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Misplaced interests

How politicians calling for higher taxes are helping themselves, not you

By: Richard Rahn – May 7, 2013

There is considerable evidence that drinking one glass of red wine per day for most middle-aged men has more health benefits than costs. There is also considerable evidence that drinking three or more glasses of wine per day causes more health problems than benefits. Even so, the owner of your favorite winery might encourage you to drink at least three glasses a day, perhaps with the following argument: "If you and my other customers drink three times as much, it will enable me to hire more workers, thus increasing employment." What the winery owner conveniently ignores is the damage the additional drinking causes to both your health and your pocketbook, and the fact that if you spend less on wine, you probably will be spending more on other goods and services, thus increasing employment in those areas.

Many of the economic arguments I hear from the political class — including members of Congress and President Obama — are equally fallacious. It is tiresome to hear the president (as he did again last week during his news conference) and others say, time and time again that if we just tax and spend a bit more, our problems will diminish.

Rational people understand that some government is necessary, but too much government is destructive both to one's pocketbook and one's liberties. Those who advocate more government spending are much like the owner of the winery who confuses one's self-interest with the public interest. The fact is that virtually all studies that have examined the optimum size of government have concluded that government spending that is more than 30 percent of gross domestic product (GDP) is counterproductive. Many studies have shown the optimum size to be well under 25 percent. Federal, state and local government spending in the United States now is about 40 percent. By comparison, in 1990, it was 33 percent; in 1960, it was 27 percent; and in 1913, it was 7.5 percent of GDP. By optimum size, economists mean that the costs of government activities in general (which, of course, vary from activity to activity) do not exceed the benefits.

The costs of government also include the negative effects of taxing and borrowing, which discourage work, saving and investment. Steve Entin, a former Treasury official and now a senior fellow at the nonpartisan Tax Foundation, has produced solid studies showing that the short-term revenue-maximizing rate for the capital-gains tax is between 9 percent and 10 percent. Mr. Entin's studies also show that the revenue-maximizing rate for the corporate income tax is 14 percent, in contrast to the current U.S. rate of 35 percent — the highest in the world — making the United States noncompetitive.

Economics Nobel laureate James Mirrlees has shown that the long-run revenue-maximizing individual tax rate is approximately 20 percent. (Earlier on, Sir James was an adviser to British Labor Party officials and had supported high marginal tax rates before he had completed his research.) In addition, there is considerable evidence that even in shorter-run periods, maximum revenue is achieved at rates of less than 35 percent. For instance, the proportion of the tax paid by top earners greatly increased when the maximum federal tax rate was reduced to 35 percent during the Bush administration. The revenue-maximizing tax rate for any tax is normally above the rate that maximizes job and wealth production, and so society may benefit from even lower tax rates. The reason these numbers are not close to 100 percent is that it is well known that people will spend considerable effort to find legal or even illegal means to avoid paying taxes, including working, saving and investing less, leading to lower economic output and a smaller tax base, which means less tax revenue. This is the "Laffer curve" effect.

No serious person who really understands the negative economic impact of ever-bigger government, higher tax rates and more borrowing could support such proposals. Certainly, I am aware that when I write "no serious person" could support these things, I am referring to more than half of the Washington political class, including the media. A serious person could support more spending on a specific government program that might provide more benefits than costs, provided that person was also for reducing equal or larger government programs that do not meet the cost-benefit test. A serious person might also support a type of tax increase (an excise tax) that would do less damage than the current high income-tax rates, if the tax increase was made totally conditional on an income-tax reduction first.

The next time you hear a politician say, "We need to have more government spending," immediately picture that person as the one who is standing behind the bar, encouraging you to have another drink. Does the bartender have your best interests at heart, or is he squeezing more money out of you?