IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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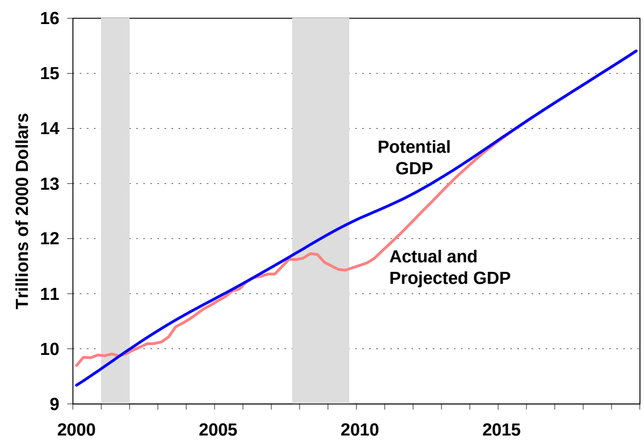
THE PRESIDENT'S BUDGET: MULTIPLYING BENEFITS OR SUBTRACTING VALUE?

Most schools of economics would say not to raise taxes in a recession. President Obama's Budget submission professes to cut taxes for 95% of households. However, much of the apparent tax cut is a "rebate" that is more spending than tax reduction. Further, the implicit energy tax in the President's cap and trade proposal, if enacted, would be passed on to consumers and take back the bulk of future rebates from most families.

The President's tax plan clearly raises taxes on millions of upper income taxpayers and on businesses. Their tax rates are already the highest, leaving them the least income after-tax out of each added dollar earned. Thus these tax increases would do the most to squeeze the remaining after-tax incentives to produce. Treasury Secretary Geithner told the House Ways and Means Committee not to worry, that the higher taxes for affluent Americans would not interfere with the recovery because they will not come until 2011 once "we are safely into recovery." (In fact, the capital gains and dividend tax increase would start in 2010. The energy taxes would not start until 2012.) Pretending that there would be no damage if we wait two years to take the poison is nonsense. The income and energy tax increases would reduce GDP whenever they are imposed, for as long as they are kept. Whether you reduce output and income forever starting in 2010, 2011, or 2012 does not make much difference.

Congressional Budget Office's Comparison Of GDP And Potential GDP



Source: Congressional Budget Office.
GDP stands for gross domestic product. Shaded bars mark recessions.

A chart in the Congressional Budget Office's *Budget and Economic Outlook* shows GDP to be well below its assumed current potential. This sort of Keynesian chart has appeared in CBO Outlooks and in *Economic Reports of the President* since at least the 1960s. Keynesians think that if a dollar of deficit spending simulates another half-dollar of private spending (a "multiplier" of 1.5), then spending two-thirds the gap will close it. (A tax cut works too, but supposedly less well, because some of the cut might — gasp! — be saved.)

Stimulus economics was debunked by Milton Friedman in the 1960s. The Treasury must borrow to pay for spending or a tax cut (the so-called government budget constraint), so "disposable income" is taken out of the economy with one hand while being injected with the other. Initial stimulus: zero. Multiplier: irrelevant. Government spending or a tax rebate has no effect on "demand" and GDP. More recent research reinforces Friedman's insight.

In addition to the government budget constraint, Friedman's "permanent income hypothesis" also tells us that people set their consumption based on their expected income over time (a lifetime, or at least, several years), not just at the moment. A temporary tax cut, such as a rebate, would tend to be saved, not spent, in any case. (That is just as well, since the Treasury will need to borrow it back.) Harvard Professor Robert Barro goes further. His "rational expectations" theory has people deliberately saving the tax cut (even a permanent one) against the likely event that the government will not cut spending, and so will have to raise taxes (with interest!) in the future. This may assume a bit too much foresight on the part of the public, and is not necessary just to predict that a spending increase or a tax cut (even a permanent one) will not boost the economy by handing money out. Even so, the Congressional Budget Office reports that, if the budget is eventually balanced by raising taxes to cover the added debt engendered by the stimulus, the economy will be weaker in the long term as a result of the stimulus measures. So we have three theoretical reasons to disbelieve "multipliers": the very practical and mechanical observation that the government has to borrow to avoid bouncing checks, the phenomenon of sticky consumption, and rational taxpayers.

A fourth, non-theory reason is that rebates have not worked in the past. The rebate enacted in February 2008, and paid out that spring and summer, appears to have had little impact on consumption. The Ford rebate in 1976 did nothing, either. It was a retroactive reduction of one's 1975 tax, which could have created no possible incentive to earn and report more income the year before, because time travel is impossible. When President Carter proposed a larger rebate two years later, Finance Committee Chairman Senator Russell Long opposed it, on the grounds of "Fool me once, shame on you. Fool me twice, shame on me." He called it a scheme to drop $50 bills off the top of the Washington Monument. It did not pass the Senate.

Government spending raises GDP only if it adds more to output than the resources it uses could produce in private endeavors (a good bit more, in fact, to cover the distortions created by whatever tax is eventually raised to pay for it). A tax cut can raise GDP, but only if it is a type that lowers the tax bite "at the margin" on additional income that might be earned in the process. That would increase the supply of labor and capital inputs, raising output and income, and then (and only then) lift demand. That sort of tax reduction, if permanent, would raise future actual and potential GDP on a permanent basis.

Unfortunately, where the President's tax plan would cut taxes, it would be mainly not at the margin and would not generate growth. Where the President's tax plan would raise taxes, it would hit at the margin and would reduce actual and potential GDP thereafter. A new "potential" line in the chart would have to be drawn well below the old one. Restoring output to a diminished potential (which is never shown in the Keynesian graph) is not an appropriate policy goal.

Here's the right way to look at the tax changes. For people in the top two brackets, income tax rates would rise to 36% and 39.6% (from 33% and 35% at present). For roughly the same group, the top capital gains and dividend rates would rise to 20%, and the expiring limits on their personal exemptions and itemized deductions would be retained, adding about 1.5% to 3% to the income tax rates for single filers and couples with two children, respectively. That is on top of state and local income taxes, the Medicare tax, and the Social Security tax if the workers in the households are earning less than the wage cap. Since they now keep only 45% to 55% of marginal labor or business income after tax (i.e., on income other than capital gains and dividends), a five or six percentage point rise in their tax rates would cut their remaining incentives to work, save, and invest by ten to twelve percent. The rise in the capital gains and dividend tax rates is on top of the existing corporate tax, squeezing after-tax returns. Due to the increased federal and state taxes, corporate pre-tax income would have to rise nearly seven percent to maintain normal after-tax returns to the shareholders. The private sector would shrink.

The "make work pay credit" would lower the marginal tax rate for people earning up to $8,100 in wages this year and next, but raise the marginal tax rate by some significant amount on all income, from either wages or savings, over the adjusted gross income range (starting at $75,000 for single filers, $150,000 for joint filers) used to phase out the credit. (So would a proposed rise in the Earned Income Tax Credit.) The people whose marginal rate would go down produce much less than the people whose marginal rate would go up, so the income-weighted effect is to boost the tax penalty on work and saving.

Looking only at the individual income tax changes, we estimate that capital investment would have to earn so much extra to pay the higher taxes that the private business sector capital stock (plant, equipment, commercial structures) would shrink by almost 6% (about $1.5 trillion) over five to ten years compared to levels it would otherwise reach. Private business sector output and labor income would each be 2.4% lower than otherwise after all adjustments. Lower wages would offset much of the make work pay rebate. The private sector losses translate to a drop in actual and potential GDP of over 1.8%, or a drop in economic growth of 0.4 percentage point yearly for 5 years (losing about 10% of the Budget's projected real growth over the period). About 45% of the revenue gains expected from the income tax increases alone would be lost due to lower incomes. Other taxes, on payroll, corporate profits, excises, etc. would grow less too. The net result would be a $2 billion annual revenue loss, rather than the revenue gain of $67 billion by 2014 that the budget projects from the tax hikes on upper-income taxpayers.

The higher capital gains and dividend tax would discourage people from realizing their gains and discourage dividend payments for a decade or more, eliminating another chunk of revenue, cutting perhaps another $12 billion or so in 2014. We will shortly publish a paper by Professor Paul Evans of Ohio State that finds the revenue maximizing capital gains tax rate to be about 10% (and might be nearer zero if the adverse effects on the economy and other tax revenue are considered). Boosting the rate to 20% will not make money for the government.

The Administration Budget advocates retaining the estate portion of the estate and gift tax at 2009 levels (a credit offsetting tax on the first $3.5 million per individual or spouse, a 45% top rate on the rest) instead of letting it expire in 2010. The Budget Resolution passed by the Senate suggested raising the credit to offset $5 million and reducing the top rate to 35%. Unfortunately, the House Resolution and the final conference version stuck with the Administration plan. The death tax is death to any incentive to increase assets beyond a certain amount, and the penalty rises with age as one draws closer to the event that triggers the tax. (Suppose a person expects to live until age 85. Put a dollar aside at age 20, and it may earn enough over 65 years to cover the income tax along the way, and the estate tax at age 85, and still be worth a dollar in present value. Put it aside at age 80 and there is no way it can earn enough to handle a 45% hit in 5 years.) I estimate that retaining the estate tax at current levels (instead of letting it expire) would reduce investment and drive wages down by enough to reduce total tax receipts from other sources by about twice what the estate tax brings in. Instead of preserving $26 billion for the Treasury, as in the Budget forecast, keeping the tax rates and credits at 2009 levels will cost $26 billion by 2014. The more generous Senate Budget Resolution reform would do far less good than letting the tax expire, but even that limited improvement would cover its costs and bring in about $2 billion more revenue from other sources. A tax that reduces jobs and incomes so much that it loses revenue, and so cannot even claim to help pay for any government benefit or service, is very bad policy.

The other major tax hike in the President's Budget is the "climate tax", a set of emissions quotas to be auctioned off averaging $66 billion a year from 2012 to 2019. The Budget Resolution also contains a presumed revenue plug from this source. Cap-and-trade auction money would raise the cost of everything that is energy, or is made or moved with energy. Felt by all consumers, it would lower the value of wages and incomes from saving, making it a tax on all labor and capital income, i.e., on all U.S. output. Some of the money would go to subsidize renewable energy that is more expensive than traditional sources because it generates less energy for any given amount of inputs. Pro-growth? Hardly.

To further reduce energy availability, the President's Budget plan would specifically penalize capital investment by energy firms, which would lose the manufacturing credit (a 9% credit against the corporate income tax that effectively lowers the rate from 35% to 31.85%) and face adverse shifts in taxes and fees on offshore production and restricted write-offs of drilling costs and lease payments. The Budget would also hit U.S.-based multinational businesses by restricting the deferral of tax on foreign source income. U.S.-based companies would be less able to compete abroad. They would lose export sales of U.S. goods and services to their shrunken foreign subsidiaries, and reduce their U.S. employment, profits, and tax payments to the Treasury. The Congressional Budget Resolution appears to go along with this philosophy.

It is foolish to claim that the tax increases will not do any damage because the rates will remain at or below some levels of the past, either the income tax levels of the Clinton years or the capital gains and dividend levels of the Reagan years. Those comparisons are not meaningful. The economy has expanded more than it otherwise would have based on the lower tax rates in place today, and raising them from current levels will contract the private sector and wipe out the projected tax revenue.

In tax policy, tax rate reductions on additional capital and labor income that would be good for the long term would be good for the short term too. Tax rate increases would be harmful long term and short. The rebates and non-marginal hand-outs that Keynesians claim will help in the short term would not do so, and would weaken the economy in the long term as tax rates on labor and capital must be higher to pay the added interest on the swollen debt.

There are other concerns with the Budget proposals and the Resolution passed by the Congress. The proposals include a huge increase in government meddling in the economy, would cause the national debt to soar, and would saddle future budgets and future generations with substantially higher amounts of interest and higher taxes. The focus of this piece, however, is on the invalid Keynesian theories regarding "economic stimulus" and the lack of understanding of how taxes and spending actually affect the economy.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.