

Note to Fareed Zakaria: Tax Rates Affect Behavior

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By Michael Pentto

Fareed Zakaria is not a fiscal conservative by any means. His left leaning bias towards relying on tax increases to fix our deficits, instead of spending cuts, makes that abundantly clear. On his "What in the World" segment on Sunday's GPS program, Mr. Zakaria excoriated former Treasury Secretary Hank Paulson and former Chairman of the Federal Reserve Alan Greenspan for not asserting that they want taxes to increase in order to balance the budget--Zakaria's comment was prompted from an interview those gentlemen conducted the prior week with David Gregory from Meet the Press.

It is true that I've spilled much ink over the mistakes Paulson and Greenspan have made in the past. The monetary policy stance of Alan Greenspan in the latter part of his tenure was irresponsible, to put in kindly and Henry Paulson's belief that we should take on more debt to bail out our over leveraged condition--even for a short period of time--was absurd. But to the credit of both these men, they steadfastly believe that the nation's most salient issue in the longer term will be the discrepancy between expenditures and receipts.

Even Fareed assents to the notion that our long term structural debt and deficits are the most pressing concern that faces America. But he also said, "The Bush tax cuts are the single largest part of the black hole that is the Federal budget deficit." How is it that he can know that for sure? After all, tax cuts create jobs by incentivizing innovation. They empower individuals and businesses by allowing them to decide what they want to produce and what they want to consume, rather than some person in Washington. As a result, the economy and markets function in a more balanced and efficient manner. The outcome is you end up generating higher growth rates in GDP and actually increase revenue for the Treasury. The biggest part of the "black hole" in deficits was not the Bush tax cuts but it was instead his increased spending on two wars and a new entitlement program that created the huge red ink. There would be no deficit if the government learned to spend only what it takes in as revenue. That means--brace yourself Keynesians--a drop in revenue from an economic slowdown should be met with a commensurate cut in government spending.

However, Zakaria feels that the only viable alternative is to address the revenue side of the equation. What he fails to recognize is that raising tax rates or imposing new levies and fees do not always lead to an

increase in revenue. That's because people's behavior changes when you take more of their money away from them. Failing to recognize this fact is tantamount to believing that entrepreneurs can always increase their profits by simply raising the prices of goods they sell. But business owners can't always boost their bottom line by raising prices because consumers change their buying habits in reaction to prices. Likewise, the private sector changes their entrepreneurial strategy (for example whether or not to start or expand a business) based on the government's portion of their profit. Therefore, the government cannot always increase revenue by simply raising taxes.

Fareed further stated that, "...cutting the deficits without any tax increases would require massive cuts in middle class programs that would never pass." But I'm not convinced passing new or increased taxes would be any easier Mr. Zakaria. The republicans usually coalesce very firmly around the issue of not raising taxes, especially during a recession. In fact, many republicans and economists correctly believe that raising taxes would be the worst thing for this economy during a time of crisis. That's why Messer's Paulson and Greenspan so steadfastly refused to agree that allowing the Bush tax cuts to expire-which is a tax increase-would help reconcile our budgetary imbalances. They understand that it would not increase anything except government's control, power and influence in the affairs of markets; not necessarily an increase in revenue to the Treasury.

It was also not; as Mr. Zakaria contends political "pandering" that caused those men to eschew tax increases. It was instead their innate understanding that we need economic growth along with spending reductions to rescue the country from the upcoming fiscal disaster. What we cannot afford to do is discourage economic growth in an attempt to increase government coffers. Besides, history has clearly proven government has the proclivity to spend any money it collects and not to pay off debt, so how can we be sure the revenue from tax increases would be used to reduce deficits this time around?

What we need to learn as a nation is that taxes need to be made permanently low in order to incentivize risk taking and promote viable and sustainable economic growth. Then we must simply accept that government should only spend what it realizes in revenue. If taxes paid as a percentage of GDP continue to grow, as Mr. Zakaria espouses, he will get his wish and the U.S. will resemble Greece in the coming years. Along with that "distinction", government's involvement in the private sector will also reach a point that cannot be reversed without catastrophic consequences, if we have not reached that point already.