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RAHN: Sidetracking the gravy train

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If you are an elected official, and you have to make a choice between raising taxes on your constituents or cutting the number of government employees and their salaries, what would you do? For most of the last few decades, in most places, the politicians would just raise taxes. Now that is changing, and here is why.

In recent weeks, what used to be a rare event is becoming commonplace, and that is public employees losing their jobs or having their wages and benefits cut. Government employees are rioting in Greece (as if that does any good when the cupboard is bare) because many of them are losing their jobs. Greece, Spain, Portugal and even the Cayman Islands have announced they will be cutting public-employee wages and benefits. Many state and local governments in the United States are doing the same thing.

Most public employees have been pampered, rarely getting fired, with wage and benefit packages steadily rising, so now many are paid far more than their private sector equivalents. A recent study, using data from the Bureau of Labor Statistics, showed that average U.S. federal salaries exceed average private-sector pay in 83 percent of comparable occupations. In addition, according to the Bureau of Economic Analysis, the value of health, pension and other benefits averaged $40,785 per federal employee in 2008 vs. $9,882 per private-sector employee. A recent study done by Chris Edwards, director of tax policy studies at the Cato Institute, showed that pay in state and local governments "averaged $39.66 per hour in 2009, which was 45 percent higher than the private sector average. The public sector advantage was 34 percent in wages and 70 percent in benefits."

The overstaffing and sloppy work performance in the public sector is the subject of countless jokes, which would not be funny if they did not contain a strong element of truth. Even civil servants joke about the 80-20 rule - where 20 percent of the employees do 80 percent of the work and vice versa. The late-night comedians can always get a laugh when describing the indifferent attitude of department of motor vehicle employees. Professors in many public

colleges now only teach one or two classes per semester. When I was a young professor, we taught three or four courses (which was not particularly taxing). No wonder college tuitions have been rising far faster than inflation. The private-sector has been surging in productivity growth while much of the public sector has negative productivity growth.

As most of the world's governments head toward a Greek-style meltdown, taxpayers increasingly realize that if government spending is growing faster than the economy, there is no way that tax increases can solve the problem - and most countries have about reached the limit of how much more tax revenue they are going to be able to coerce and extort from their citizens.

There is a definite limit to how much tax revenue the government is able to extract. The accompanying chart shows that even though income tax rates have gone up and down, tax revenues from the income tax (as percent of gross domestic product, GDP) have been remarkably stable, varying much more with the rate of economic growth than with the tax rate. For instance, over the last 70 years in the United States, maximum federal income tax rates have ranged from a low of 28 percent (1988-1990) to a high of 92 percent during and just after World War II, yet tax revenues have never exceeded 20 percent of GDP. In 1989, when the maximum individual tax rate was 28 percent, individual income tax revenue was 8.3 percent, and total revenue was 18.4 percent of GDP, both slightly above average for the period from 1970 through 2008, even though the maximum rate was 70 percent during the years 1970-1982. The fact is that beyond some point, people will find legal or illegal ways to avoid paying taxes regardless of the rate - and will engage in political tax revolts.

Unless basic changes are made in the medical and retirement "entitlement" programs, they will continue to grow both as portion of federal spending and GDP. As explained above, it is most unlikely that tax revenues will grow much as a percentage of GDP, and hence the deficits will get larger while all of the non-entitlement programs of government will be increasingly squeezed.

Governments have three ways out of the dilemma. They can debase the currency and cause inflation to reduce the debt. This will cause the real value of employee compensation to fall, including that of government workers (note: the government cannot fully index wages to compensate for inflation, because it will only increase government spending, causing even more printing of money and higher inflation). The government can default (explicitly or by extending maturities and reducing interest rates), which will restrict future borrowings, making it necessary to lay off workers. Or the government can be responsible and start to reduce all spending, including entitlements and government employee salaries and benefits.

Whatever course any government takes means that the golden days for most government employees are - or soon will be - over.

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