The Washington Times
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Only High-Tax Adherents Are Surprised

By Richard W. Rahn
Published July 28, 2010

Evidence is clear that big-government policies mean little growth

Do you think more government spending helps economic growth or harms it? On Friday, the White House again increased its federal budget deficit forecast and reduced its economic growth forecast for 2011. It is abundantly clear that the economic program the administration and Democratic Congress instituted 18 months ago - primarily massive increases in government spending - is not working as advertised. Surprise, surprise.

There are some - but not all - Keynesian economists and assorted left-wing ideologues who argue that we need more government spending. Then there are the Chicago- and Austrian- school economists who argue that we need less government spending. Those who advocate more spending claim there is a "multiplier" on government spending. That is, for each dollar government spends, there is more than a dollar increase in national output. If this is true, why should there be almost any limit on government spending? Why not triple government spending to make everyone richer?

Many countries have tried to spend themselves into prosperity - like Greece. The Keynesian multiplier seems to be one of those ideas that always works better in theory than in practice. Both Lyndon B. Johnson, a Democrat, and Richard M. Nixon, a Republican, tried the increased-government-spending option. And what did it get us but inflation and slow growth?

The Chicago- and Austrian-school economists argue that government spending is the curse rather than the cure. They provide studies that show that for each additional dollar spent by government, gross domestic product (GDP) actually is reduced as much as $3.40. It is true that once Ronald Reagan was able to begin the reduction of government spending as a percentage of GDP by the mid-1980s through the second Clinton administration (with a Republican Congress), the U.S. economy grew far faster than the long-term trend. It also is true - as demonstrated by considerable global empirical research - that there is a strong negative correlation between the size of government and economic growth once government spending reaches approximately 25 percent of GDP.

Many politicians lean toward accepting the big-government theory rather than the small-government model because more spending increases their power. They also like to hear that tax increases cause little economic damage. This probably is why they have tolerated

the notoriously inaccurate tax-revenue forecasts from their own congressional Joint Committee on Taxation (JCT). For decades, the JCT has had a systematic bias in overstating the revenues to be gained from tax-rate increases and overstating the revenue losses from tax-rate reductions. In essence, it has been the tool, either wittingly or unwittingly, of those who want larger government.

Stephen J. Entin, a former senior economist in the Treasury Department and now president of the Institute for Research on the Economics of Taxation, noted that in cases of tax-rate changes, those in the JCT assume "that GNP, employment, and incomes do not move. In the case of a capital gains tax rate change, they ignore that a higher tax rate would require a potential investment to have a higher pre-tax return for it to be worth doing, resulting in less capital formation, lower productivity, wages, and national output."

The JCT, by giving Congress bad numbers, is partially responsible for the highly destructive tax code we have. The result is that the U.S. GDP (according to many good tax economists) is 10 percent to 15 percent lower than it would be otherwise. Lower GDP not only means that more people have lower standards of living, but that more people die unnecessarily. Wealthier countries can provide better medical care and engage in more medical research.

Bad numbers lead to bad policy. The Obama administration argues that the many tax increases in the just-passed health care and financial regulation bills, as well as other tax increases slated to go into effect at the beginning of next year, will do little economic damage. I am willing to bet that if the administration allows these tax increases to go into effect, it will again be surprised by bigger deficit numbers and slower economic-growth numbers than it now forecasts.

In the June issue of the American Economic Review, Christina and David Romer (she is chairman of President Obama's Council of Economic Advisers) published a study they recently completed which concludes: "Our results indicate that tax changes have very large effects on output. Our baseline specification implies that an exogenous tax increase of one percent of GDP lowers real GDP by almost three percent. ... In addition, we find ... that investment falls sharply in response to exogenous tax increases." These results are similar to those reported by many other serious economists.

Forecasts from those who have an ideological bias in favor of big government - rather than from those who look at the empirical evidence - will cause their adherents to be surprised again and again.

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