



Beyond Simplification

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Reducing tax paperwork is important, but minimizing government's impact on the economy is key

Talk of taxes and tax reform abounds, and it has ever been thus -- especially when election time rolls around. The story of the tax code -- insofar as yet written -- is also the story of government and politics. In the beginning, taxes begat government; government begat spending; and spending begat more taxes, more government and more spending.

Tax reform is about good economics. Politics, on the other hand, has been about bad economics since the 1930s, when FDR created the modern day version of the Jacksonian spoils system. In 1938, Harry Hopkins said: "We will spend and spend, tax and tax, and elect and elect."

Nevertheless, as the damage done by taxes that are too high and badly structured becomes ever greater and more obvious — even to Washington — there are glimmers of hope. Circumstances may be combining to make good economics good politics – in which case tax reform in its broadest and truest sense may be upon us.

Consider the following apocryphal news report from sometime in the future -- perhaps next year or possibly never.

"Flash! The minimalist school of tax policy has prevailed. Gone is the extravagantly baroque tax structure of the past. In its place there is a new one of stark, utilitarian efficiency.

"The large and once powerful "tax industry" is recoiling in shock. Thousands of lawyers and accountants are having to make the painful transition to productive employment. Lobbyists are seeking disaster relief for themselves.

"There is real human suffering all across America. Severe environmental degradation is occurring. Smoke fills the air as mountains of discarded tax forms burn out of control. Noise levels are becoming unbearable, as the clatter

of commerce replaces the soothing sibilance of shuffled paper.

“The toll of disaster victims is mounting. Unable to endure, some have broken under the weight of despair. Bands of stricken bureaucrats wander the streets of the nation’s capital, befuddled and bereft. How could this happen? Where will it all end? Then, the unthinkable happened:

“Minimalism began to spread.”

Emotionally (*note -- emotion is a force not to be discounted in any political upheaval), tax reform is about the “mountains of discarded tax forms”. Some of the most enthusiastic warriors see the battle solely as one against paperwork and a prying IRS. In reality, however, like most things governmental, taxes are about money -- and the first purpose of reforming taxes is to enable the noisy “clatter of commerce” to provide more jobs and higher incomes for everyone.

Because of the dynamic relationship between taxes and spending, and their destructive effects when applied in excess, tax reform writ large is also about reforming government itself, the way it decides to tax and spend, why and how much -- and ultimately, it is an attempt to change the practices of politics in America.

The Cost of an Unreformed Tax

A few definitions may be helpful, starting with the meaning of tax reform.

Taxes have large and powerful effects on behavior and, therefore, on economic performance. An unreformed tax is one that has the most adverse effect on economic performance and, therefore, costs the most, per dollar of revenue yield to the government. A reformed tax is just the opposite. It has the least adverse effect per dollar of revenue yield. A large amount of any tax – even a reformed tax -- is bad for the economy, and a large amount of an unreformed tax is disastrous.

The current federal income tax, individual and corporate, is quite clearly on the bad side of the line, unredeemed by the fact that in the past it has been even worse. Had not the extraordinarily high marginal tax rates that prevailed in the 1950s and 1960s been reduced to the more tolerable but still too high levels of today, and had not the nearly prohibitory double and triple taxes on saving and investment been ameliorated somewhat, it is probable that the U.S. economy would today be no more than 60 percent or so of its present size.

Even with current rates and less destructive multiple levies on capital, taxes cost the private economy two to three times more than the revenue yield to the government. On average, \$1 of revenue ends up costing \$2 -- and at the

margin, a \$1 increase in revenue from additional taxes on capital costs the private economy \$3 to \$4. (See Martin Feldstein, "The Effect of Taxes on Efficiency and Growth" (Cambridge, Mass.: National Bureau of Economic Research, 2006) and N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide" (Cambridge, Mass.: National Bureau of Economic Research, 2006)).

There are two components of "cost". First, there is the \$1 of tax. People no longer have this money; the government does. Second, there is the lost income -- perhaps as much as \$3 -- that the economy would have produced had not the government intervened. People do not have it to save or spend, but neither does the government. It's gone, never produced and irretrievable.

Economists may argue around the edge about the exact size of the "deadweight" loss, but it is an iron law that taxes do cost the economy more than the revenue yield to the government. This powerful fact alone -- although conveniently ignored by politicians -- is the central reality of governance in our free market economy today. It means that unless government is continually to make people worse off, each dollar of spending must by some measure be said to produce a benefit to society that is greater than a dollar.

Some dollars do, but most do not. And the more government grows, searching for more things to do and spending ever more dollars on more projects, the more likely it is that an ever-larger portion of government spending will be worth less than its cost. Many of government's hot new spending programs may be highly worthwhile -- times change and everything government does is not bad. But instead of paying for the new expenditures by cutting back funding for one of yesterday's supposedly hot new programs (that didn't work and is now nearly useless), the government almost invariably keeps that old program and imposes more high-cost taxes to pay for the new one. The absurdity of this practice is obvious.

If every time the Congress sought to raise taxes, the 100 most inefficient preexisting government spending programs were put at the margin and -- out in public -- matched up with the high cost of a tax increase, it would be clear that the combination of government taxing and spending is making Americans worse off. A recent study by the Office of Management and Budget shows that over 400 federal spending programs with a total annual budget of \$650 billion received grades of "D" or "F" for lack of performance.

Strictly mathematical measures that weigh the amount spent against discernible results produced obviously do not capture all the benefits of all government programs. In some cases they do and in some they don't. Who can fully measure the value of educating a child or of national defense? But it is also the case that the true cost of taxes exceeds the \$2 to \$4 per \$1 of revenue that

most economists compute. Who can measure the real cost of jobs lost, raises not received, mortgages not paid, education foregone and healthcare not obtained because of the economic damage done by taxes?

When one looks at the dynamic interactive relationship between taxes, spending and economic growth, the second critical reality of governance in a free market economy is as arresting as the first: many of the problems that modern liberal governments in the United States and elsewhere seek to cure by increasing public spending are the result of taxes imposed by government to pay for existing levels of spending. The lesson to be learned from this self-perpetuating (and self-magnifying) circularity is not that government should stop taxing and spending; but it is, rather, that the government should stop falsifying its books of account in an ongoing process of misleading both itself and the voters.

Keeping Spending to a Minimum

Presently, the federal budget first assumes that a dollar of taxes costs only a dollar, and then most politicians pretend that each dollar of spending produces more than a dollar of benefit. (If it did not, what excuse could there possibly be for them having spent it?) The better politicians -- of which there are many -- know about the high cost of taxes and the measurably low value of most government spending, but they are swept along by the force of tradition and the inability of any one member of Congress (or in most cases, even a President) to alter the onward and upward sweep of a federal government now more powerful than they.

Tax reform in the broad sense is unlikely to occur until the government fundamentally changes its financial accounting by adopting a Cost-Benefit Budget that, out in the open and with full public participation, systematically weighs the benefits of all government spending programs -- both existing and proposed -- against the true cost of taxes necessary to pay for them. Cost-benefit budgeting would not mean that the public would receive less services from government that are truly important. Indeed, cost-benefit budgeting would enable the government to do more of the things for which it is uniquely suitable -- and a growing economy would greatly reduce the number of people in need of assistance from government.

The case for a growing economy, a minimalist government concentrated on achieving the best with the least, and presided over by a President and Congress content to do their limited constitutional duties quietly and efficiently, is impeccable. It has been made elsewhere far more expertly than here. But the ruling combine in Washington, made up mostly of entrenched incumbents, lawyers, lobbyists, and others to whom the government is a vital source of profit, has for many decades been moving in the opposite direction. It will not

and probably cannot voluntarily give up its power or change its character.

Change will occur when the voters rise up in righteous anger, smite the offenders and replace them with public servants who have but one standard by which to measure everything: "Is it good for America?"

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