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Tax cuts as government curb

By Richard W. Rahn
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ROME, Italy. -- Sitting in a pleasant cafe on a sunny spring day, my Italian friend arrives and says, "Richard we have had a wonderful month here in Italy because we have had no government." He referred to the fact that between the defeat of the last government at the polls and formation of the new government, no new initiative to tax, misspend the taxpayers' money or new major regulation had been possible.

People intuitively know that when governments are capable of activity, most often the citizens' pocketbooks and liberties are at risk.

If you go to the major European cities, such as Rome, Paris, London, Munich, Berlin and so on, as a tourist or occasional visitor, you look around and think all is well. The restaurants are full, the tourist attractions and the downtown streets and buildings have been spruced up, and the crowds are large and seem happy. But underneath these islands of prosperity, there is economic and demographic rot, which, if not reversed, will destroy the European good life.

The source of the economic rot can be summarized in three words: too much government. "Too much government" means too much misspending of the taxpayers' hard-earned money, destructive tax rates and tax policies, and too much unnecessary and destructive regulation.

Nothing new here -- but back across the Atlantic in America, a little storm was raised when one of President Reagan's economic advisers said he thought the Reagan and Bush tax cuts had led to more, rather than less, government spending.

One argument by advocates of President Reagan's tax cuts is that "they would starve the beast," meaning lower tax rates would force less spending. The fellow causing the storm was Bill Niskanen, chairman of the Cato Institute and former acting chairman of Reagan's Council of Economic Advisers.

Mr. Niskanen is a very fine economist who has made significant contributions to the field over the last several decades (and is an old friend). Basically, he argued government spending went up (as a share of gross domestic product) under the first Reagan tax cuts, went down a little bit under Bill Clinton's tax increase, and rose again under the current President Bush. Thus "starving the beast" did not work and may have been counterproductive. Predictably, the anti-Reagan and -Bush left jumped on the Niskanen statements to support their view that "supply side economics" had been a failure. Bill Niskanen actually showed even the best economist can occasionally be wrong.

Let's hop back to Europe where I am at the moment. Italy, France and Germany began several decades ago to adopt a high-tax and spend government model, while the U.S. was moving toward a lower tax rate model. Federal spending in the U.S. is now lower as a percentage of GDP than when Reagan took office. Federal government spending was also a bit less when Reagan left office (it increased the first couple of years because of the recession and defense build-up, then declined).

Mr. Niskanen is rightly concerned that low tax rates and large government deficits give the illusion government does not cost as much as it really does, and hence the people and the politicians are in denial.

But again, the high-tax European model has resulted in even less fiscal responsibility than in the U.S. All the major countries run deficits roughly the size of that in the U.S., and their debt relative to GDP is far higher. (Italy runs a deficit about 50 percent higher than the U.S. and has threefold the debt-GDP ratio).

Mr. Niskanen's mistake was to only look at the situation for a very few years in the U.S., rather than over a long time, and to fail to look at what has happened in the rest of the world. Major low-tax economies, such as Japan, Switzerland and the U.S., have much smaller government sectors than the major high-tax-rate countries. He also ignored the need for the Reagan defense build-up and the cost of the Iraq war, which were one-time events.

Yes, Mr. Niskanen is right that government spending is destructive, because governments in general spend less efficiently and waste more than the private sector. But high tax rates are also destructive, because they discourage productive work, saving and investment and thus encourage growth of the underground economy (again, Italy is a prime example).

Would those who prefer the high-tax-rate, high-government-spending model also prefer the economic stagnation and high unemployment Italy, France and Germany suffer as a result? Mr. Niskanen is correct that cutting tax rates did not sharply reduce the size of government as some of us hoped, but it did cause high economic growth and limited the size of government, despite the illusion of costless debt to which Mr. Niskanen refers.

But as a final test, think about this: 100 years ago, the U.S. federal government only spent about 3 percent of GDP (as opposed to the current 20 percent). If the government had been prevented from ever taxing more than 3 percent of GDP (as opposed to today's 18 percent), would the U.S. government be larger or smaller?

Richard W. Rahn is director general of the Center for Global Economic Growth, a project of the FreedomWorks Foundation.