Forbes

The Real Problem With Obama's Tax-Cut Priorities

Nov. 15 2010

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Below is a copy of my remarks to a group of students this past week-end. The assigned topic: the challenges of restoring economic prosperity in America.

I don't have the time, nor the expertise to talk about many of our chronic problems like Social Security, Medicare & Medicaid, the need for better immigration policies and inter-city public education. John Goodman and my colleagues at NCPA have the comparative advantage on those topics. I'll stick to the macro-economic monetary and fiscal policy issues that are so much in the news today.

For context, we suffered a severe financial crisis that brought us to the brink, whose impact lingers even today, a collapse of mortgage & housing markets that are still searching for a bottom, and an unemployment rate still stuck at 9.6%, or more like 17% if the broader concept of unemployment is used.

All these factors have made for a very slow and weak recovery that theoretically has been going on for almost a year and a half, which many people haven't noticed yet.

Moreover, the recession plus many of the policies designed to counter it (but not all of them) have expanded our budget deficit and the accumulated debt to levels unprecedented since WWII. The deficit, which was long too large at 3% of GDP—is now close to 10%, at around $1.3 trillion per year. Outstanding government debt has gone from around 40% of GDP to around 60% and still rising. With debt growing much faster than our economy to support it, sooner or later, something has to give.

Our great, short-run policy dilemma is that measures to stimulate the economy will make the fiscal problems worse; and measures to reduce the deficit and debt will weaken the economy. Our choice—largely by default—has been to worry about the weak economy today, and, hopefully, the deficit tomorrow.

However, the new political realities have taken new government stimulus spending off the table, to a large extent because the first huge round of stimulus spending was so poorly planned and executed.

This leaves only monetary policy, which has had the pedal to the metal for almost 2 years in terms of short-term interest rates. The Fed is just now beginning a new round of what others call "quantitative easing," to stimulate money and credit growth, and perhaps put some downward pressure on longer term-interest rates.

This program has proven to be more controversial than I think it should be, both domestically and with foreign officials, who seem to believe, or pretend to believe, that it is an indirect but deliberate way of weakening our currency relative to theirs and stimulating our exports at the expense of theirs. (Beggar my neighbor policies.) I don't buy this interpretation, but it has been dominating the news recently.

Europe's policy priorities are different from ours because of their sovereign debt crisis earlier this year in several of the Euro-zone countries, starting with Greece, moving to Spain and Portugal, and now focused on Ireland. Commentators like to refer to Portugal, Italy, Ireland, and Greece collectively as the PIIG countries.

When the debt crises flairs up in any of the PIIG countries, it usually weakens the Euro, bringing the stronger countries (a relative term) to the rescue. Because of their debt crisis, Europe is having to deal with their fiscal deficits and debt first, putting their own sluggish economies (except Germany) on the back burner.

You are probably aware that riots broke out in France over its government's proposal to extend the early retirement age of public employees from 60 to 62—in 2018.

Our fiscal fundamentals are not much better than many of the European countries; so we need to start soon getting our own fiscal house in order. But how?

The Democrats emphasize more government stimulus spending, while the Republicans emphasize stimulus through lower taxes, particularly lower marginal tax rates.

Neither side has been immune from their ideology getting in the way of stimulus, however. The big-spending Democrats also want to raise taxes, while the tax-cutting Republicans also want to reduce spending.

Underlying these compromised positions on stimulus is a fundamental difference in attitude toward the size, role, and scope of government.

Many tax cutters don't worry too much about the resulting larger deficits because they think it will create more pressure to reduce spending and the size of government. Many of the proponents of more spending don't mind much if that becomes the first step in making government larger relative to the private sector.

Hoping to break through this political/philosophical deadlock, the President appointed a commission to recommend fiscal measures, composed of members of each political party, co-chaired by Erskine Bowles, a moderate Democrat, and Alan Simpson, a moderate Republican. These co-chairs surprised the world earlier this week, including their own commission members apparently, by putting several suggestions on the table for consideration.

This will likely smoke out a lot of politicians who are for spending cuts and balanced budgets in the abstract, but can't bring themselves to propose specific cuts—particularly those that might harm someone in their own district. Meanwhile, a clear and present danger is that the Bush tax-rate cuts of 2001 and 2003 are scheduled to expire at the end of this year, in about 6 weeks.

And the current zero death tax rate is scheduled to rise automatically to 55 percent. (My two sons have been looking at me funny lately.)

What happens to all these taxes and others, such as the corporate income tax, will be a huge deal for the economy. President Obama all along has promised to keep the Bush cuts (wholly or in part) for the middle class, which he defines as those having incomes below $200,000 (single) or $250,000 (joint) and let the cuts expire for those above those income levels.

That would raise the top two income tax brackets, the highest from 35 percent to almost 40 percent. It would also raise the capital gains tax from 15% to 20%, and the dividend tax from 15% to almost 40%. And the death tax to 55%.

The recent election strengthened the hand of those who want to extend all the tax rates at current levels, but the lame duck Congress may be a little cranky and not in an accommodating mood.

We'll probably have to wait until early next year and hope for some retroactive relief. Meanwhile, the uncertainty weighs heavily on the economy.

We all know, intuitively, that higher tax rates depress economic activity, which reduces somewhat the increase in tax revenue expected from the higher rates. We also all know,

intuitively, that lower tax rates tend to stimulate economic activity and thus recoup some of the tax revenue lost by the lower tax rates.

Conventional wisdom generally agrees that higher government spending and/or lower taxes will stimulate the economy, but increase the budget deficit. Conventional wisdom also agrees that lower government spending and/or higher tax rates will reduce the budget deficit, but depress the economy.

There is one theoretical way out of this dilemma: Supply-side economics, featuring the Laffer Curve, which under some circumstances enables us to have our cake and eat it too. In its extreme version, the Laffer Curve posits that the stimulus from tax-rate cuts might be so great as to actually increase tax revenue—a free lunch.

I personally think that is too much to hope for as a general matter at current tax rates, but I would consider a tax-rate cut that produced only minimal revenue loss to be successful.

The Laffer Curve-effect is more likely to work miracles if the highest marginal income tax rate is very high to begin with—say over 50 or 60 percent—and if the taxpayer has control of when to realize income for tax purposes. The two potential candidates are capital gains taxes and the corporate income tax. Taxpayers can time their capital gains, and CEOs can relocate their companies, or at least the countries where they invest the most.

That last point raises another free-lunch possibility: If we would lower the U.S. tax on foreign source earnings, much of them would flow back to the U.S. for investment here rather than abroad.

NCPA recently had Art Laffer as a speaker, and he acknowledged something that I had only suspected. He said his Laffer Curve-effect worked only at the highest income level—where taxpayers can afford tax lawyers and accountants. He said it didn't work below the highest income level. Presumably, he considers the effect at the highest levels strong enough for it to work overall.

Ironically, this means that if the president and Congress cut taxes for the middle class, it would reduce tax revenue, and, if they raised tax rates for the highest income levels, it would also reduce tax revenue. That means that from the government's tax revenue point of view, the president's plan is the worst plan possible—both aspects reduce tax revenue. A divided Congress may save the president from that catastrophe. Let's hope so.

I had an epiphany this week about the Laffer Curve. It is that looking at it and playing around with it focuses your attention on what tax rate maximizes government tax revenue. Your eye is drawn to the peak.

It dawned on me that by focusing on the tax revenue-maximizing tax rate, it might cause some people to think that is the proper goal of tax policy—maximum tax revenue. Maximizing Uncle Sam's take is hardly a worthy goal of tax policy.

Economics aside, it seems to me that having the government take more than, say, a quarter of your hard-earned income just isn't right on moral grounds. And, it might just be good for the economy—and tax revenue.