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COMMENTARY

Save the Bush Tax Cuts

By STEPHEN J. ENTIN
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The most troubling threat to the economy is not a recession induced by subprime loan worries. The drivers of economic growth are factors such as technology, investment and population, and inhibitors of growth include taxes and regulation. These inhibitors -- especially taxes -- are the real source of danger in the years ahead.

Chad Crowe

The likely expiration of the Bush tax cuts is bad enough. More ominous still are the plans to hike taxes on saving and investment that are bubbling away in every congressional committee for whatever program they are currently drafting: energy, agriculture, health, etc. Every liberal member and presidential candidate has his or her favorites.

The Bush tax program, particularly the 2003 Tax Act, boosted productivity by encouraging the investment to make a larger capital stock possible. That investment is what finally kicked the recovery into a higher gear. What was the quantitative effect of the 2003 tax cuts -- and what would be the damage from letting them expire? Here are my estimates, using the Heritage Macroeconomic Seminar service price and tax rate/revenue calculator developed by Gary Robbins, and a simple Cobb-Douglas model of the economy used at the Institute for Research on the Economics of Taxation.

For a capital asset to be worth creating and employing, it must be projected to earn enough to recover its cost before it becomes unproductive (depreciation), pay taxes imposed on its revenues, and leave about a 3% risk-adjusted real (after inflation) rate of return to its owners. That combined gross rate of return is the service price of capital, or the hurdle rate. The lower the service price, the higher the sustainable capital stock, the average wage and the level of GDP. The 2003 Bush tax cut knocked the service price down by nearly 10%.

How? The 15% cap of tax rates on dividends and capital gains was a very large reduction in the double taxation of corporate income. It was equivalent to a big cut in the corporate tax rate and the biggest boost to investment of the Bush tax packages. Lowering the marginal income tax rates in the top four tax brackets cut the service price for noncorporate businesses and rewarded work and risk-taking. The projected end of the estate tax would give a further boost to investment.

Nevertheless, the investment surge from the Bush tax cuts will taper off as the added capital made possible by the lower service price is finally acquired, by about 2008-2013. Historically, it has taken about five years for the quantity of equipment to adapt to major tax changes, and about 10 years for structures. Growth should then revert to a more normal pace, but from a higher base.

Keeping growth near the 3.2% rate of the last three years would require more reductions in the service price of capital. We need more than an extension of the Bush tax cuts: deeper cuts in the tax rate on dividends and capital gains, cutting the corporate tax rate and marginal tax rates on noncorporate businesses, and letting businesses write off their investment spending faster.

If, instead, the Bush tax cuts expire as scheduled at the end of 2010, much of the newly acquired capital made possible by the tax cuts would no longer be sustainable. We would see businesses disinvest -- investment would slump to allow the capital stock to shrink back to old-law levels through attrition. That would flirt with recession.

Ominously, this is exactly what some members of Congress and candidates for president are espousing. They would keep parts of the tax cut that are politically sacred but do little or nothing for growth (the child credit expansion and the 10% bracket, for example), but let the parts that spurred expansion die.

Killing the 15% tax rate caps on capital gains and dividends, the marginal rate cuts, the bracket widening for joint returns (marriage penalty relief), and the partial estate tax relief currently in place, would jump the service price of capital by more than 10% (to 22.5% from about 20.3% currently), according to the Heritage service price calculator. A 10% jump in the service price is a big deal. A lot of capital would be unable to earn enough to pay the higher tax; I estimate that the stock of business plant, equipment, and inventories would ultimately be about 16% less compared to what it would be under current tax rates. Hours worked would fall 2%. Private-sector output and wage and capital income would drop 7%. That would mean an eventual 5%-6% reduction in GDP.

The present Congress thinks it can raise $200 billion a year (at 2006 income levels) by letting the growth provisions of the present tax system die, but with no damage to GDP. Wishful thinking.

The tax calculator shows that a 7% reduction in private-sector income would depress federal individual income-tax revenues by $140 billion (more than a 7% drop because lower incomes drop people into lower tax rate brackets). That's not all.

I estimate that payroll taxes, federal corporate income taxes, customs and excise taxes, and the estate tax would drop $85 billion. Result: a net loss of $25 billion. State and local governments also would take a revenue hit, and likely raise taxes, further depressing GDP. Worse, this would all cost workers and savers roughly $700 billion to $800 billion in lost output and income.

Those would be the permanent effects. The transition is even dicier. Reverting to a lower capital stock would mean slashing business fixed assets and inventories by $2.5 trillion over 10 years. It would require cutting investment spending by 18%, or 1.9% of GDP (more in the first five years, less later). The investment slump would reduce a 2.5% annual expansion to a crawl. If disinvestment spread to the home-building sector, it could mean recession.

Alarmist? Consider precedent. Lyndon Johnson pushed a 10% war surtax on income through Congress in April 1968. It was the primary trigger for the 1969-1970 recession. Congress rushed to end it early in 1970. Investment spending crashed by 7%, and rebounded after the surtax was history. That surcharge had a fraction of the impact on the service price of capital that would occur if the Bush tax cuts expire.

Consider Japan as well. In 1988-1990, the Miyazawa tax program aped and outdid the worst anti-capital elements of the U.S. Tax Reform Act of 1986. Japan instituted a capital-gains tax where there had been none, and ended near universal tax-favored saving incentives for everyone below retirement age. It raised land taxes twice. These hits to capital crashed stock and land prices, made banks insolvent, and crushed investment. It took Japan 15 years to recover.

If Congress goes down this road, expect a similar outcome. When congressmen do not study history, the rest of us are condemned to repeat it.

We should rather be thinking of more rate *cuts*. Growth will slow even if the Bush cuts are simply extended, but we would keep the increase in the base level of GDP they made possible. Letting the cuts expire would undo a fair bit of the capital formation since 2003, forestall gains yet to come, and shunt GDP to a lower baseline. Hiking other taxes would only make matters worse.

Mr. Entin is president and executive director of the Institute for Research on the Economics of Taxation.

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