



## The Fiscal Bottom Line

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Just because something is simple and makes sense does not mean it isn't true -- even in Washington. Consider the proposition 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 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, each additional \$1 of tax revenue costs the economy not only the \$1 of tax but an additional \$1 to \$2 in lost income.

So why not cut taxes and spending? There is plenty of room for reducing the nearly \$3 trillion federal budget, without cutting anything even resembling muscle and sinew. Another good rule of thumb (attributed to Milton Friedman) is that the government usually spends \$3 to do a \$1 job.

Imagine if all 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? And imagine -- if you can -- a government that keeps its hand out of your pocket, its nose out of your business, and does its own assigned tasks with cost-effective competence.

Nevertheless, just because something makes sense does not mean it will carry the day -- especially not in Washington. Consider the two versions of the truth that may be drawn from a recent study by Gregory Mankiw, an economist at Harvard.

Reduced to its essence, Mr. Mankiw 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 the 95 cents of additional economic growth induced by the tax cut.

To the champions of bigger government, the important truth of the Mankiw study was that the amount of tax on induced economic growth was insufficient to make up for all of the revenues 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 truth. If Congress is willing to forego 50 cents of revenue, the economy would grow and people would have \$2 more income. If given the choice, most people would take the \$2.

Now apply the conclusions of the Mankiw study in reverse -- to tax increases. The results illuminate the high costs of providing the government with an additional \$1 to spend. A purported \$1 tax increase on dividends only nets the Treasury 50 cents -- but costs Americans \$2 in lost income, plus 50 cents in tax. When a higher rate is levied on all forms of income, an attempted \$1 tax increase yields only 77 cents -- but costs Americans 95 cents in lost income plus 77 cents 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 between \$2.25 and \$5, counting both tax paid and income lost. A May 2006 study by Harvard's Martin Feldstein, "The Effect of Taxes on Efficiency and Growth," confirms the disproportionately large economic losses associated with tax increases.

The economic losses that result from increased taxes fall mainly on low- and middle-income earners in the form of salary increases not obtained and jobs not gotten (or lost); and this burden applies irrespective of whether those who lose out pay or do not pay income taxes. The regressive nature of the adverse economic fallout from high taxes cannot be avoided by concentrating those taxes on ostensibly rich capitalists. In fact, Mr. Mankiw's study confirms that concentrating taxes on capital exacerbates the damage to the economy.

Unfortunately, the new party in power in Congress has threatened to impose higher tax rates on dividends, capital gains and the incomes of upper-bracket taxpayers in general. They will tell the public that they are raising \$50 billion of revenue from the malefactors of great wealth and that they will spend this money wisely.

A decent respect for the truth would, however, require them to warn the American people about the most likely results of the tax increase. The higher tax rates will cost them about \$60 billion in lost incomes and jobs. Because of that economic damage, the revenue yield from the tax increase will be only about \$33 billion, not \$50 billion. And at the margin, the entire \$33 billion will be spent on perks, pork, patronage and other waste.

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