The Washington Times November 29, 2011

Tooth-Fairy Tax Policy

by Richard W. Rahn

High-tax advocates are either credulous or envious of wealthye

President Obama said last week that we need to increase tax rates on the wealthiest Americans to obtain an extra $100 billion in tax revenue, and he blamed the failure of the supercommittee on the unwillingness of the Republicans to increase tax rates. Do you agree?

If you think increasing tax rates on the “rich” is the correct economic policy, then you also need to believe the following:

- That most government spending is cost-effective, and cutting 3 percent of it (approximately $110 billion out of the current $3.7 trillion budget) would be more damaging than increasing taxes by $100 billion on many of those who create jobs. When the extraction cost of taxing and borrowing is properly considered in doing cost-benefit analysis of government spending, many, if not a majority, of government spending programs fail the test. For instance, the Department of Education alone spends more than $100 billion per year, but there has been almost no improvement in test scores in the more than three decades the department has been in existence.

- That getting rid of the huge amount of waste and fraud in government programs, whether it is Medicare, Medicaid or defense, would do more damage to the economy than increasing tax rates on many highly productive people. Every year, many studies by government agencies and nongovernment groups show billions of dollars of waste and fraud within government, yet few government employees are fired or sent to jail, and little is done to correct the problems.

- That it is not appropriate for many of the programs the federal government now operates to be done at the state and local level for reasons of cost-effectiveness and for responsiveness to the people. The Constitution gives very few powers to the federal government but great power to the states, yet Washington spends hundreds of billions of dollars on programs for which it has no constitutional authority.

- That being “rich” or “wealthy” is the same thing as having a high income. Many wealthy people generate much of their income from nontaxable sources, such as state and local bonds, and would not be affected by the higher tax rates being proposed. But some people with high incomes, such as young doctors, may have negative net worth because of the debt they incurred to obtain their education, and yet they would be hit by these proposed taxes.

- That it is somehow “fair” to tax at a higher rate someone who works twice as hard as others who choose to take it easy. Many people who have high incomes work very hard and long hours, and they went through many years of schooling that their lower-income colleagues did not. Also, many high-income people produce new goods, services and jobs, which greatly benefit their fellow citizens, Steve Jobs being Exhibit No. 1. To tax the most productive and creative citizens at higher rates is a suicidal notion of fairness.

- That tax rates are the same thing as tax revenues. Most high-income earners are also intelligent. If they are taxed more, they are going to find ways to legally or illegally avoid much of the tax, including moving to lower-tax states or countries, or ceasing to earn as much taxable income. This is why the static revenue estimates made by the Congressional Budget Office and many of the Keynesian models always overestimate the amount of revenue that can be obtained by tax increases on high-income people. There are many studies showing that the long-run revenue-maximizing rate for high-income people is less than 30 percent, yet the Obama tax increase proposals would push the marginal tax rates, particularly on those living in high-tax places such as California and New York City, to the 50 percent range, which is self-defeating.

- That liberty, specifically the liberty to enjoy the fruits of one’s own labor, is not particularly important and, thus, there is no reason not to force some people to be tax slaves for the benefits of others. The basic function of government is to ensure liberty and protect person and property. If the government takes half of your product through coercion to give to others, then you have also lost much of your liberty.

The fact is that in 2006 and 2007, when the United States was near full employment, tax revenues, with the “Bush tax cuts” in place, were more than 18 percent of gross domestic product, which was the average for the past 40 years. A decade ago, federal expenditures were also slightly more than 18 percent of GDP, as contrasted with the current 23 percent. The budget would be balanced if the government were no bigger (as a percent of GDP) than it was at the end of the Clinton administration and tax rates no higher than they were at the end of the second Bush administration. Finally, the top 1 percent of taxpayers paid 37 percent of the income tax, even though they only had 17 percent of the income. Isn’t that more than fair?

Some believe in the tooth fairy, and some believe that tax increases on the rich are the solution rather than part of the problem. In each case, believers have lost touch with reality. Politicians and media members who advocate higher taxes may believe in the tooth fairy or know the truth, but they advocate higher tax rates as a way of gaining power or out of envy.

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/2011/nov/28/tooth-fairy-tax-policy/