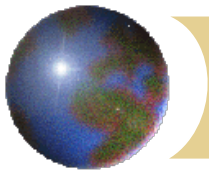


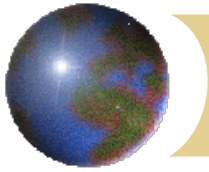
Tax and Spending Reform for New Mexico and the United States

Albuquerque, 2016



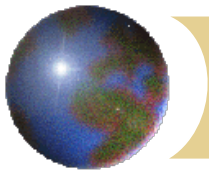
Two Major Issues

- ❖ What is the appropriate role of government?
- ❖ The classical liberal vision of small government.
- ❖ Or the welfare state vision of large government.
- ❖ How should government be financed?
- ❖ Broad-base and low-rate system designed to minimize distortions.
- ❖ Or a tax code as a tool of social policy.



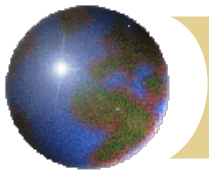
What is Good Tax Policy?

- ✦ Tax Income at one low rate, ideally no more than 20 percent.
- ✦ Define the tax base correctly, taxing Income only one time.
- ✦ Tax all income alike, since neutrality ensures economic criteria rather than tax provisions determine resource allocation.
- ✦ Tax only income earned inside national borders, the common-sense notion of territorial taxation.

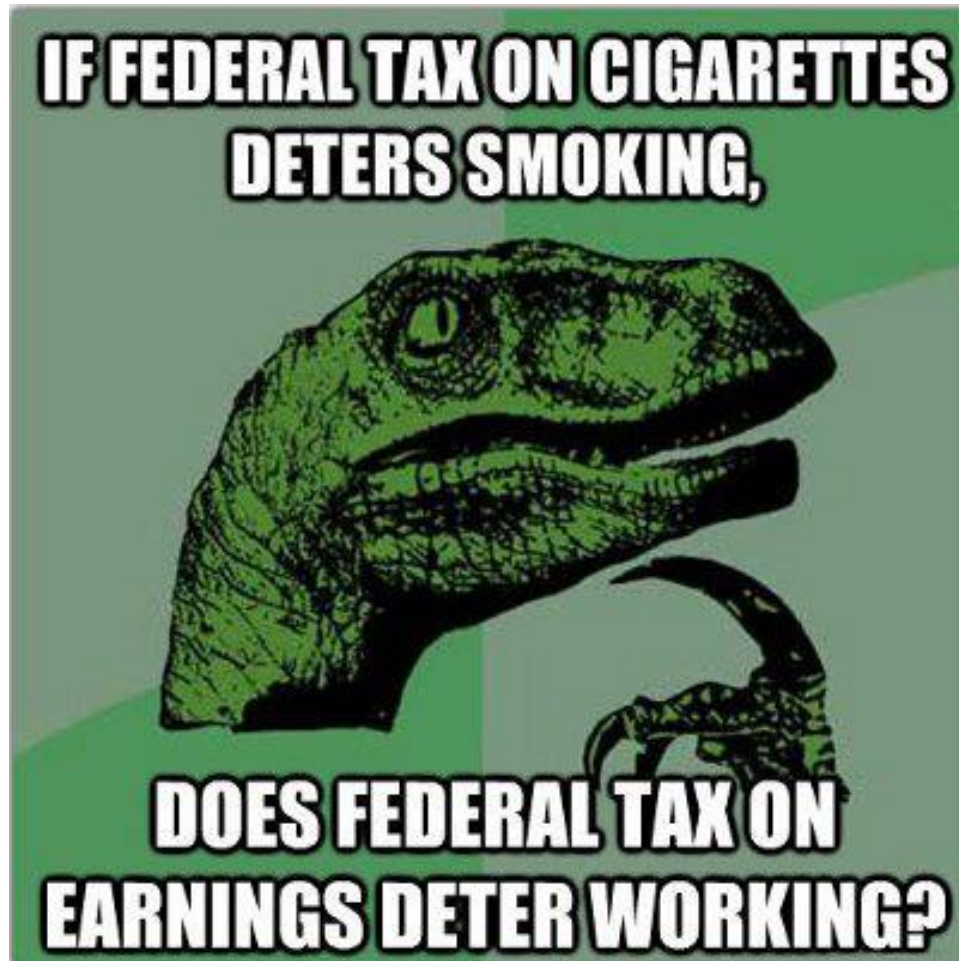


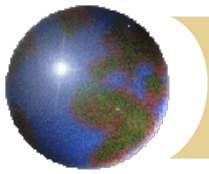
Why Have a Low Tax Rate?

- ❖ The marginal tax rate – the burden on the next increment of income – must be kept low.
- ❖ A low marginal tax rate rewards productive behavior. People will work more, save more, and invest more.
- ❖ Incentives to hide, shelter, under-report income are lower when the marginal tax rate is reasonable.
- ❖ Research indicates that the marginal tax rate should be no higher than 20 percent.



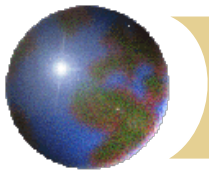
Tax Rates Determine Incentives



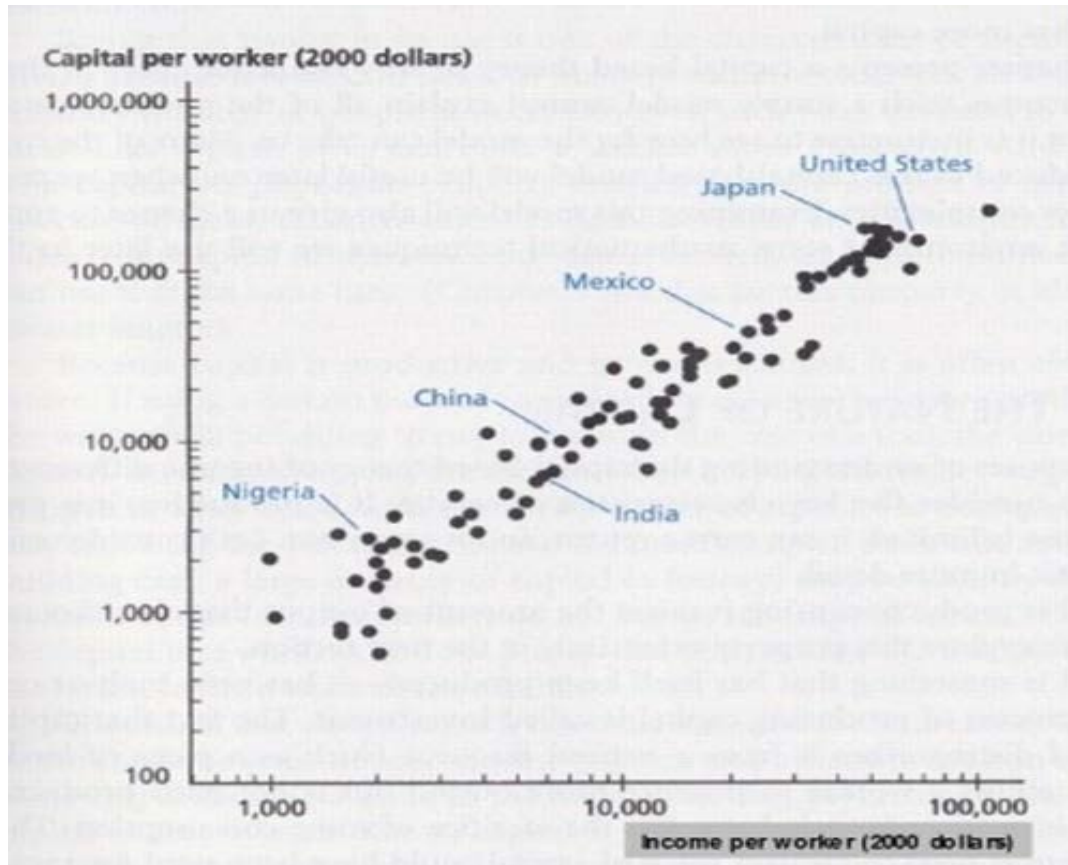


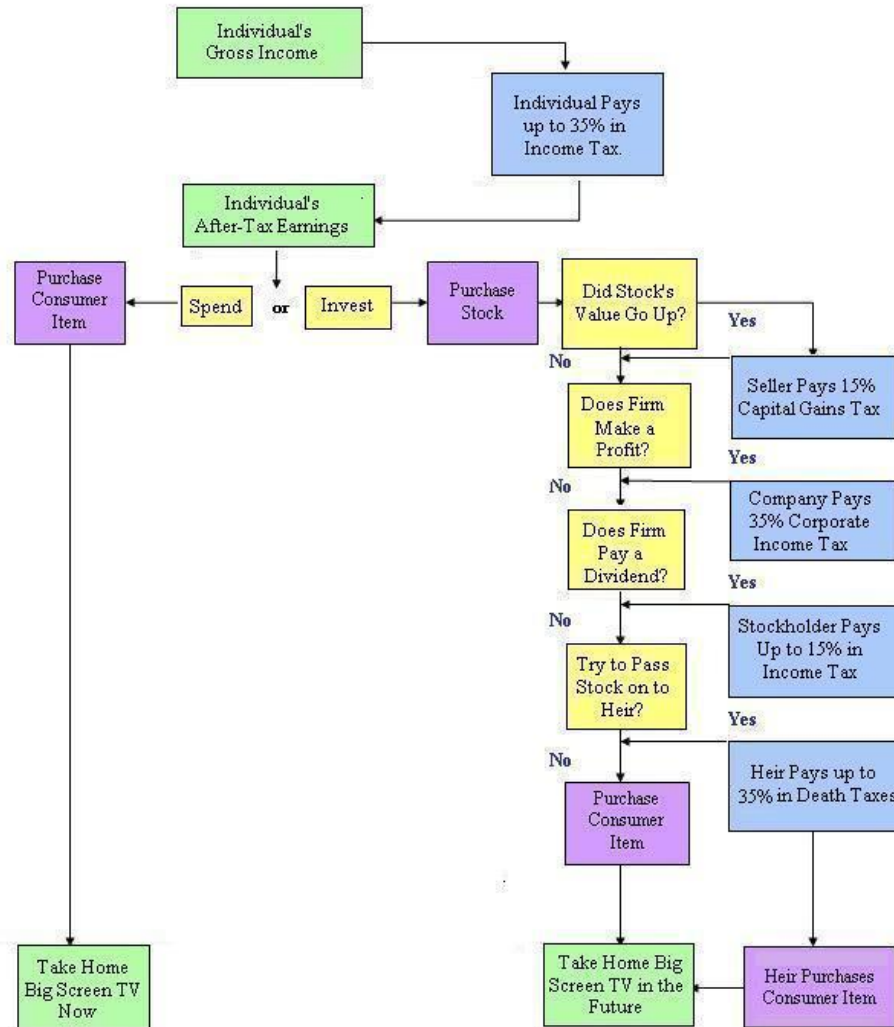
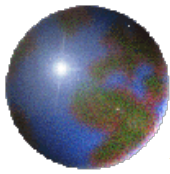
Why Tax Income Only One Time?

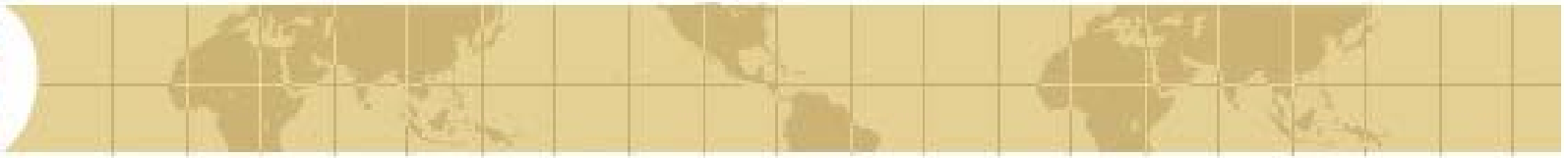
- ❖ Many nations impose multiple layers of tax on income that is saved and invested.
- ❖ This is the wrong definition of the tax base.
- ❖ Taxes on interest, dividends, capital gains, and inheritances are examples of the discriminatory treatment of capital.
- ❖ This is a self-destructive policy since it harms the activity – capital formation – that all economic theories agree is necessary for economic growth and rising living standards.



More Capital = Higher Income





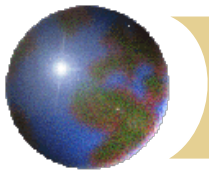


Best Way to Harvest Apples?

📍 Pick from tree?

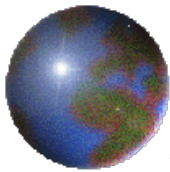
Chop down tree?

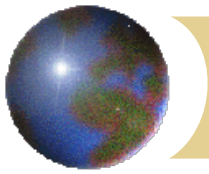




Why Neutrality?

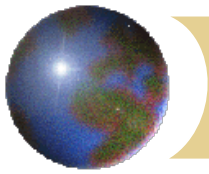
- ❖ Government should not pick winners and losers.
- ❖ Special preferences and penalties distort the allocation of capital and undermine efficiency, leading to lower incomes.
- ❖ Special preferences and penalties also encourage taxpayers to squander time and energy in search of political advantage instead of concentrating on productive behavior.





What Happens if Problems Fixed?

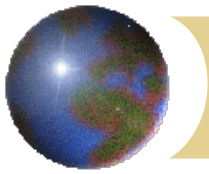
- ✚ If you solve the problems of high tax rates, double taxation, and improper distortions, you get a flat tax.
- ✚ The Hall-Rabushka flat tax is the gold standard of tax reform.
- ✚ In theory, same good results from a sales tax, but would need to repeal the 16th Amendment.



The Barack Obama Flat Tax

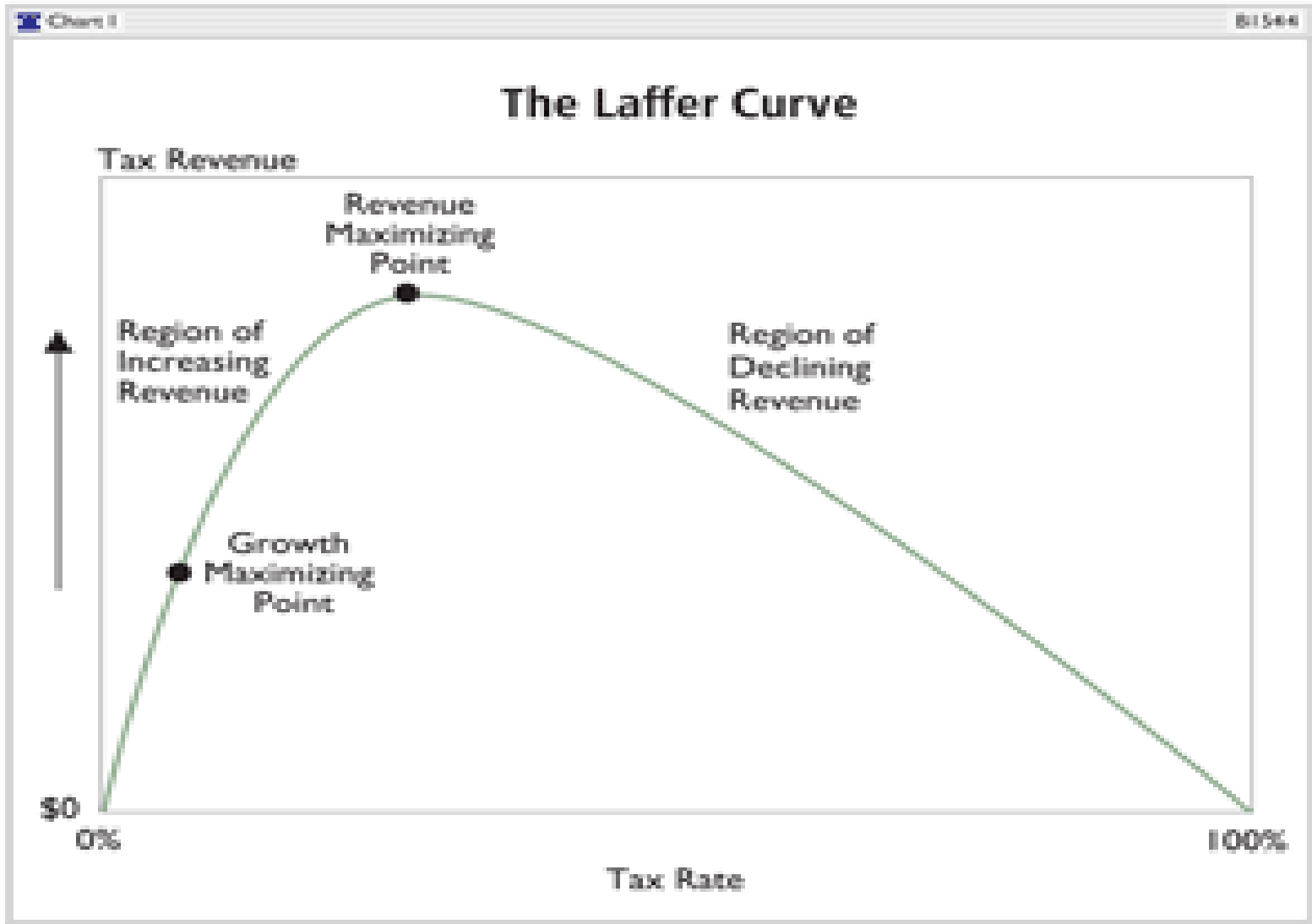
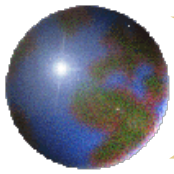


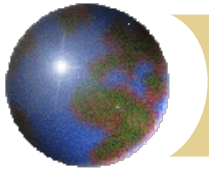
What did you make last year?	
Send it in	



The Laffer Curve

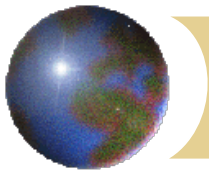
- ⊕ Higher tax rates force people to send more of their income to government.
- ⊕ Higher tax rates discourage people from earning and reporting income.
- ⊕ To determine the impact of a tax policy change on tax revenue, which effect dominates: The rate change or the change in taxable income?
- ⊕ Answer can vary over time since even small changes in long-run growth rates can have a large effect over time because of compounding.





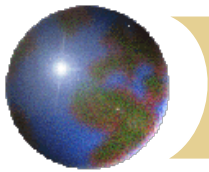
Tax Rates, the Rich, and Revenue

- ✦ In 1980, there were 116,800 rich people.
- ✦ Those rich people reported \$36.2 billion of income to the IRS.
- ✦ They paid \$19.0 billion of income tax to the federal government.

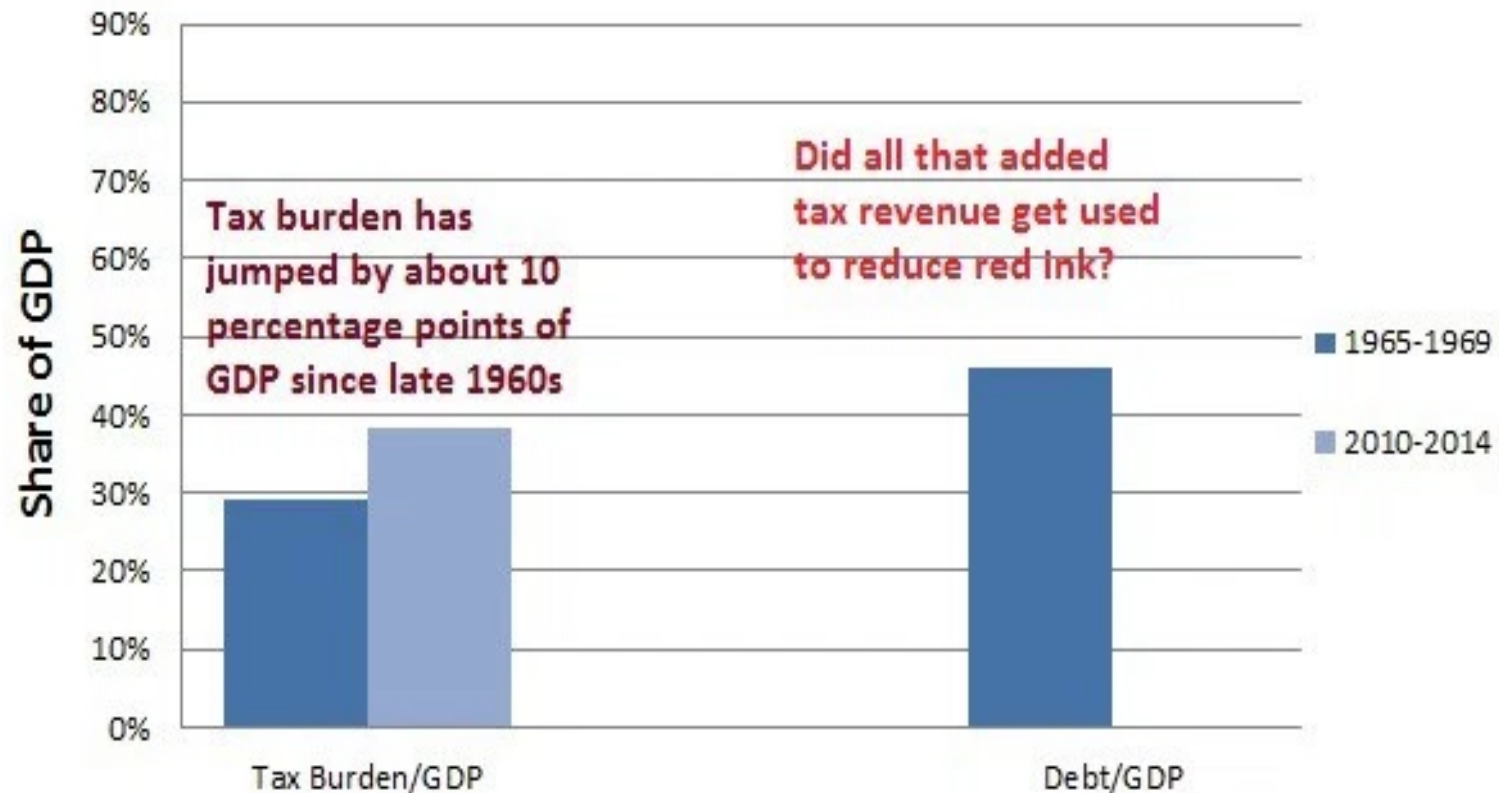


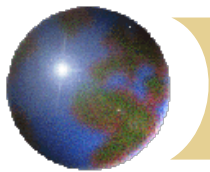
Tax Rates, the Rich, and Revenue

- ✦ In 1980, there were 116,800 rich people.
 - ✦ Those rich people reported \$36.2 billion of income to the IRS.
 - ✦ They paid \$19.0 billion of income tax to the federal government.
- ✦ By 1988, there were 723,700 rich people.
 - ✦ Those rich people reported \$353.0 billion of income to the IRS.
 - ✦ They paid \$99.7 billion of income tax to the federal government.

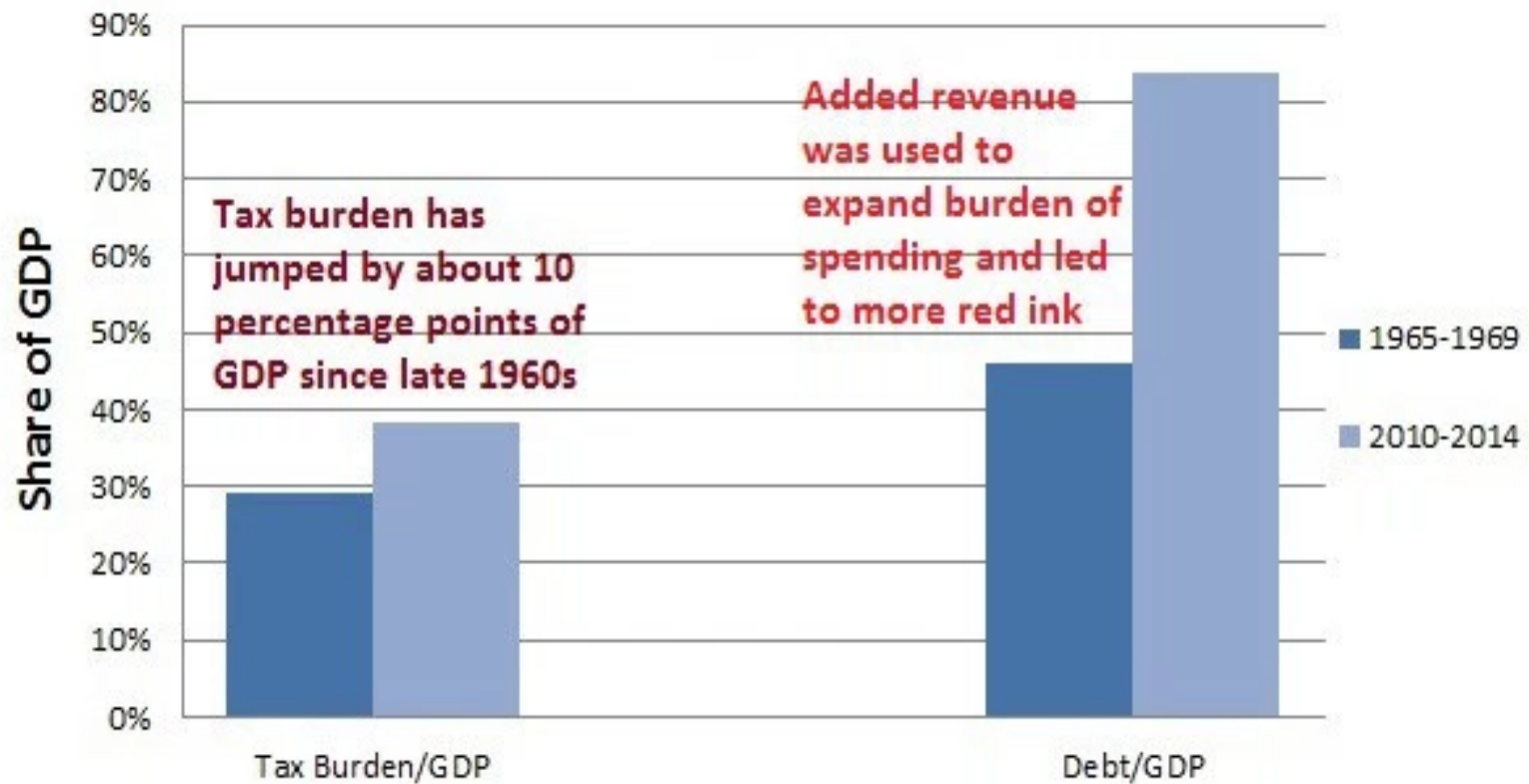


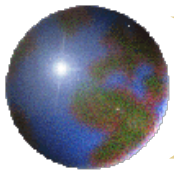
Do Higher Taxes Result in Less Red Ink?



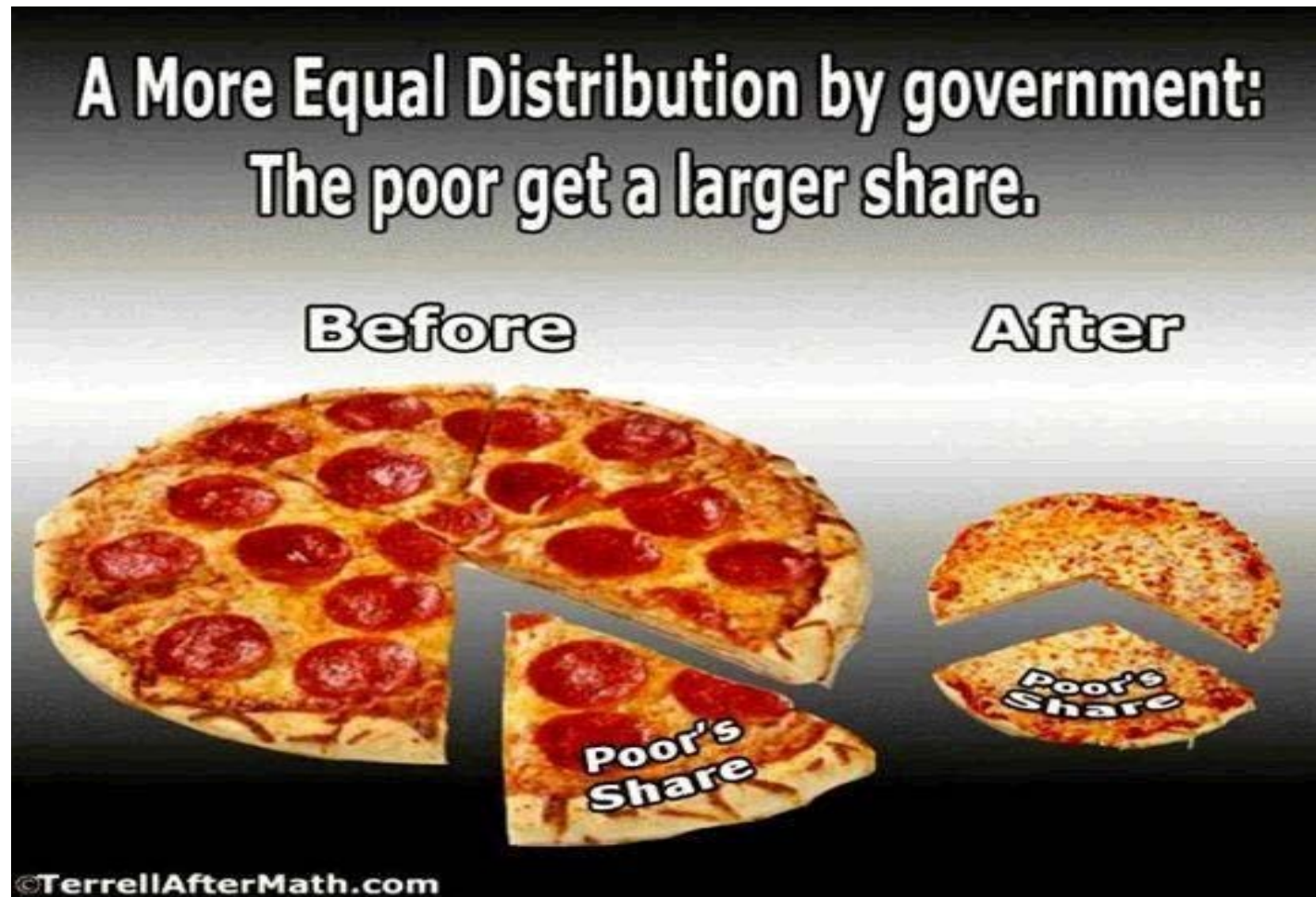


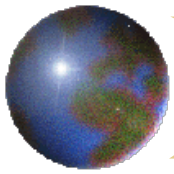
Rising Tax Burden Leads to More Debt in European Nations





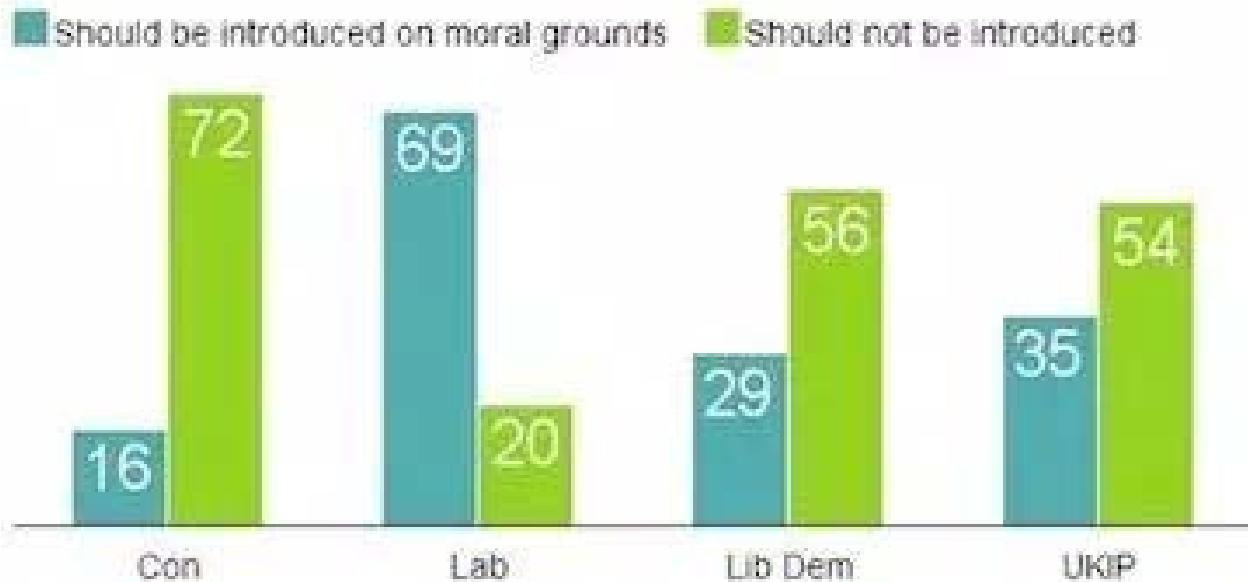
Re-Slicing a Shrinking Pizza



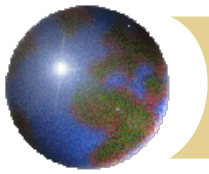


Self-Destructive Attitudes

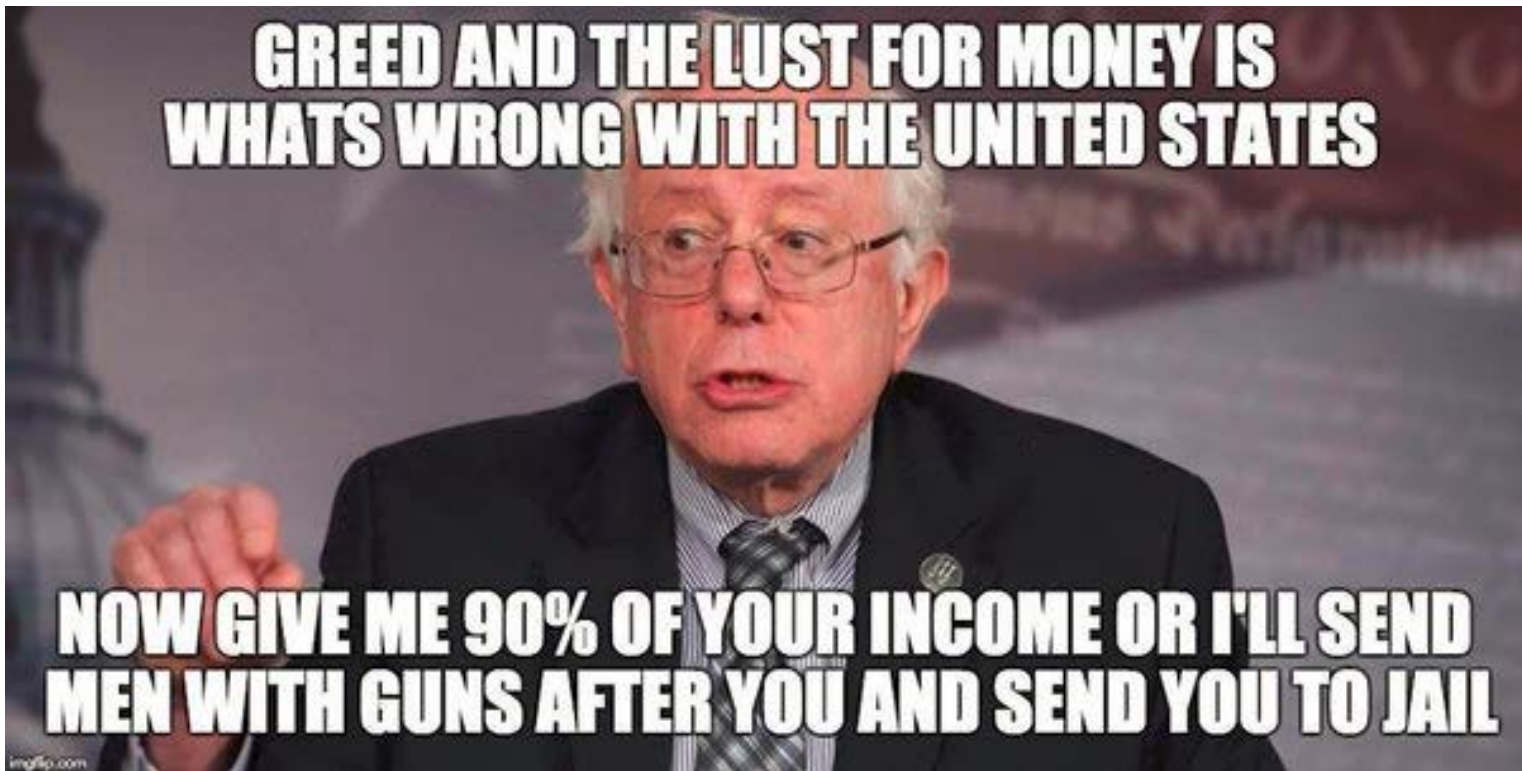
Imagine it was the case that a top tax rate of 50p did not bring in any extra money. Which of the following would best reflect your view? %

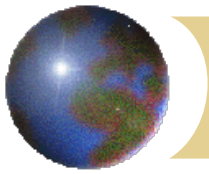


Source: **YouGov**



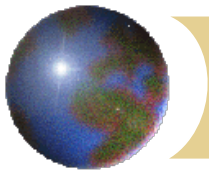
Politician = Hypocrite





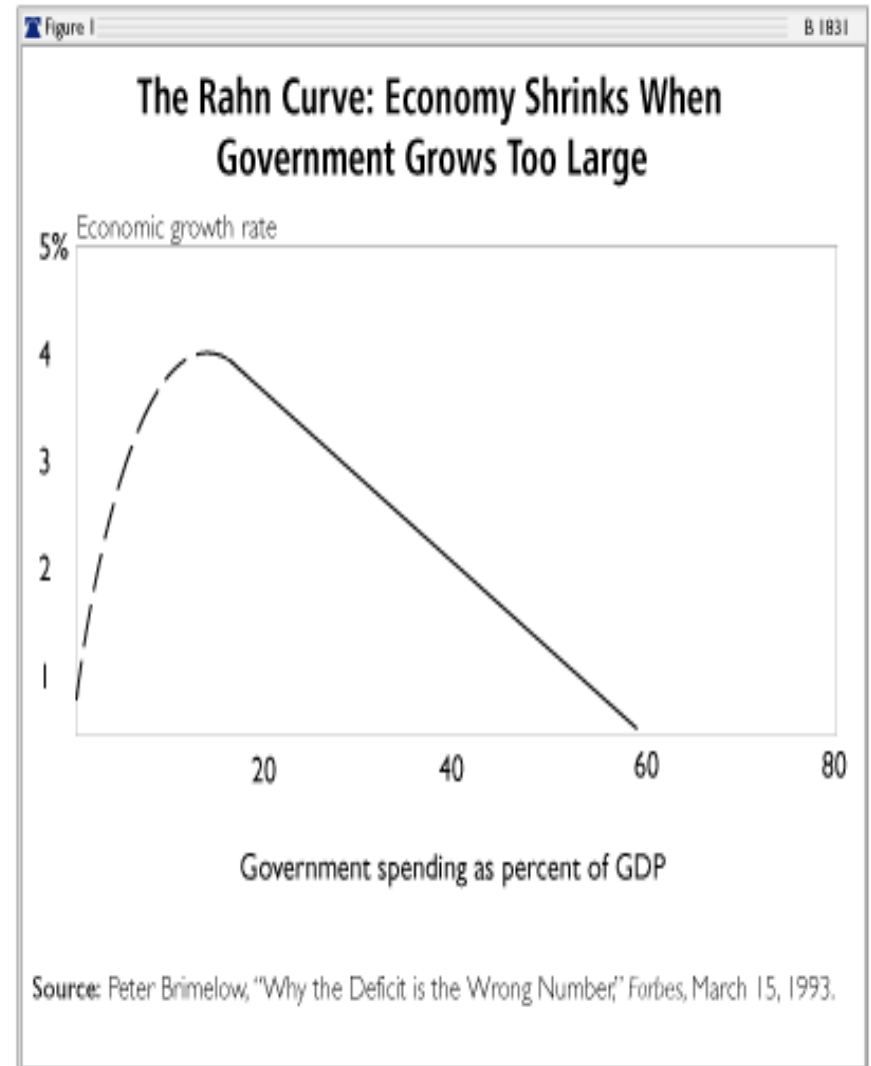
Government Spending and Growth

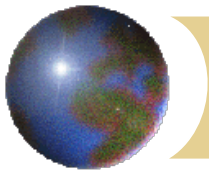
- ✦ If government spending is zero, presumably there will be very little economic growth because enforcing contracts, protecting property, and developing an infrastructure would be very difficult. Some government spending is necessary to uphold the rule of law.
- ✦ Government spending reduces growth, however, when the public sector becomes too large, leading to punitive tax rates and misallocation of labor and capital.



The “Rahn Curve”

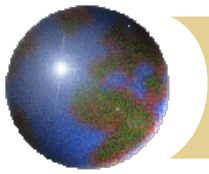
- There is a “Rahn Curve” relationship between government spending and economic growth similar to the “Laffer Curve” relationship between tax rates and tax revenue.





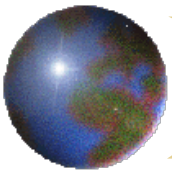
Empirical Estimates of the Rahn Curve

- ✦ Academic studies generally find that the growth-maximizing level of government is 17 percent-23 percent, though a European Central Bank study put the figure as high as 30 percent.
- ✦ Every single western nation spends above the growth-maximizing level in these studies.
- ✦ Because of data limitations, the actual growth-maximizing level of spending presumably is lower than shown in the studies.

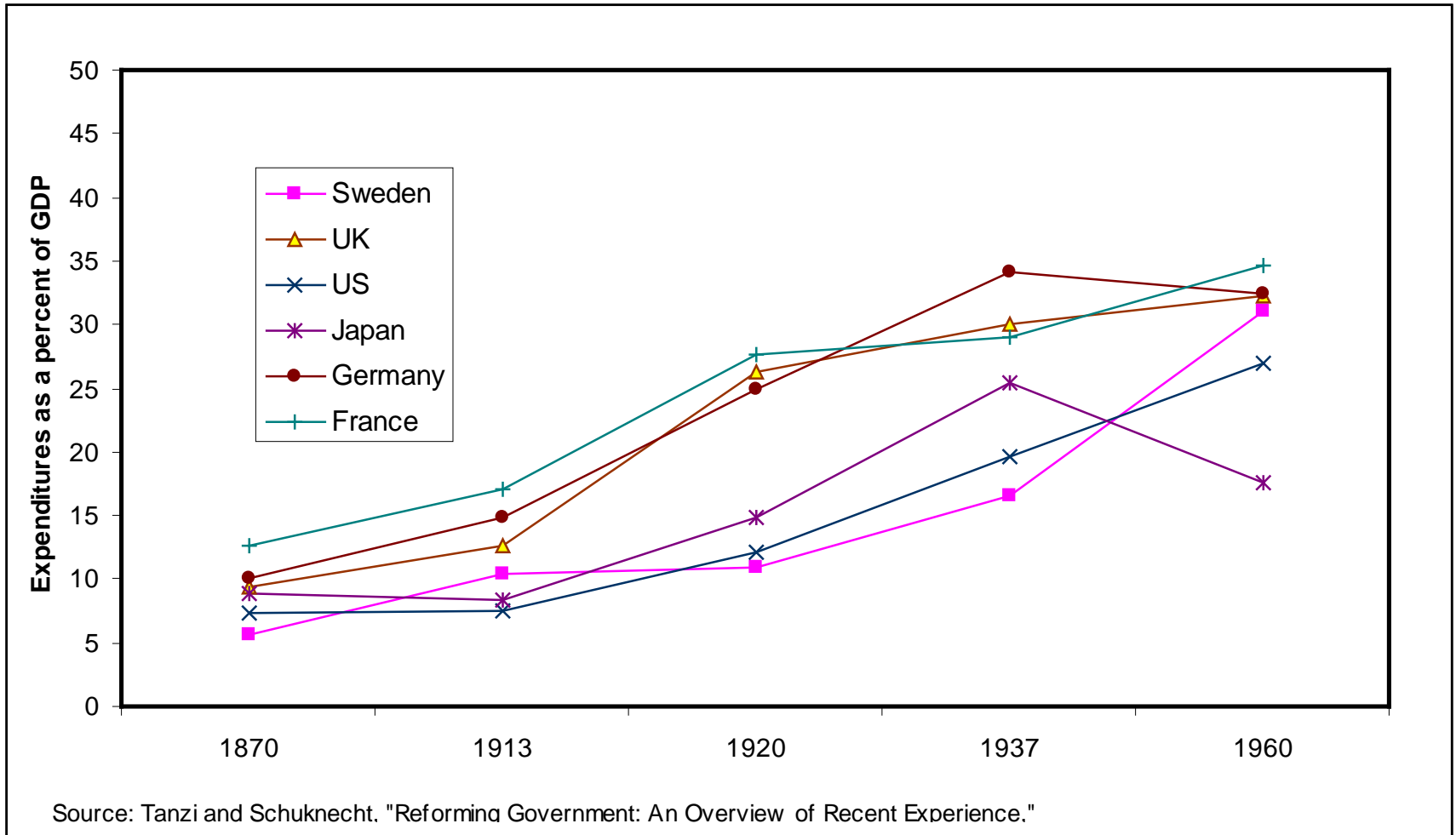


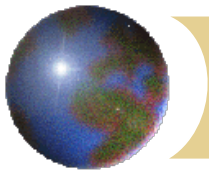
What About Wealthy Welfare States?

- ❖ Don't Europe's welfare states show that big government is not an impediment to growth?
- ❖ No. They became rich because they used to have small public sectors and laissez-faire policy (indeed, still have laissez-faire policy).
- ❖ Government expanded after they became wealthy and could afford anti-growth policies.
- ❖ A nation (or state) can tolerate one percent growth once it is rich. But a poor nation (or state) will never become rich with one percent growth.



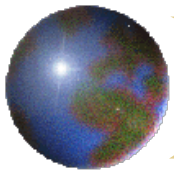
Burden of Government Used to be Small





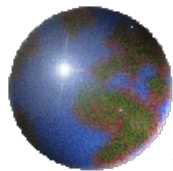
What Would Solve Budget Problem?

- ⊕ The answer is simple – just restrain the growth of spending.
- ⊕ If nominal revenue is projected to grow 7 percent each year, as CBO projects, red ink can be reduced if spending grows by a lesser amount.
- ⊕ A freeze balances the budget by 2017.
- ⊕ Letting spending grow by 2 percent each year means fiscal balance in 2021.



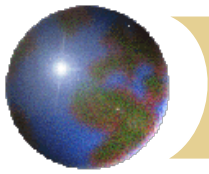
MITCHELL'S GOLDEN RULE

**The Private Sector
Should Grow Faster
than the Government**



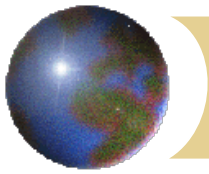
Nation	Years	Average Annual Spending Growth	Change in burden of Government/GDP	Change in Deficit/GDP
Ireland	1985-1989	1.5%	-12.2%	-9.9%
New Zealand	1991-1997	0.5%	-11.0%	-5.8%
Sweden	1992-2001	1.9%	-15.0%	-10.5%
Canada	1992-1997	0.8%	-9.4%	-9.3%
Netherlands	1995-2000	1.5%	-5.2%	-3.8%
Italy	1996-2000	1.1%	-6.2%	-6.0%
Singapore	1998-2007	-1.1%	-15.9%	-10.4%
Slovakia	2000-2004	1.3%	-14.5%	-9.9%
Taiwan	2001-2006	-0.6%	-5.9%	-7.0%
Israel	2002-2005	0.8%	-5.7%	-2.7%
Germany	2003-2007	0.2%	-5.4%	-4.3%
Switzerland	2004-Present	1.9%	-3.2%	-1.4%
Estonia	2008-2011	1.1%	-5.4%	-4.3%
Lithuania	2008-2012	0.8%	+1.3%	-0.4%
Latvia	2008-Present	-4.2%	-7.1%	-7.0%
Iceland	2009-Present	1.9%	-6.7%	-6.8%

Source: IMF World Economic Outlook database, spending at all levels of government.



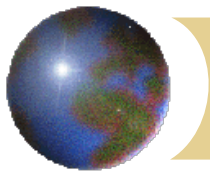
Hong Kong's Article 107

- ✦ The Basic Law (constitution) of Hong Kong explicitly states that spending should not exceed 20 percent of economic output and that government shouldn't grow faster than GDP.
- ✦ This system has worked.
- ✦ Though unclear whether success is because of Article 107.

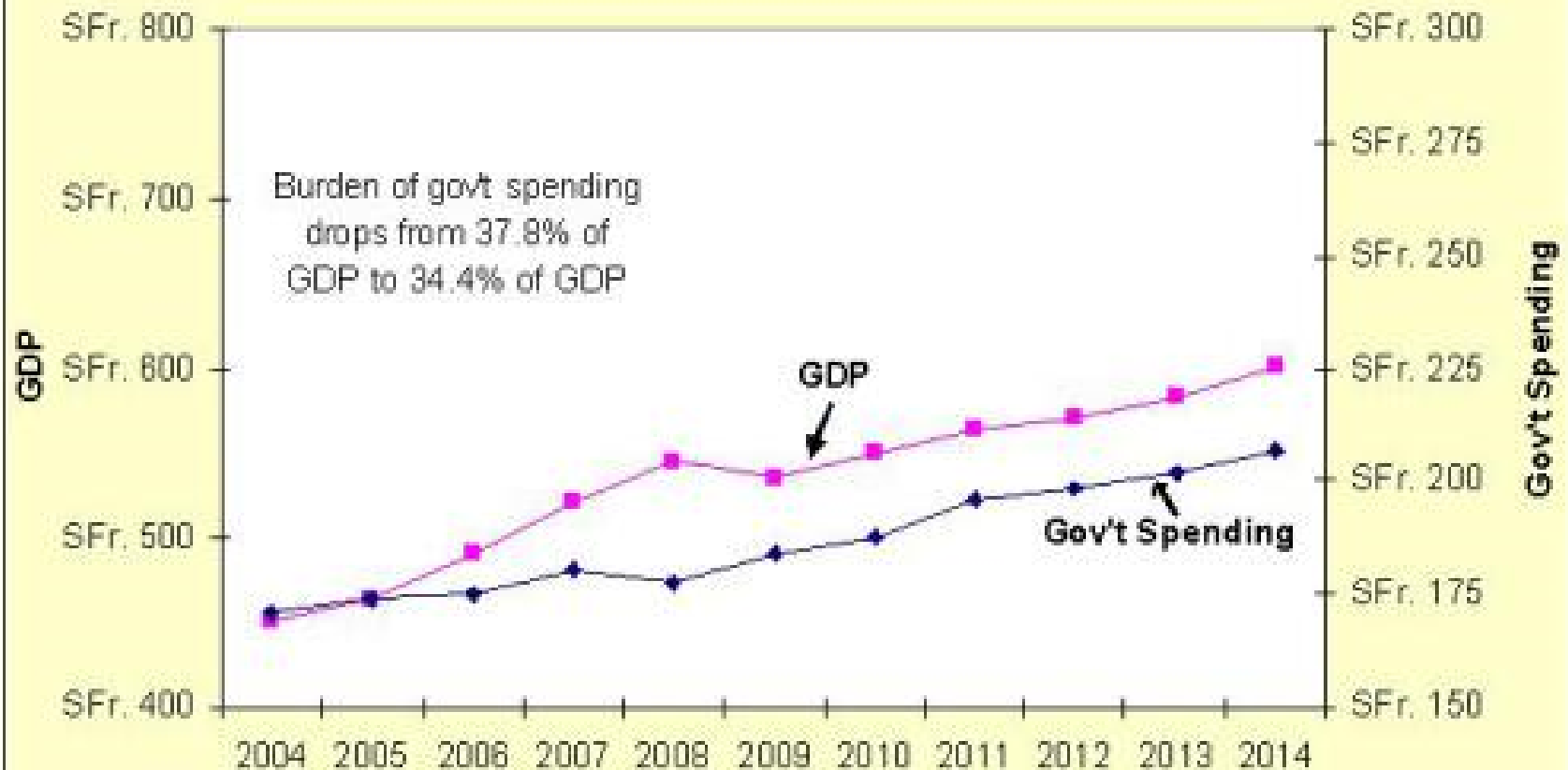


Swiss Debt Brake

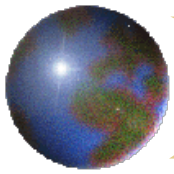
- ❖ Imposed by 84.7 percent of voters, the debt brake is akin to a balanced budget requirement over the business cycle.
- ❖ Restricts spending so budget can't grow faster than a rolling average of projected revenue.
- ❖ Tax hikes are not a threat because of referendum requirement.



Debt Brake Yields Long-Run Spending Restraint in Switzerland



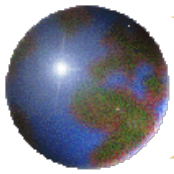
Source: IMF



Big Government Inevitably...

How the Welfare State Begins



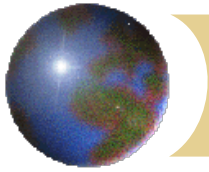


...Erodes America's Social Capital

How the Welfare State Ends

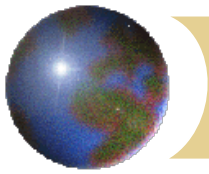


Stewart
VI.2011



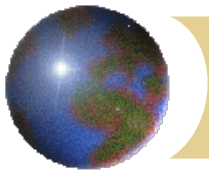
What Are the Lessons?

- ✚ The world is a laboratory showing the benefits of small government and sound institutions.
- ✚ Jurisdictions such as Estonia, Ireland, Chile, and Hong Kong are role models.
- ✚ Poor people reap enormous benefits, though rich people may become richer faster than poor people become richer.
- ✚ Long-run growth is the key variable.



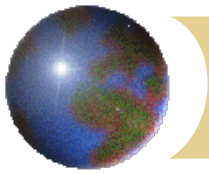
National Implications

- ❖ Because of demographics, we're becoming Greece.
- ❖ This election offers little reason for hope.
- ❖ Neither major candidate supports genuine entitlement reform.
- ❖ Don't expect tax cuts or tax reform.



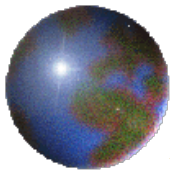
Good Policy for New Mexico?

- ❖ Goal: No state personal income tax.
- ❖ If there must be a state income tax, it should be flat.
- ❖ If there are multiple rates, the top rate should be low.
- ❖ Same rules generally apply for the corporate income tax.



What about Gross Receipts Tax

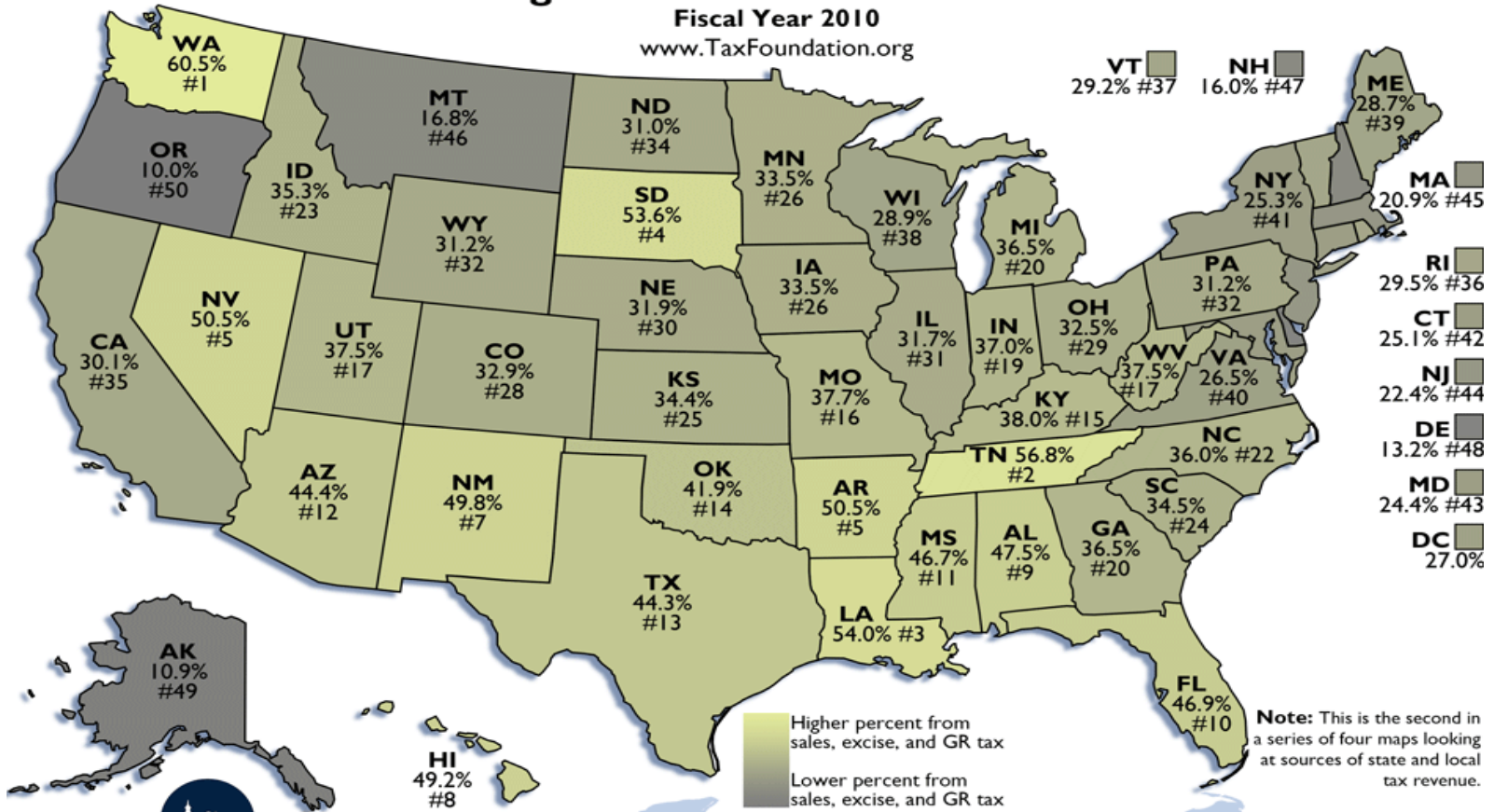
- ❖ A very unusual tax.
 - ❑ Is it a replacement for the sales tax?
 - ❑ Is it a replacement for profits tax?
 - ❑ Or is it just a way to get revenue?
- ❖ At a very low rate, not a big issue.
- ❖ As the rate climbs, potential distortions become very important (cascading).



Sales, Excise, and Gross Receipts Tax Revenue as a Percentage of All State/Local Tax Revenue

Fiscal Year 2010

www.TaxFoundation.org



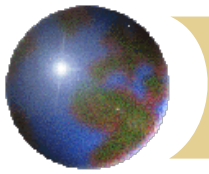
Note: This is the second in a series of four maps looking at sources of state and local tax revenue.

For more data, visit

www.taxfoundation.org/article/sources-state-and-local-tax-revenues

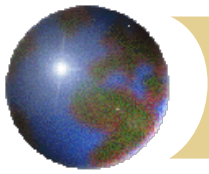
Source: U.S. Census Bureau





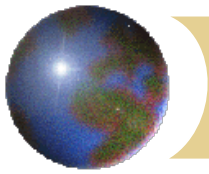
Balanced Budget Rules Don't Work

- ❖ 49 out of 50 states have rules requiring fiscal balance.
- ❖ Has this stopped over-spending in California? In New York? In Illinois?
- ❖ The European Union has anti-deficit rules.
- ❖ Has this stopped over-spending in Greece? In France? In Sweden?



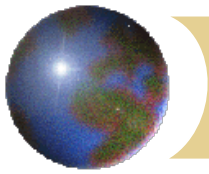
The Boom-Bust Cycle

- ❖ Balanced budget rules are misguided because big spending increases are possible during periods of strong growth.
- ❖ When a recession inevitably occurs, revenues fall and spending is stuck at high level.
- ❖ This means tax hikes and a “ratchet-up” effect on size of government.



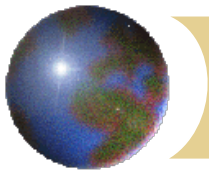
Spending Is the Fiscal Problem

- ❖ Too much spending is the underlying disease.
- ❖ Deficits and debt (like ever-rising taxes) are symptoms of that disease.
- ❖ Replacing debt-financed spending with tax-financed spending is no solution.
- ❖ Moreover, tax hikes lead to weaker economy and more spending.



The Solution: Spending Caps

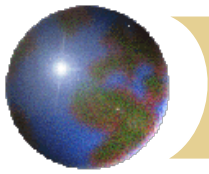
- ✚ Directly address the real problem by explicitly targeting the burden of government spending.
- ✚ Various options
 - ▣ TABOR-type rule
 - ▣ Formula spending cap
 - ▣ GDP-related spending cap
 - ▣ Constitutional restriction



How Do We Get There?

✚ Three challenges

- ❏ Correctly identifying the problem – big government is the disease. Deficits and debt are symptoms.
- ❏ Figuring out ways to “bend the cost curve” of government spending.
- ❏ Convincing the American people that liberty is better than dependency.



Conclusion

✚ For more info

▣ www.cato.org

▣ www.danieljmitchell.wordpress.com

▣ www.youtube.com/afq2007

▣ @danieljmitchell