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Tax Increase Con Men

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'Revenue' boost plan depends on assuming away growth

Would you prefer to have 25 percent of $200 that you can see or 20 percent of $300 that you cannot see immediately? Many battles, including the current ones in Washington, are fought between those who can see the consequences of actions several steps in the future, like good chess players, and those who cannot.

Former Vice Chairman of the Federal Reserve Alan Blinder wrote an article in the Wall Street Journal this past week attacking Republicans who have said that more government spending will kill jobs. In the same vein, my old friend Bruce Bartlett, a Treasury official in the George H.W. Bush administration, wrote an article attacking former Minnesota Gov. Tim Pawlenty and other Republicans for claiming the Reagan tax cuts paid for themselves. (Note: Mr. Bartlett used to be a supply-side advocate, but in the past few years, he has become an almost full-time Republican basher and, not surprisingly, now writes for the New York Times.) Mr. Blinder, Mr. Bartlett and others of their stripe no longer seem to be able to see beyond the first-order effects of an economic policy.

The reason these old questions are still causing arguments is because the answers give a guide to which future economic policies are likely to be effective and which are not. Did President Reagan's tax cuts pay for themselves? Mr. Bartlett states: "The fact is that the only metric that really matters is revenues as a share of the gross domestic product. By this measure, total federal revenues fell from 19.6 percent of GDP in 1981 to 18.4 percent of GDP in 1989."

The real fact is that Mr. Bartlett has it dead wrong.

It is not only the size of the revenue share of GDP that matters, but, more important, the size of the pie (GDP in this case). Real GDP grew by more than 34 percent from 1982, when Reagan's tax-cut policies started to take effect, through

1989. (A mixture of both tax increases and tax-rate cuts over the Reagan years resulted in a massive drop of the top marginal rate from 70 to 28 percent.) This was an average annual real growth rate of approximately 4.5 percent, much higher than either opponents or proponents of the Reagan policies had forecast. When Mr. Bartlett and others argue that the Reagan-era tax cuts did not pay for themselves, even though real inflation-adjusted revenues rose, they are, in effect, saying that some other, unspecified policies would have brought in more revenue. From the beginning of 1979, there was no real economic growth under President Carter's tax-rate regime. The economy did not start steady growth again until the fourth quarter of 1982, when the Reagan tax cuts were being phased in.

Why should one believe the economy would have grown as fast under the Carter tax regime with a 70 percent top rate? If you assume, as I and many others do, that a continuation of the Carter policies would have produced an economic growth rate of no more than 2.8 percent and probably lower (which is the 30-year average economic growth rate and also is almost identical to the growth rate of the two years of the so-called Obama "recovery") then the Reagan tax cuts did pay for themselves in seven years. Again, the size of the pie counts, and a much larger pie results when it compounds at 4.5 percent rather than 2.8 percent.

Higher economic growth also results in a bigger permanent stock of capital, which can have wealth-enhancing effects many years into the future. Some Roman aqueducts built 2,000 years ago are still being used. Lower tax rates, particularly on capital, make it easier for entrepreneurs to raise capital for new ventures, some of which can have enormous productivity and other beneficial effects on society. Those beneficial innovations that were squashed by high taxes or destructive regulation are never seen. Without specifying the alternative policy regime and knowing the precise effects of it, as contrasted with the Reagan policies, Mr. Bartlett and the others cannot "prove" that the Reagan tax cuts did not pay for themselves in seven years.

Likewise, Mr. Blinder can only see the jobs that are created by direct government spending but not the jobs that are destroyed by it. When funds are spent on a less productive government job, there is diversion of productive resources along with the dead-weight loss of the taxes or borrowing needed to pay for it. Many studies show that most governments are larger than optimal and thus more government jobs lead to fewer total jobs. A study published in the British Economic Policy Journal concluded: "Empirical evidence from a sample of [Organization for Economic Co-operation and Development, OECD] countries in the 1960-2000 period suggests that, on average, creation of 100 public jobs may have eliminated 150 private sector jobs."

Finally, Mr. Blinder ignores the important fact that as government spending increases as a share of GDP, the percentage of adults employed in the civilian labor force decreases and vice versa.

There is little doubt that if much of the counterproductive government spending, regulation and taxation were removed, the U.S. economy could grow for many years at a 5 percent or higher rate. If higher taxes and more government spending were the keys to prosperity, it would be easy to see. The question is: What is unseen?

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