The Washington Times

RAHN: A world without income taxes

It's possible with more modest Fed monetary policy

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The Washington Times
Monday, October 8, 2012

Why should the federal government bother to impose taxes when it can use the Federal Reserve to "print" all the money it needs to pay its bills? Last year, the Fed bought 77 percent of all of the government's new debt, which is the equivalent of printing money. The government borrowed almost 40 cents for each dollar it spent, with the Fed printing 30 cents of each dollar spent through its bond purchases (creating new money) — an amount equal to about 7 percent of gross domestic product.

What would happen if the Fed printed enough money each year to cover the cost of the federal income tax of approximately $1.4 trillion? Most people who have taken a course in economics know that it ultimately would result in a high rate of inflation. Inflation occurs when the growth in the money supply is greater than the increase in real goods and services. Changes in the number of times the same dollar is spent in a year (which economists call the velocity of money) also can cause apparent inflation and deflation.

Both the Fed and the European Central Bank have, in essence, announced they are going to create whatever quantity of money they think will be required to increase employment, with the claim that we do not need to worry about inflation. Many monetary economists disagree, for good reasons. For example, former International Monetary Fund economist Warren Coats, who has a major role in creating many central banks and currency boards around the world, wrote last month: "The Federal Reserve's latest round of quantitative easing (QE3) is not likely to help the U.S. economy's recovery, but increases the risks of new asset bubbles and inflation."

One can envision a world where there is both apparent price stability and no income taxes. The following is to encourage you to think about possible alternatives to the existing economic order.

Prices of most things in real terms tend to fall over time — that is, products get better and cheaper. Computers and cellphones are obvious examples, but it is also true with automobiles and food. Almost all foods get less expensive in real terms over the decades, and their quality improves despite myths to the contrary. Automobile prices rise less than the rate of inflation in most years, yet each year, the product gets better and safer. Even gasoline is less expensive in real terms than it was in the 1920s. Back then, there were scary stories of how the world was about to run out of oil in just a few years. Now, in most years, recoverable reserves grow at a faster rate than production. Rest assured that nobody alive today will see a world that has “run out of oil.”

When the world was on the gold standard in the latter half of the 1800s and early 1900s, prices did tend to fall slowly (an average of 1.7 percent year by year), which is known as deflation — because increases in the production of gold lagged real economic growth during that period. The small amount of deflation was both manageable and useful since each year, people were able to buy a little bit more with each dollar.

In recent decades, productivity growth has been increasing at an average rate of about 2.5 percent per year. U.S. population growth has averaged about 1 percent per year. Thus, if the Fed increased the money supply by roughly 3.5 percent per year, the economy could have close to perpetual price stability, with the productivity gains being used to fund government spending.

Currently, the federal government is spending about 23 percent of GDP, and so you are probably thinking it is impossible to have a world where the federal government only spends 3.5 percent of GDP. However, up until World War I (before the income tax), the federal government only spent about 2.5 percent of GDP. In the 1920s, it was spending less than 4.5 percent of GDP.

The fact is the United States could have a radically smaller government — which would not require a federal income tax or some big replacement tax — without taking away the social safety net or gutting defense. Existing entitlement programs, including Social Security and Medicare, could be replaced by true, fully funded insurance programs following the Chilean model as roughly 30 other countries have done (the payroll tax would still be required to support these programs). Farm subsidies and other forms of corporate welfare would have to be abolished, and the United States would need to give up its role as a global policeman and concentrate on protecting the homeland.

The U.S. Constitution provides the guide for the right size of the federal government. An adequate government could be funded without taxing incomes by relying on user fees, reasonable excise taxes, payroll taxes for the safety net, and noninflationary, modest monetary expansion. The Fed’s current monetary policy is going to cause many problems because of its excess.

A smaller government, without income taxes, would mean much higher economic growth and job creation — and thus would allow a perpetually small deficit, with the profits from the Fed being used to fund part of the government. A government that grows at a slower rate than the private economy and with an annual deficit less than the rate of GDP, is a prescription for long-run economic prosperity.

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