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THE REGRET MATRIX
Real spending as a percentage of GDP

Vote	Cut Spending	Do Not Cut Spending
Raise taxes	2% growth	Recession
No tax increase	4% growth	2% growth

* At 2 percent growth, the deficit problem continues to get worse, guaranteeing a financial crisis and rising unemployment. An average of 4 percent growth (as occurred in the last 7 years of the Reagan and Clinton administrations) is sufficient to reduce the deficit problem and will result in a doubling of GDP in a little over 17 years.

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Vote Higher Taxes Now, Regret It Later

by Richard W. Rahn

GOP should think before erring

If you are a member of Congress and you wish to be re-elected, do you increase your chances of winning by voting for or against raising taxes on the "rich"? In decision theory, "regret" is defined as the difference between the actual payoff and the payoff that would have been obtained if a different course of action had been taken. In the upcoming votes on the "fiscal cliff," members of Congress will be making decisions about what is best for the economy and the nation and what is best if their highest goal is re-election.

For a member of Congress to make the decision, it is helpful to know some economic history and theory. Democrats keep saying they want to go back to the tax rates of the Clinton administration (maximum marginal personal income tax rate of 39.6 percent), during which time there was high growth (4.4 percent in 1998), but federal government spending was just 19.1 percent of gross domestic product (GDP), as contrasted with 24.6 percent at the moment. Looking at U.S. economic history, there is no evidence that the economy can produce high growth and low unemployment with Clinton-era tax rates and current levels of spending and regulatory impediments. Neither the president nor other leading Democrats are talking about rolling back spending and regulatory burdens to Clinton-era levels. Forget all of the talk about a trillion here in more tax revenue or a trillion there in spending "cuts." What is relevant is both the size and type of spending as a percentage of GDP, and tax rates on labor, saving and investment.

Higher marginal tax rates on labor, capital and regulations that do not meet a solid cost-benefit test slow economic growth. Most non-Keynesian and nonsocialist economists know that higher government spending as a percentage of GDP slows economic growth. Government is not as efficient as the private sector in allocating resources, and collecting taxes and borrowing adds dead weight to the economy. The overwhelming empirical evidence is that as government spending grows as a share of GDP, economic growth tends to slow in all countries where the public sector is above 25 percent of GDP (the U.S. total for federal, state and local government spending is now about 38 percent of GDP).

Given this information, a member of Congress should expect that voting for higher taxes and, particularly, increasing marginal tax rates will result in a slower economy, and that reducing government spending as a percentage of GDP will increase economic growth. Warren Buffett, a well-known Democrat and Obama adviser, correctly said last week that if tax revenues equal 18.5 percent of GDP (where they were in 2007 under the George W. Bush tax rates) and spending is reduced to 21 percent of GDP, the financial crisis should fade.

Now, back to the regret matrix. If Congress as a whole votes not to increase taxes and votes to reduce spending now as a percentage of GDP, economic growth will be vigorous. If Congress votes to increase taxes and either not cut or increase current real spending, a recession is almost assured. If Congress votes to increase taxes and cut real spending, or votes not to increase taxes but to increase real spending, economic stagnation or something close to it is likely to continue.

The problem is that the president and many Democrats do not seem to believe that increasing any taxes, particularly on job creators, and increasing government spending will damage the economy. They also seem to believe that even if they are wrong and the economy tanks, they can blame it on the Republicans.

The bottom line is that if you are a Republican, you certainly are more likely to regret voting for a tax increase than voting against it, because, when you try to get re-elected, you will be viewed by many of your constituents as having lied if you signed a pledge to not increase taxes. If the economy is in poor shape, the mainstream media will give you no credit, despite your vote to go along with the president. Finally, Republicans should be asking one key question: If the top 1 percent of taxpayers are now paying more of the income taxes than they were under Mr. Clinton (38 percent now, 35 percent then), how can Democrats consider that unfair?

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