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We don't Need a Tax Increase

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President's plan to hit up the rich would mean slower growth for everyone

President Obama and many other Democrats - and even a few Republicans - claim that the huge deficits the United States is experiencing result from the George W. Bush-era tax rate cuts. Is this true, and must we have a tax rate increase? The short answer is no.

First, a little budget history. In the 40 years prior to the 2007-09 Great Recession, tax revenues as percentage of gross domestic product were remarkably constant, never varying more than 2.3 percent above or below 18.3 percent of GDP. This fact is all the more remarkable given that the maximum individual income tax rate during this period varied from a low of 28 percent to a high of 70 percent. Federal government expenditures also were remarkably constant during this same 40-year period, never lower than 18.2 percent or higher than 23.5 percent of GDP, and deficits averaged about 2.5 percent. The debt-to-GDP ratio rose and fell during this period and was a manageable 36 percent as late as 2007. Yet, in the past four years, the debt-to-GDP ratio has almost doubled.

The accompanying table details some basic facts. In 1986 (under President Reagan), there was a tax reform, which by 1988 had a maximum individual tax rate of only 28 percent. The maximum rate was raised to 39.6 percent under President Clinton in 1993 and reduced to 35 percent under President Bush in 2003. Although tax rates went down in the 1980s, up in the 1990s and down again in the first decade of this century, each decade had some normal years (neither bust nor boom) that produced the 40-year average tax revenue of 18.3 percent of GDP. These "average" periods also had close to average deficits, but in each period, the deficit was less than the rate of economic growth, so the debt-to-GDP ratio fell.

What all these numbers show us is that the current tax regime, in normal times (with normal economic growth rates - approximately 3 percent), will produce enough tax revenue to cover the historical rate of spending with only a small and manageable deficit. The current long-term deficit and GDP-to-debt problem was caused by a big jump in federal "stimulus" spending over the past three years - not the Bush tax cuts. This has caused federal spending to rise from its historic 20 percent to up to 25 percent of GDP.

In essence, Mr. Obama and the others who are advocating tax increases - either enthusiastically or reluctantly - are saying that they want or expect the federal government to be bigger as a share of the national economy than it has been in the past and this bigger government should be financed through higher taxes. Wanting a bigger government is a value judgment. Saying a bigger government is a necessary evil because of the rising cost of "entitlements" misses the point that under present law and practice, the costs of the entitlements never stop rising as a percentage of GDP until they consume the whole pie, which obviously will not happen.

NO NEW TAXES

Tax Revenues and Tax Rates in "Normal Years"

	1988-1989	1994-1996	2006-2007
Av. Tax Revenue as a % of GDP	18.3	18.4	18.4
Av. Outlays as a % of GDP	21.2	20.6	19.9
Deficit as a % of GDP	3.0	2.2	1.6
Max. Income Tax Rate (%)	28.0	39.6	35.0
Av. Rate of Economic Growth (%)	3.9	3.4	2.3

Sources: Congressional Budget Office, Bureau of Economic Analysis

The real question is what percentage of our incomes do we divert to pay for entitlements and how best should this be financed? House Budget Committee Chairman Paul Ryan has set forth a plan to finance entitlement spending without increasing taxes, and he has challenged others to come up with alternative plans that can be debated.

Medicare is the single biggest problem in that it is and will continue to be a rapidly rising share of GDP under current policy. But if it is decided not to allow Medicare to increase as a share of GDP, it could be accomplished immediately by some combination of increasing co-payments, deductibles, means testing, etc. None of the entitlements is "uncontrollable" as is often alleged. The only thing lacking is the political will to make hard decisions.

Mr. Obama has made it clear in his statements and in his proposed budgets that he wants a bigger government. Yet he has proposed the most inefficient and destructive way of trying to finance this bigger government. His proposals involve increasing taxes on the rich (i.e., those earning more than $200,000 a year, which is a rather loose definition of rich). If he had even a most basic understanding of economics and public finance, he would know that there is insufficient income among this group to pay for the programs he wants. The chances of getting them to pay much more is close to zero because increases in some tax rates do not necessarily result in more tax revenue. The United States already has one of the most progressive income tax systems in the world. Thus, the only way for the government to obtain significantly more revenue is to increase taxes greatly on the lower- and middle-income groups who now pay very little. But increasing tax rates on the upper-, middle- or lower-income groups will have the nasty side effects of further slowing economic growth and increasing unemployment.

One of the first things that economic students learn is if you tax something, you get less of it, and if you subsidize something, you get more of it. Mr. Obama, in his radio address Saturday, said his solution to high gasoline prices is to increase taxes on oil companies, which produce the gasoline. Reagan understood the importance of economic growth and was the last president to have a degree in economics - and it showed. Mr. Obama wants wealth redistribution and appears never to have read a basic economics book - and it shows.

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