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Obama's Money Misunderstanding

by Richard W. Rahn

RAISING REVENUE BY RAISING TAXES DOESN'T WORK

In times past, political leaders would lay out their domestic and foreign policies in clear, coherent terms. President Obama talks about getting our fiscal house in order but fails to propose any meaningful spending cuts. His proposals to increase the tax rate on the top 2 percent of taxpayers would fund the government for eight days, assuming no behavioral change by those whose feathers are being plucked. In the real world, we know people will spend a great deal of time and effort to avoid paying high marginal tax rates. In high tax states such as California and New York, high earners will be expected to pay marginal tax rates well over 50 percent.

We only need to look at what happened in Britain after the former Labor government of Gordon Brown increased the top rate to 50 percent. In the tax year 2009-10, more than 16,000 people declared an annual income of more than 1 million British pounds. This number fell to 6,000 after the tax rate was increased, partially because two-thirds of those who earned 1 million pounds or more left Britain to avoid the top rate. George Osborne, the current finance minister, just announced that the Conservative government will reduce the rate in order to obtain more revenue.

Mr. Obama seems to have forgotten that Christina Romer, his first chairman of the Council of Economic Advisers, and her husband, economist Paul Romer, had done studies showing that income tax rates above 33 percent bring in no extra revenue because people adjust their behavior to avoid the high taxes. Other credible researchers have shown the revenue-maximizing rate to be even lower -- in the 20 percent to 30 percent range. Simulations based on historical experience indicate that Mr. Obama's tax-increase proposals, particularly on capital gains and dividends, are likely to be big revenue losers, not revenue gainers.

The president says we must increase tax rates because we need more tax revenue. Yet he proposes the most economically destructive way to go about it -- increasing marginal tax rates primarily on capital and job creators. The president also tells us that tax rates must be increased because of "fairness," but he refuses to define "fair." He has said even if a higher tax rate on capital gains does not increase revenue, it should be done in the name of "fairness." Again, this is incoherent. How is it fair to tax some people -- the job creators -- more than 50 percent of their income and not tax others at all?

Many Republicans also have been incoherent and inconsistent. Republicans are fond of telling us that their party is the party of smaller government and lower taxes, but many of them act far differently from their rhetoric. The brilliant political thinker and activist Grover Norquist has created a "brand" for the Republicans -- the low-tax party -- which has been shaped by the no-tax-increase pledge he developed for candidates. Mr. Norquist understood that picking the battlefield (as the Chinese general Sun Tzu taught 2,500 years ago, or Henry V demonstrated at the Battle of Agincourt in 1415) could be the key to political success. Mr. Norquist's battlefield has been "no tax increases."

If Republicans truly believe government is too big and should be downsized, it is incoherent and inconsistent to say we are open to "new revenues." As the economy grows, tax revenues grow, but that kind of revenue growth is very different from higher tax rates or fewer deductions. If Republicans agree to more tax revenues as a share of gross domestic product (GDP), what they really are saying is we agree that government will be, or should be, larger. Once they abandon their own battlefield of cutting government spending to match revenues, they are fighting on the Democrats' battlefield of much larger government and more taxes to pay for it. Agreeing to deploy on the Democrats' battlefield will be demoralizing for the Republican base and will mean the Republicans are signing on to lower growth. That's not smart.

Finally, there is the Federal Reserve, which is engaged in a totally incoherent monetary policy. The Fed not only is continuing to buy tens of billions of mortgage-backed securities each month but has announced it is going to step up its purchases of U.S. government bonds. In essence, we have one branch of government funding much of the government by printing money, and history shows us this is not likely to end happily. The reason all of the money-printing has not shown up in inflation figures yet is that much of the new money is being bottled up in banks because of new regulatory measures and other changes. The result is that large and established companies can get all the credit they want but smaller and entrepreneurial companies are being starved for credit. Savers also are funding the runaway spending by not being able to make enough on their savings to cover taxes and inflation. The Fed, in effect, is applying a non-legislated tax on savers. The Fed argues it can continue to make these bond purchases without causing inflation. If that is so, why don't we get rid of all taxes and have the Fed print money to cover all government spending rather than just 30 percent of it?

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