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Avoiding a year-end fall from a fiscal cliff

By: Bob McTeer **May 25, 2012**

A huge fiscal cliff looms at year-end when massive tax increases, equal to about 3 ½ percent of GDP, and large and arbitrary spending cuts take effect automatically if Congress doesn't do something before then. You might say the question is whether they will put a fence at the top of the cliff or an ambulance at the bottom. Gridlock will amount to a vote for the ambulance.

This harsh, cold-turkey, approach to our fiscal deficit has the advantage of forcing the issue one way or another. If left in place, it will finally deal with the deficit in a meaningful way, but the cost is likely to be tipping our fragile economy into another recession. Our GDP and job growth have already slowed substantially, and the European albatross is likely to continue to bedevil us.

The tax increases will not only include ending the social security tax break in place today and additional taxes associated with health care reform, but it will include ending the marginal tax rate reductions enacted during the Bush administration. It's not just the sheer amount of tax increases that will slow the economy, but the adverse incentive effect of higher marginal tax rates that will penalize work, saving and investment.

It may be politically incorrect to say so out loud, but higher taxes on capital gains and dividends, the latter to the same rate level as earned income, would be particularly destructive. Labor productivity and wages depend on the amount of capital labor has to work with. A higher capital to labor ratio means higher wages and income for labor.

Economists generally agree with this, but it is too counter intuitive for most politicians to touch. Instead, they are likely to fall back on the "fairness" argument—that corporations and those who earn dividends and capital gains should "pay their fair share." This ignores, of course, the fact that taxes on dividends and capital gains are taxes on income that has already been taxed at the corporate level.

Some supply siders argue that higher taxes on any form of income is self defeating since it slows economic activity sufficiently to reduce the tax take to the government. My hunch is that at current tax levels, a higher tax on earned income, and perhaps dividends would increase the tax take but by much less than the percentage increase in the tax rates. That's probably not true of a hike in the capital gains tax. Higher tax rates on capital gains would likely reduce the total tax collected since capital gains recipients have some control over if and when to realize the gain.

If the government really wanted to generate more tax revenue, the lowest hanging fruit is probably the corporate income tax, which, at 35 percent, is the highest in the world. A

substantially lower corporate tax rate would reduce the incentive for American corporations to locate operations abroad and increase the incentive for them to bring their earnings back home.

Whether tax rate increases are totally self-defeating or only partially so, their cost in reduced economic activity is high relative to tax revenue gained. A much more productive way to tackle the budget deficit and debt problem would be to restrain the growth in government spending over time, especially by bending down the cost curves in entitlement programs. Putting sensible programs in place now that would restrain spending growth over time is much better than the cold-turkey approach at year end.