[Obama versus the supply-siders – to extend the Bush tax cuts or not? That is the question…]

Published by [Jason Welker]

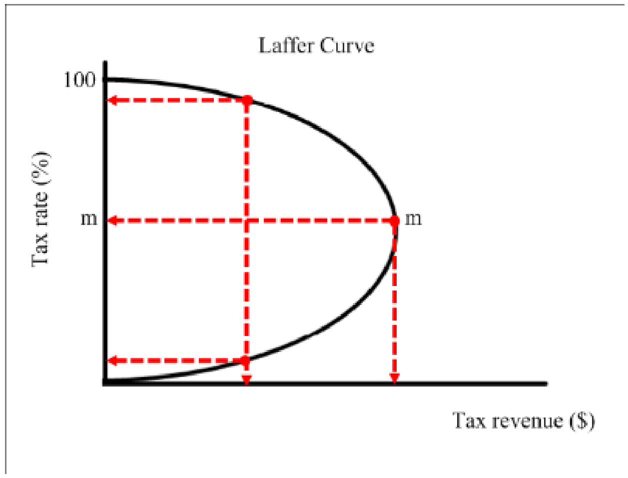
As the United States enters its mid-term election period, one of the major issues being discussed in Washington D.C. is whether or not the "Bush Tax Cuts" of 2001 and 2003 should be extended. In essence, the tax cuts under the previous president lowered America's marginal tax rates at all income brackets. From the Wikipedia article on the ["Bush tax cuts"]:

- a new 10% bracket was created for single filers with taxable income up to $6,000, joint filers up to $12,000, and heads of households up to $10,000.
- the 15% bracket's lower threshold was indexed to the new 10% bracket
- the 28% bracket would be lowered to 25% by 2006.
- the 31% bracket would be lowered to 28% by 2006
- the 36% bracket would be lowered to 33% by 2006
- the 39.6% bracket would be lowered to 35% by 2006

To be clear, the White House and president Obama do not want to repeal all of the tax cuts above, only those enjoyed by those in the highest income bracket. The 35% marginal tax rate only applies to households earning above $250,000 in the United States. This bracket includes less than 2% of American households. So what Obama wants to do is raise the marginal tax rate by 4% on income earned above and beyond $250,000. Only a couple of million Americans will be affected by this tax increase, while more than 98% of American households will experience no increase in income taxes.

The backlash against Obama has been fierce. The main argument against raising taxes on the richest Americans comes from the Republican party, who argue that higher taxes on the rich will decrease the incentive for workers to produce more output and increase productivity to earn higher incomes. In addition, say the Republicans, it is the rich who are the investors, the capitalists, the firm owners in an economy. Increasing income taxes on the rich will decrease their incentive to invest and thus decrease the overall demand for labor in the nation, leading to lower overall levels of employment and national output. This *supply-side* argument claims that higher taxes may in fact lead to less taxable income, thus lower tax revenues for the government.

[The Economist's Free Exchange Blog] wrote a piece last year on supply-side economics and the Laffer Curve, a popular graphic used by the supply-side to argue against increases in taxes.



"The basic reasoning behind the so-called "Laffer curve" is plain, uncontroversial, and by no means was discovered by Arthur Laffer. There is nothing to tax if no one produces anything. But taxes affect the return and therefore the motive to supply labour to economic production. An increase in the tax rate can reduce the pool of wealth to tax — the tax base — by reducing the supply of labour. No taxes, no revenue. Also, 100 percent tax rates, no revenue. Somewhere in between — exactly where depends on, among other things, the responsiveness of labour supply to after-tax wages — there will be a point at which an increase in rates delivers a decrease in revenue. If the tax rate is already past that point, a tax cut delivers more revenue.

…labour supply is just one of many ways in which an increase in tax rates may reduce the effective tax base. In addition to working less, individuals may alter their savings and investment patterns, bargain to shift more of their labour compensation to untaxable perks and benefits, move to a different tax jurisdiction, consume more tax-deductible goods, or simply hide income from the tax authorities."

As Laffer's model shows, at certain tax rates, a tax cut will lead to an increase in tax revenue. So how can policy makers be sure whether the United States is currently at a point on its Laffer curve that an increase in taxes won't result in a decrease in tax revenue?

"Supply-siders" who oppose Obama's plan to repeal the tax cut, and even argue further tax cuts would benefit the US economy, need to look more carefully at where America is on the Laffer curve.

Republican politicians of late have exhibited a dismaying lack of respect for basic science, and it is not much of a surprise that many are also cavalier about fiscal economics. At current tax rates, new cuts will not "pay for themselves" in the short run. Emphasizing this point, however, does not begin to imply that raising tax rates is smart or harmless.

In a separate piece on *the Economist's* blog, the relationship between tax rates and long-run economic growth is further analyzed. The blog presents the main point of the supply-side argument:

Our baseline specification suggests that an exogenous tax increase of one percent of GDP lowers real GDP by roughly three percent.

On the other hand…

…we find that a tax cut of one percent of GDP increases real output by approximately three percent over the next three years.

So do tax cuts “pay for themselves” as some politicians in the United States have argued in opposition to Obama’s desire to let Bush’s tax cuts expire?

Tax cuts don’t exactly “pay for themselves”, but they also don’t diminish revenue after about two years. That is, after about two years, the government receives revenues equal to what it would have received at the higher rate, but taxpayers enjoy a lower burden. It is an important advance to discover that because cuts do lead to an immediate dip in revenue, they often inspire offsetting tax increases that retard the growth effect of the origina cut. Nevertheless, the effect of cuts on output is generally strong enough to bring revenue back to where it would have been otherwise.

So it’s possible that keeping taxes lower may indeed lead to higher growth and more taxable income down the road in the United States. But all the above analysis neglects to take into account one other VERY important consideration that the US government must consider at this point in time. In a year in which several European nations, most notably Greece, have encountered debt crises, the need to generate tax revenues to finance government spending is as important as ever.

Ironically, some of the same people who oppose ending the Bush tax cuts on the rich also oppose deficit financed fiscal stimulus. People like Niall Ferguson argue that continued deficits threaten to “bring down the US bond market” as foreign and domestic investors lose faith in the US government’s ability to pay off its ever growing national debt. These “deficit hawks” argue that the US should take drastic steps to balance its federal budget, much as several European governments have begun to do, to reduce the likelihood that investors will begin demand higher interest rates for investing in government bonds, which in turn could drive up interest rates for the private sector, crowding out private investment and plunging the US economy into another recession.

The tradeoff may come down to this. Higher taxes now, or higher interest rates AND higher taxes in the future. Raising taxes on the rich now will allow the US to achieve a more balanced budget in the future. This means less government borrowing, less government debt, and lower interest rates on government bonds and in the private sector. It also means that there will be less debt to pay interest on, which makes debt repayment (currently almost 10% of the government’s non-discretionary budget), less of a burden in the future. A more balanced budget now (achievable if we repeal the tax cuts for the riches Americans) means less debt in the future, lower taxes in the future, and lower interest rates in the future.

I’ve always said that humans are short-run creatures living in a long-run world. I think Americans epitomize this reality. American voters can always be convinced to vote against new taxes, or vote for the guy who promises to lower their taxes. But in this case, over 98% of Americans will not even be affected in the short-run, however in the long-run the majority stands to gain from tax increases on the rich in the form of less debt to be repaid and more private investment as government borrowing and the resulting crowding-out of interest sensitive spending by the private sector is reduced.

By the way, one of the most prominent supply-side economists of the last half century agrees with me on this one. Here's former Chairman of the Federal Reserve Alan Greenspan arguing for a repeal of the Bush tax cuts:

Discussion questions:

1. Under what circumstances would a tax increase harm not only workers and firms, but reduce government tax revenue as well?
2. What would a Keynesian say about the wisdom of raising taxes at a time when unemployment is as high as it is in the United States right now?
3. How does achieving a more balanced budget now assure that Americans will have to pay less in taxes in the future?
4. Do you believe that asking the riches Americans to pay 4% more in marginal taxes now will lead to more unemployment in America? Why or why not?

About the author: Jason Welker is a teacher at Zurich International School in Switzerland, where he teaches Advanced Placement and International Baccalaureate Economics. In addition to maintaining numerous online resources for economics student and educators, Jason developed the online version of the IB Economics course for Virtual High School and is currently authoring a textbook for IB Economics students for Pearson Baccalaureate which will be available in Spring of 2011. His economics student wiki won the 2007 "Best Educational Wiki" award from the "EduBlog Awards". Read more posts by this author