The Washington Times
www.washingtontimes.com

More Evidence

By Richard W. Rahn
Published October 10, 2007

If you are or were a smoker, how high would the tax on cigarettes have to be before you would start growing tobacco in your back yard and rolling your own?

The Democrats in Congress say they want to fund their proposed expansion of the children's health program through higher tobacco taxes, which they also say will discourage people from smoking. Some people will pay the additional tax, some will stop smoking, and some will grow their own tobacco (or go to black markets, as pot smokers do).

Knowing how tobacco smokers will respond is key in estimating how much revenue will come in from the proposed tax rate increase — if any. There are tax economists who can give pretty good estimates about the consumer response, but unfortunately they will not be found (or at least be allowed to speak) in the Joint Tax Committee (JTC) of the U.S. Congress, where the "official estimate is made."

A new econometric study by A.J. de Bruin of Erasmus University in the Netherlands, looking at the effect of changes in tax rates on labor over the last two decades in Belgium, France, Italy, the Netherlands, the United Kingdom and the United States, has just been published. It is an extension of some recent work by Nobel laureate Edward Prescott of Columbia University, which not only verifies the damaging effect of income taxes on labor, but also estimates the magnitude of the effect for several countries and the time it takes for changes in tax rates to affect labor markets.*(*The paper can be found on the following Web site www.freedomandprosperity.org.)

This and many other similar technical studies of the effect of tax rates on the willingness of people to work, save and invest are important because when Congress and other legislative bodies ignore such data, they tend to make tax rates higher than what would be optimal to maximize the welfare of the country. The conclusion of the above referenced study and many others is that a decrease in marginal tax rates on productive activity in high-tax societies causes a rise in economic activity (more growth). This increase in economic activity generates additional government revenues that, in part, compensate for the revenue loss due to the lower tax rate.

The reverse is of course also true: An increase in tax rates will lower economic activity and provide the government with less additional revenue (and higher unemployment) than would be expected without any behavioral changes.

However, there are a number of members of Congress, mainly Democrats, but also some Republicans, who like to pretend people will not respond to increases in tax rates in negative ways (this is called static analysis). For decades, this group has had effective control of the official tax scoring committee. Thus, they overestimate the tax revenue that will come in from a rate increase and overestimate the loss in revenue from a tax rate cut, which serves the interest of those who, for ideological reasons, want to increase the size of government.

After all too many years, the Bush administration is at least trying to have its Treasury Department tax office (OTA) undertake some dynamic analysis (i.e., considering the behavioral response). However, Congress refuses to fund this modest effort (we are talking about less than a million dollars), let alone clean up JTC, which refuses to allow public scrutiny of its estimating procedures.

The Heritage Foundation recently published a book, "The Secret Chamber or the Public Square: What Can be Done to Make Tax Analysis and Revenue Estimation More Transparent and Accurate?" by Bill Beach, David Burton and Dan Mastromarco, which describes the problem in detail and proposes solutions.

The Bush administration is looking at its legacy. It should now insist on honest, transparent, accurate revenue estimating by OTA and JTC and make sure they have the necessary funds for the work. The expenditure of perhaps at most several million dollars on proper estimates *would save the American taxpayer hundreds of billions of dollars* — and that would be a great legacy.

If Congress will not vote the necessary funds, the president and Treasury Secretary Henry Paulson should call for private donations to competent public policy research organizations, such as the Heritage Foundation, the Institute for Research on the Economics of Taxation (IRET), etc., to do the necessary work. The administration and members of Congress could then use these estimates about the revenue impact of proposed tax bills, rather than the politicized estimates of the JTC.

Richard W. Rahn is chairman of the Institute for Global Economic Growth.

http://www.washingtontimes.com/apps/pbcs.dll/article?AID=/20071010/COMMENTARY/110100011