said, not unlike "Vaclav Havel, an artist who traduced the state."

But it is unlikely that a woman who puts gelatin in her bra and bounces around reciting *Village Voice* verities inspired East Europeans to throw out their Soviet masters. The comparison with Havel is particularly strained. Havel experienced censorship: The government banned his works and threw him in jail. Hughes and Finley simply found their subsidies cut off, which caused the tough-girl revolutionary to leave the meeting room crying. *Pauvre enfant terrible.*

The council threw out these grants and three others recommended by the advisory Inter-Arts Panel. The panelists who had backed them were members of the organizations that would sponsor the performances and stood "to receive remuneration."

The NEA is shot through with such conflicts of interest. There is a revolving door at the endowment that would send a tachometer into the red. NEA grants to the Guthrie Theater Foundation in Minneapolis jumped from $300,000 in 1986 to $1.2 million in 1988, after Edward Martenson, formerly head of the NEA's theater program, became president of the Guthrie, reports George Archibald of the *Washington Times*. The Spoleto Festival USA in Charleston, South Carolina, found its NEA booty similarly augmented the year after Nigel Redden resigned as the head of the NEA's dance program to become the festival's general manager.

NEA Administrator John E. Frohnmayer promised at the hearing to devise stronger, stricter rules governing conflicts of interest in grant-recommending panels. But several council members argued such rules would hurt experimental art. They claimed that the NEA could not avoid having panelists who are involved with the grants it considers.

Council member Wendy Luers said that the performance art "field is much smaller [than traditional art circles], and you have to draw panelists from a much smaller pool." And Phyllis Curtain, also on the council, said, "If you're going to find peer panels to judge a particular field, you have to find the people who are involved in it." Luers and Curtain defended the experimental arts panel, but with a curious defense—one refuting the claims that NEA-sponsored performance art is challenging and creative. "Finding a panel of, let's say, diverse views in this field is not all that easy," said Curtain. And that's the problem. How committed to experimentation can a group of artists be if their views are all the same? Indeed, there is something fundamentally absurd about peer review of avant-garde art: Truly original artists have no peers.

The majority of the projects the Inter-Arts Panel recommended reflect the left-wing sensibilities for which performance art has become famous. One project brings together Los Angeles homeless to participate in performance pieces. One bestows money on the Citizen's Environmental Coalition to plant toxic-eating foliage in some contaminated soil. (The *process* of the soil becoming clean will produce an "invisible aesthetic.")

But the paradigm grant is for a roundtable discussion by the Road Company of Johnson City, Tennessee: "Community leaders, scholars and Road Company members will develop the specific agenda of discussion. Possible topics include industrial and economic development in the area, the definition of culture for the region, and ethics in city government and in other local institutions." This is art only in the sense that someone claiming to be an artist says it is.

Can one listen to M.K. Wegman, the