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A Dubious Deal For Reduction In Entitlements

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Rumors are circulating that Republicans may by next year be desperate enough to accept tax increases in exchange for decreases in entitlement expenditures. This would be part of a bipartisan deal designed to postpone the fiscal calamity that will occur when currently promised entitlement benefits become totally unaffordable.

Wholly apart from whether any "grand compromise" involving tax increases is a good idea (it isn't) or whether the Democrats can be trusted to do a clean deal on permanently reducing entitlements and stick to it (they can't), anybody planning to participate in such a high-risk game should at least start off with the right facts and figures. Otherwise, well-intentioned seekers after fiscal sanity - not to mention the voters - will get sucker-punched again.

Bad Voodoo

According to the voodoo budget accounting rules in use by both the administration and Congress, $1 of additional tax revenues for the government costs the private sector only $1 - and that $1 in taxes is equal to $1 in spending. Looked at in this self-delusional way, a dollar-for-dollar swap of tax increases in exchange for spending cuts might sound good on the evening news, and it would indeed help balance the government's accounts in a mindless bookkeeping sense.

But the shocking truth is that each $1 of tax increase actually costs the private sector economy $2.50 - and, in some circumstances, much more. Thus, instead of a dollar-for-dollar swap, as advertised, for every $1 of spending reduction, there would be at least $2 of a tax increase, part of which is visible and part of which is hidden.

The visible part is the $1 that is paid into the IRS' coffers and officially counted. The hidden part is the amount by which people's wages, salaries and other pretax incomes are smaller in the first place - before any check is written to the IRS - solely because of the economy's negative reaction to the tax increase.

It has long been known among analysts in and out of government that tax increases adversely affect economic growth; that $1 of additional tax, therefore, reduces pretax and after-tax incomes; and that, when correctly accounted for, the total is substantially greater than $1.

A new study by the National Bureau of Economic Research at Harvard confirms that the total cost of raising $1 of additional tax is about $2.50. Our model produces almost identical results ($1 of visible tax plus $1.57 of "lost" wages, salaries and other income).

Recent calculations by the Congressional Budget Office produce similar results in the case of an across-the-board tax increase on both labor income and capital. A tax increase solely on capital - such as upping the tax rate on dividends - costs about $4.30 per $1 of revenue raised, according to the methodology used in a new study by former Bush administration economic adviser Gregory Mankiw, also at Harvard.

The Truth Is (Almost) Out There

The Treasury Department's own newly established Dynamic Analysis Division is, itself, well on the way to confirming and quantifying the high costs of tax increases - and, if allowed to fully develop its capacity, will for the first time in history soon be telling Americans the truth about how much tax (visible and invisible) they are paying.

Once voters know the truth, tax increases that help the government balance its cooked books but make people worse off by a ratio of at least 2-to-1 will not be very appealing. Even high-tax Democrats will be restrained when the voters learn that the economic burden of high "taxes on the rich" actually falls mainly on low- and middle-income wage earners.

The first thing that incoming Treasury Secretary Hank Paulson should do is make his department's fledgling Dynamic Analysis Division a matter of the highest priority, expanding its resources and broadening its mandate to look at the economic consequences of spending as well as taxes. That way, voters will know that cutting spending is in most cases conducive to economic growth in much the same way that raising taxes is harmful to economic growth.

On the congressional side, more members should follow the statesmanlike example of Sen. Judd Gregg, chairman of the Senate Budget Committee, who has introduced S. 3521 that would face up to the entitlement crisis by cutting spending. And all members of Congress should enthusiastically follow the lead of Rep. Paul Ryan, the likely next chairman of the House Budget Committee, whose Legislative Line Item Veto Act of 2006 was recently passed by the House.

Lower spending means lower taxes, and the combination of the two means economic growth and higher incomes.

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