What is a Tax Increase?

Let's imagine I am an independent, self-sufficient gold miner and consistently mined 1000 oz. of gold each year, and dutifully paid 300 oz. to various governments for my income tax assuming a simple flat 30% income tax rate.

- **What if** I invested in a new sifting pan that improved my mining efficiency such that I now produce 1200 oz. each year, should I be obliged to pay more than 300 oz. in taxes?

  Government has conditioned us to believe we would not experience a "tax increase", if the *tax* ***rate*** of 30% in this example remained the same. Therefore, they would argue a payment of 360 oz. (30% of 1200 oz) is **NOT** a tax increase. Clearly a young math student or anyone who has not been "conditioned" by government would assert that anything more than the initial 300 oz. would, in fact, be an absolute real tax increase.

- **What if** government issued and controlled a fiat currency called the dollar, and they pegged the value of the 1000 oz. of gold you produced to be $100,000 at the beginning of the year. Assuming the government required payment of taxes in dollars, you would obligingly exchange 300 oz. of gold for $30,000, then pay government their tax requirement at the end of the year. No problem so far… Now assume this government debased the fiat currency such that your 1000 oz. of gold would now be worth $200,000. If this government also has a progressive tax system that would place income earned over $100,000 into a higher marginal tax rate of say 50%, you would be required to pay $30,000 (a 30% tax rate) for the first $100,000 of income, then $50,000 (a 50% tax rate) for the next $100,000 of income. The tax total would now be $80,000 or a gross 40% of your total $200,000 income, which, by the way, has not increased its buying power more than the original $100,000 because all goods and services cost twice as much due to government's currency debasement (inflation) process. Since government did NOT CHANGE the TAX RATES, they have conditioned us to believe this is NOT a tax increase. Again, ask the young math student for the truth…

- **What if** government cut tax rates, but did not decrease spending such that budget deficits resulted. In this case issuing and selling Treasury bonds must fund the deficits, which adds incrementally to all outstanding Credit Market Debt. The result is a society with a greater aggregate claim (increased financial "paper" assets) or expectation of future goods and services delivered without any increase in the size, capacity, or efficiency of the economic engine (capital goods making up all businesses). This Treasury bond addition effectively dilutes the value of all financial asset claims, which is another way of indirectly taxing the now disillusioned gold miner. So, if I review my investment portfolio and think of the future stream of real goods and services I could purchase, I would now have to adjust my expectations lower.

"Austrian Enginomics" recognizes that ANY tax paid to government in excess of the original 300 oz of gold IS A TAX INCREASE. Further, any dilution of financial asset valuations is, again, an indirect tax increase.

What About the Laffer Curve Effect?

The Laffer curve logically demonstrates that a cut in excessive marginal tax rates may actually increase government revenues, GDP, and productivity by motivating businesses to grow their output and profits more as they will be able to keep a greater percentage of the spoils themselves.

A lower tax rate on a higher profit could yield higher total tax revenue for government than a higher tax rate on a much lower profit.

This is a wonderful concept if government spending is constrained to an absolute limit and does not creep up with the output increases, and our Central Bank does not participate in gross market interest rate manipulation via expansive monetary and credit policies. Considering a very strong annual historical U.S. productivity rate of 2.0%, a realistic structural productivity increase of 20% better than our history (a 0.4% increase totaling 2.4%) might be feasible if the tax rates dropped significantly enough to motivate entrepreneurs to allocate a greater proportion of resources to productivity improvement efforts. Also, a structural 0.5 to 1.0% increase might be possible in the employment percentage applying the same logic as the motivation to improve productivity such that the entrepreneur would hire more people to grow his business more so than under the higher tax environment. Thus a total of a 1.0 to 1.5% structural increase in total output might be realistic.

One can easily see these "realistic" numbers are paltry compared to the bounding output and profit gains of the late 90's and 2002-2006. Profits increases for US corporations by year beginning in 2002 were 15.5%, 12.1%, 19.1%, 12.5%, 22.5% (3-qtrs in 2006)[1]. The fundamental drivers of profit growth generally are employment growth due to population increases (approx. 1%), productivity (approx. 2%), and inflation (2.5% for the past 5 years). Total those you get 5.5%. Add in the incremental 1.0-1.5% due to the "Laffer Curve" effect you have a total of 6.5%-7.0%. The stark contrast between this increase and the profits of the past 5 years highlights the REAL reason for the massive increase in government revenues…. **Monetary and Credit expansion!** …NOT the Laffer Curve effect. We experienced the greatest credit expansion in the history of the Republic under the Greenspan FED. Clearly, businesses were falling over themselves raking in increased sales and profits due to the ever-abundant floods of liquidity. Those increases yielded extraordinary profit, executive compensation, and capital gains, which yielded massive non-structural government tax revenue increases. The problem with these "non-structural" monetary and credit expansion illusions of wealth is that they must reverse when the boom fever ebbs and creditors realize they've overextended their generous qualification hurdles. The inevitable contraction of credit will be extremely painful. In any case, there is still a real tax increase (NOT a decrease) due to companies and executives realizing higher incomes PLUS being pushed into higher tax brackets. Of course, complaints of higher taxes in this case are rare because the extraordinary excess profit and compensation they enjoy mask the increased tax bite.

Is a Real Tax Increase "Fair"?

This may surprise you coming from a freedom lover, but I would assert, yes…! Assuming we were utilizing a gold-backed currency and I refer back to my gold mining example, the justification for a real nominal tax increase (300 oz. up to 360 oz.) would include:

- If I personally enjoyed a 20% improvement in productivity as a result of my investment in a new gold sifting pan and we expect to keep the existing talent level of people currently serving in government, I would expect to have to pay them 20% more. Otherwise the talent would be attracted away from the necessary government services, assuming all others in business increased their productivity the same 20% and rewarded their employees with 20% increases in wages.
- If productivity improved 20% in private industry, then government productivity would likely improve the same 20%. Private labor vs government labor may operate at different levels of efficiency normally, but the proportional scaling applied to both is reasonable. Given this improvement in government efficiency, would it be reasonable then to cut

government labor by 20% to maintain the same level of government services? Possibly, but I believe it is more reasonable and certainly practical to expect a government service enhancement just as we expect enhancements in every other part of our economic lives when productivity improves.

Note: I personally believe we have far too much government control and spending in our lives today, so the comments above are applicable in a relative context; regardless the size of an existing or future government.

The real tax increase I advocate would be ONLY the increase as a result of applying the EXISTING TAX RATE to a growing wage or profit (the 60 additional oz. of gold in my mining example).

Conclusion:

Tax increases manifest themselves in many hidden ways. The only means to ensure government is not committing fraud via hidden taxation is to incorporate a full commodity backed currency, and constitutionally require a balanced budget amendment.

Unfortunately, at this stage the U.S. is trapped. The hidden asset inflation and currency debasement that has not become visible is lurking in the background yet to be discovered. Once these inflated assets are tasked (cashed in) the magnitude of the wealth illusion will be exposed. There is absolutely nothing government or central banks can physically do to increase the aggregate size of the economic engine. Only entrepreneurs can do that. Government's only capability is to further attempt to disguise the illusion with yet another illusion via further currency debasement. Taxes that have been collected in this "non-structural" condition will not be continuing. I anticipate this asset illusion discovery will happen in the 2008-10 time frame or sooner as the Boomers retire, thus prompting a global economic collapse, in addition to severe government revenue shortfalls.

By Russell Randall 1-09-2007
Home Page: www.austrianenginomics.com

References:
(1) Bureau of Economic Analysis (BEA) table 1.16D Corporate Profits by Industry