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Obama deficit plan: Is there ever a good time for a tax increase?

By Ron Scherer **September 19, 2011**

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Would President Obama's tax-the-rich proposal, part of a plan to raise some revenue for deficit reduction, actually harm the economy?

Critics say it would, but economists suggest a major part of the equation involves the state of the economy itself. By 2013, the earliest Mr. Obama's tax reform policies would go into effect, no one knows if the economy will be humming along, muddling through, or in a recession.

To that, economists suggest it's anyone's guess. Yes, the economic outlook is that uncertain, leaving any analysis of the economic impact of a potential $1.5 trillion in tax hikes equally uncertain. Congress, Greece, and the housing market could all play significant roles – but what those roles might be are yet to be determined, experts say.

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The optimists believe the US housing market, suffering since 2008, will revive, giving the economy a significant boost.

Those who are less optimistic, think the economy will be moving ahead at a snail's pace – not much different than today.

And the pessimists think the financial problems in Europe could send the US economy back into recession – assuming it's not there already.

"Next year is probably more uncertain than 2013," says economist Joel Naroff of Naroff Economic Advisors in Holland, Pa. "If we get through 2012 OK, then 2013 will be good. But if not, then 2013 will be a disaster."

What Congress does

Some economists say that Congress could play a significant role in what happens next. It has already agreed to cut spending, but that will actually reduce economic activity, says Mark Zandi of Moody's Analytics.com.

He estimates the impact of the fiscal austerity will cost the economy 1.7 percentage points of economic activity unless Congress does something such as renewing the reduction in payroll taxes (think Social Security and Medicare taxes). In 2013, the belt-tightening will cost the economy 1.5 percentage points.

It's also not clear if Congress will agree to any of Obama's job-creation plans – a combination of some tax reductions, some spending on new schools, and direct grants to the states. If Congress does nothing, it could mean the economy just "muddles along for the next two years," says economist Richard DeKaser of the Parthenon Group, a Boston-based strategy consulting firm.

What Greece does

The economy next year could also be adversely affected by events in Europe, says Mr. Zandi. If the Greek government were to default on its loans, he expects Europe will have a mild and short recession. However, if the debt woes were to spread to other countries, he predicts that would drag the US into a recession as well.

If the bankers reach some accommodation on Greece, then the US economy may start to get a lift from the housing market, predicts Mr. Naroff. "A year from now you will have worked off the inventory in the housing market," he says.

Zandi, also a housing optimist, expects the housing market to increase from a current rate of building 600,000 new homes a year to 1.7 million homes a year. "That is a lot of growth," he says, "and it begins in 2013 in earnest."

What the economy does

The shape of the economy may well have a lot of bearing on what Congress does – if anything. If the economy is suffering, lawmakers are less likely to make any significant changes in tax policy. No one wants to run for reelection right after raising constituents' taxes. However, if the economy has its swagger back, they might be more inclined to act.

"The worst time to raise taxes is during a recession," says Pamela Villarreal, a senior fellow at the National Center for Policy Analysis in Dallas.

That's because tax hikes tend to take money out of the economy at a time when consumers are already in a funk. Ms. Villarreal, who supports some form of tax reform, such as a consumption tax, argues that even tax increases on the wealthy could have an adverse impact on the economy.

"If they have less to invest in job creation that trickles down to the rest of the economy," she says. "What they do to the top earners will effect the rest of us."

However, Naroff argues that tax changes on the well-to-do probably won't change their spending habits. "The Obama proposals are not aimed at people who are likely to dramatically or even at all change their spending behavior," he says.

Changing the tax code

One of the biggest battles of the year is likely to be whether to extend the so-called "Bush tax cuts" for high-income earners. Those tax cuts expire at the end of 2012 and Obama has vowed to veto any legislation that extends them again.

"I am assuming the Bush tax cuts expire but are replaced with something else," says Mr. DeKaser. "Maybe there is a change in the tax brackets, a gradual introduction of a more stringent tax policy."

If the economy is not a recession, tax changes might be good, argues Zandi. He particularly endorses some form of broadening the tax base, which is usually means shutting down loopholes and making the tax code less complex.

"If tax reform means the flattening of the tax base and it stays that way for a lengthy period of time, the economy could easily digest that and perhaps even benefit from it," he says. "If you are talking about scaling back many of the deductions and tax credits in the tax code and it becomes less complex, that could be therapeutic."

No matter what happens in terms of tax reform, Zandi expects it will be phased in. "We could not do it all cold turkey," he warns. "Households and businesses have made decisions based on those loopholes."