The Washington Times
www.washingtontimes.com

No Tax Increase Needed

By Richard W. Rahn
Published August 7, 2008

Over the past 40 years, do you think the federal government has become relatively larger or smaller in relation to the size of the economy?

Please take a look at the table below and perhaps, surprisingly, you will see that the federal government, in terms of taxes and spending as a share of total gross domestic product (GDP), has remained almost constant for decades, even though it has grown steadily in absolute terms. (State and local governments, however, have been growing as a share of GDP, and burdensome regulations have been growing at all levels of government.)

REVENUES AND OUTLAYS
(as a percentage of GDP)

Revenues	1968	1988	2007
Individual Income Taxes	7.9	8.0	8.5
Corporate Income Taxes	3.3	1.9	2.7
Social Insurance Taxes	3.9	6.7	6.4
All other Taxes and Receipts	2.5	1.6	1.2
Total Revenues	17.6	18.2	18.8
Outlays	**1968**	**1988**	**2007**
Social Security/Medicare, & other mandatory	5.6	8.9	10.6
Defense	9.5	5.8	4.0
International	0.6	0.3	0.3
Domestic Discretionary	3.6	3.1	3.3
Net Interest	1.3	3.0	1.7
Total Outlays	20.6	21.1	20.0
Deficit	3.0	2.9	1.2

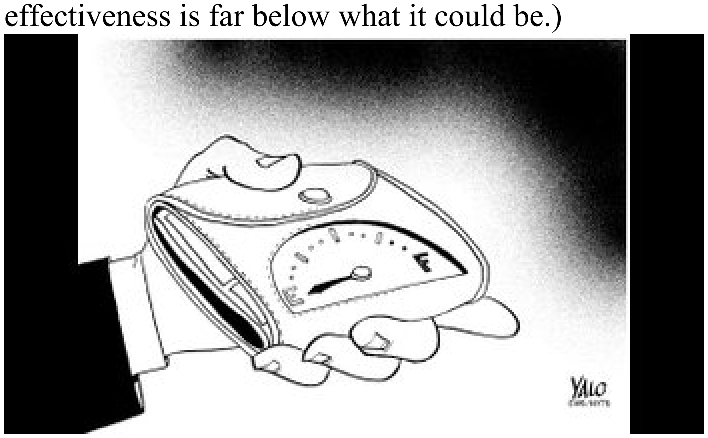
Source: Congressional Budget Office

Even though income tax rates by the end of the Reagan administration (1988) were less than half the rates of 1968, tax revenue as a percentage of GDP was actually a bit higher. Budget deficits have averaged about 3 percent of GDP for the last 40 years, and the government debt as a percentage of GDP (approximately 37 percent) is close to its historical average for the last half-century. As the numbers show, those who say disaster is upon us and we must increase taxes are just plain wrong!

There has been a big shift in spending by the federal government over the last few decades, from defense to "entitlements," specifically Social Security, Medicare, Medicaid and other welfare, medical and federal employee retirement programs. Many of those who insist that tax increases are needed argue that the entitlement programs will grow more rapidly than the economy and they must be funded. The problem with this argument is that tax increases will slow economic growth, and that no amount of tax increase can fund these programs if they are allowed to continue to grow faster than the economy. Fortunately, there are solutions that do not require any tax increase at all or substantial benefit cuts.

Other countries have solved, or are solving, the social security problem through privatization. The renowned economist, Jose Pinera, developed the world's first, major, privatized social security system when he was labor minister in Chile. The Chilean program has been in effect for 29 years, is fully phased in, and has provided the workers with a rate of return exceeding 10 percent per year compounded, resulting in many Chileans having a very large investment portfolio for retirement. The Pinera system has been so successful that more than 30 countries have now adopted it. We now know, in both theory and practice, that privatized social security provides a much better retirement for workers with far more flexibility. Mr. Pinera, working with the Cato Institute, has developed a plan for the U.S. that does not require any tax increases and would fully protect those nearing retirement, while giving younger workers the probability of having a much higher return on their retirement contributions, along with great flexibility as to when they retire.

Likewise, the existing problems with Medicare, Medicaid, etc. can be solved by largely moving to privatized and market-based systems. Greatly expanded Health Savings Accounts coupled with catastrophic insurance will solve the problem for most people, with government programs reserved for the relatively few who are unable to work or earn enough. Again, several major U.S. think tanks have developed detailed programs of how to do this without tax increases. (Note: health-care spending in the U.S. is a much larger percentage of GDP than in any other country. Yet, because of the poor design of the health-care systems - primarily due to disincentives created by government - the cost-effectiveness is far below what it could be.)



The tax increase advocates also argue we must increase taxes to reduce the deficit. The problem again is that tax increases slow economic growth, resulting in diminished growth in the tax base while, at the same time, increasing the pressure for more government spending. If Congress were to act responsibly (yes, an oxymoron), it would hold down the growth of spending, as was done in the late 1980s and late 1990s, and eliminate those government programs that do not meet a reasonable cost-benefit test. As has been shown before, such actions would quickly eliminate the deficit.

The good news is that the actual numbers show that it is possible to responsibly develop a program to eliminate the income tax and replace it with a relatively low-rate (less than 10 percent) sales tax. Once Social Security and Medicare privatizations are fully phased in, there would no longer be a need for the federal government to collect taxes to support these programs, which now account for close to half of the budget. Up until now, the sales tax proponents, such as former Arkansas Gov. Mike Huckabee, have not been able to gain traction because the sales tax rate to replace all of the present income and payroll taxes — at least 23 percent — is viewed as too high. But if most of the entitlements were privatized and counterproductive government subsidies and programs eliminated, a sales tax could easily provide all of the revenue needed for the necessary functions of government.

This program would be real constructive "change." What is needed is a candidate who is bold enough and courageous enough to take on the special interests and run with it.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.

http://www.washingtontimes.com/news/2008/aug/07/no-tax-increase-needed/