



Government Vs. Economic Growth: Taking Account Of The Real Costs

Investor's Business Daily

February 23, 2007

By Ernest S. Christian and Gary A. Robbins

If there is anything more infuriating to some liberals than George Bush himself, with his religiosity and embarrassing accent, it is the common sense, neoclassical idea that tax cuts are good and tax increases are bad.

Tax cuts are good because they stimulate economic growth, making people better off by several multiples of the amount of tax revenue the government loses. A good rule of thumb is that a \$1 tax cut induces \$1 to \$2 of additional economic growth.

Conversely, tax increases are bad because they impair economic growth, making people worse off by several multiples of the extra amount of tax revenue the government collects. Generally speaking, an additional \$1 of tax money for the government to spend costs the economy not only the \$1 of tax but an additional \$1 to \$2 in lost income.

Another good common sense rule of thumb is that when the government gets extra tax revenue, it usually spends \$3 to do a \$1 job.

So why not cut taxes and spending? There is plenty of room for reducing the \$2.9 trillion federal budget, without cutting anything even resembling muscle and sinew.

Just think how good it would be if the Congress were to do its duty; if all federal spending were exposed to the light of day and honestly evaluated, in public, on a cost-benefit basis. What if tax increases became the last instead of the first resort, to be used only after every ounce of political spoils, patronage, waste and just plain silliness had been squeezed out of the federal budget?

They Don't Get It

The virtues of lower instead of higher taxes and spending are, however, not always apparent to folks in Washington whose entire life experience, career success and, in many cases, secular religion are all bound up in making big government even bigger. Unfortunately, they often control the levers of power. If they do not pull them, they whisper in the ears of those who do.

For example, Washington's most widely read newspaper is pro-government on most matters - and when it comes to fiscal policy, yields to no one in its zeal to stamp out seditious talk about tax cuts.

Last month, the Washington Post attacked with a particularly snarky editorial ("A Heckuva Claim," Jan. 6) after President Bush had said in the Wall Street Journal that tax cuts in his first term had stimulated economic growth and that economic growth had contributed to a recent surge in tax collections.

Intending to hoist tax-cutters on their own petards, the Post cited a recent paper by Gregory Mankiw, a distinguished economist at Harvard who recently served as chairman of the President's Council of Economic Advisors. "Gotcha!" said the Post, even Bush's own economic guru can't make the case for tax cuts.

Mankiw's analysis, reduced to its essence, concluded that a \$1 tax cut on dividends would reduce government revenue collections by about 50 cents, after taking into account taxes on \$2 of additional economic growth induced by the tax cut. A \$1 tax cut from an across-the-board rate reduction would cost the IRS about 77 cents, after taking into account taxes on \$0.95 of additional economic growth induced by the tax cut.

Good Trade

To the Post, from the perspective of big government, the main point of the Mankiw study was clear and conclusive: The amount of tax on the amount of induced economic growth was not sufficient to make up for the full amount of revenue lost to the Treasury from the original tax cut. Ergo, the government has less money to spend. Ergo, tax cuts are bad.

To those of us who prefer economic growth over government growth, the Mankiw study confirmed a different and powerful point. If Congress were willing to forgo 50 cents of additional tax revenue, the economy would grow and people would have \$2 more income. If given the choice, most people would make that trade. Apparently the Post would not.

The other important point is derived from applying the Mankiw study in reverse - to a tax increase. Because of the damage to the economy, a purported \$1 tax increase on dividends nets the Treasury only 50 cents - but costs Americans \$2 in lost income, plus \$0.50 in tax.

When achieved by a rate increase on all forms of income, an attempted \$1 tax increase yields only \$0.77 - but costs Americans \$0.95 in lost income, plus \$0.77 in tax. If the government were to kick up the tax increases enough to collect a full additional \$1, the cost to the public would be \$2.25 to \$5, counting tax paid and income lost.

The devastating inefficiency of tax increases was addressed by Harvard's senior and most distinguished public finance economist, Martin Feldstein, in "The Effect of Taxes on Efficiency and Growth" (NBER Working Paper No. 12201, May 2006).

Based in part on empirical studies carried out over a period of years, Feldstein concluded that when the government undertakes to raise \$1 of tax revenue by an across-the-board rate increase, it will, after taking into account the economy's predictable adverse reaction, end up with only an additional 57 cents to spend. To get a full \$1 to spend, the government must kick the nominal tax increase up to \$1.75, which further exacerbates the damage to the economy and, therefore, to incomes and living standards.

The Mankiw and Feldstein studies lead to the conclusion that, at the margin, each additional \$1 of tax obtained by the federal government costs the private economy \$2 to \$5. Of that amount, \$1 is the tax - money that taxpayers give up and the government gets. The remainder is a "dead-weight" loss. Nobody gets it. It is wages, salaries and other income that the economy would have produced but, because of the tax increase, does not.

The proponents of high taxes and big government like to pretend that the economic burden of the dead-weight loss falls solely on the rich, but it does not. The economic loss falls mainly on low- and middle-income earners in the form of salary increases not obtained and jobs not obtained (or lost), and this burden applies irrespective of whether the victims do or do not pay income taxes.

Furthermore, the regressive nature of the adverse economic fallout from high taxes cannot be avoided by concentrating those taxes on ostensibly rich capitalists. As Mankiw and others correctly point out, concentrating taxes on capital exacerbates the damage to the economy.

No Better Off

If one is to believe their rhetoric, the new majority in Congress intends to impose higher tax rates on dividends, capital gains and the incomes of upper-bracket taxpayers in general. They will tell themselves and the public that they are raising \$50 billion in new revenue from the malefactors of great wealth and that they will spend this windfall wisely to make us all better off.

But they won't tell the American people that the higher tax rates will damage the economy. The amount of that damage will be about \$60 billion in the form of lower incomes and fewer jobs. They also won't tell the people that because of that economic damage, the revenue yield from the tax hike will, in fact, be only about \$33 billion (not \$50 billion); and that, at the margin, the entire \$33 billion likely will be spent on perks, pork, patronage and other waste that benefits

members of Congress, not the public.

Christian is executive director and Robbins chief economist of the Center For Strategic Tax Reform. Both are visiting fellows in taxation at the Heritage Foundation.