Central Planning: Prophets and Losses

People on both sides of tax issues often speak of such things as a "$300 billion tax increase" or a "$500 billion tax decrease." That is fine if they are looking back at something that has already happened. But it can be sheer nonsense if they are talking about a proposed increase or decrease in the tax rate.

The government can only raise or lower the tax rate. Whether the actual tax revenues that the government will collect as a result will go up or down is a matter of prophecy. And these prophecies have been far too wrong far too often to base national policies on them.

When Congress was considering raising the capital gains tax rate from 20 percent to 28 percent in 1986, the Congressional Budget Office advised Congress that this would increase the revenue received from that tax. But the Congressional Budget Office was wrong, not simply about the amount of the tax revenue increase, but about the fact that the capital gains tax revenue actually fell.

There was nothing unique about this example of tax rates and tax revenues moving in opposite directions from each other — and also in opposite directions from the predictions of the Congressional Budget Office. Reductions of the capital gains tax rates in 1978, 1997 and 2003 all led to increased revenues from that tax.

The Congressional Budget Office is by no means the only government agency whose prophecies have been grossly unreliable. Anyone who looks at the history of the Federal Reserve System will find many painful examples of wrong prophecies that led to policies with bad consequences for the whole economy.

In a worldwide context, during the 20th century economic central planning by governments — prophecy at the grandest level — led to so many bad consequences, in countries around the world, that even most socialist and communist governments abandoned central planning by the end of that century.

The failures of governmental prophecies in so many different contexts cannot be blamed on stupidity. Most of the people who made these prophecies were far more educated than the average person, had far more information at their fingertips and probably had higher IQs as well.

Their intellectual superiority to others may well have given them the confidence to venture into areas where no human being has what it takes to make prophecies that lead to policies overriding the plans and actions of millions of other human beings.

As John Stuart Mill said, back in the 19th century, "even if a government were superior in intelligence and knowledge to any single individual in the nation, it must be inferior to all the individuals of the nation taken together."

People competing with each other, and being forced to make mutual accommodations with each other in the marketplace, are operating in a trial and error process.

Human beings are going to make errors in any kind of economic or political system. The question is: Which kind of system punishes errors more quickly, and more effectively, in terms of forcing errors to be corrected?

A market economy with many competitors has incentives and constraints that are the opposite of those in a government monopoly.

Anyone familiar with the economic history of businesses knows that their mistakes have been common and large. But red ink on the bottom line lets them know that they are going to have to shape up or shut down.

Government agencies face no such constraint. The Federal Reserve can keep making the same mistakes in the next hundred years that it made in its first hundred years. Or it can make new and bigger mistakes.

Nor is the Federal Reserve unique. The same thing applies to the Congressional Budget Office and to government agencies on down to the local DMV.

Elected politicians not only can keep making the same mistakes. They have every incentive to deny that they made a mistake in the first place, since such an admission can end their careers.

That is why these prophets can lead to our losses.

Thomas Sowell is a senior fellow at the Hoover Institution, Stanford University, Stanford, CA 94305. His website is www.tsowell.com. To find out more about Thomas Sowell and read features by other Creators Syndicate columnists and cartoonists, visit the Creators Syndicate Web page at www.creators.com.

Related article:

The Federal Reserve: Prophets and Losses