End the Bush Tax Cuts and Start Over

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Abstract

In a contribution to the CNN.com, Bill Gale discusses Obama's proposal to extend the Bush-era income tax cuts.

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Earlier this week, President Barack Obama proposed to extend the Bush-era income tax cuts, which expire at the end of this year, for one year for people with income below $250,000. People with higher income would continue to receive all of the benefits of lower taxes on their first $250,000 of income, but the tax rate they face on income above that amount would rise.

One might wonder why we need more tax cuts, given that the Congressional Budget Office just released a study showing that tax burdens as a share of income for almost all households were the lowest in 2009 that they have been in decades and given that we face a long-term deficit problem that will require more revenues over time.

The answer, of course, is that taxes are slated to rise at the end of this year, an increase that if allowed in full, along with scheduled spending cuts that came out of the debt limit budget deal in 2011, would hurt an already weakly recovering economy in the short-term and possibly push it back into recession, if not counteracted. The president's proposal would substantially reduce the extent to which taxes are slated to rise.

The president's unwillingness to keep Bush-era tax rates for households with the highest income has been criticized on grounds that it will hurt job-creation efforts and in particular small businesses. These criticisms can be overstated, however.

First, in our current economy, with significant number of unemployed workers, job creation will depend much more on creating an economic stimulus -- that is, by cutting tax levels and by boosting spending by federal, state and local governments and by the private sector -- than a slightly lower marginal tax rate.

Second, the net tax rate businesses actually pay on new investment and new hires, not the tax rate listed in the tax law, is what should drive business choices. The "effective tax rate" takes into account that small businesses can generally write off all of their investment as a deduction in the year the investment is made. This is sometimes called section 179 expensing.

This provision reduces the effective tax rate on new investment financed by the business owner to zero. Yes, zero, because any tax on future investment returns will simply pay the government back for the cost of the deduction. This is true no matter what the tax bracket is for the taxpayer.

Indeed, if they can finance the investment with tax deductible debt payments, small businesses will face an effective tax rate that is actually negative.

Likewise, the calculus of hiring a new worker should take into account the fact that wage payments are deductible for businesses. Hence, if the law imposes a higher statutory tax rate on higher incomes, while it will raise the tax that has to be paid on the proceeds from new investment and new hiring, it also will raise the value of the deductions that most small businesses can take from the new investment and new hiring, and in a way that exactly balances out.

Third, much of the income for small businesses comes in the form of capital gains, which would continue to face a much lower rate than ordinary income.

Fourth, the vast majority, 97%, of people who receive most of their income from business sources are not in the top two tax brackets. Small businesses are essentially used sometimes as a "poster child" by those who wish to avoid higher taxes on other income at high income levels.
Still, while the president's proposal recognizes the need to avoid running straight off the fiscal cliff next January, it could be improved.

First, it does not do enough to promote economic growth in the near term. The economy would still be facing tax increases (due to the end of the temporary payroll tax cut) and government spending cuts (due to the budget deal).

In an economy that is struggling to reduce unemployment, these restrictive measures will not help. European countries have seen the failure of austerity policies and the effects would have the same impact here too.

Rather, the economy needs a bigger stimulus, with a bigger bang for the buck. This could take the form of payroll tax cuts, infrastructure investments and federal aid to states and localities, which have had to cut back on jobs and education and other forms of spending.

Second, the president's proposal prolongs highly partisan debates about the Bush tax cuts and which should be extended and for how long.

A better way to stimulate the economy and move the broader debate forward would be to let all of the Bush tax cuts expire as scheduled and be considered as part of a broader tax reform and medium-term deficit reduction effort, and institute instead an explicitly temporary cut, again a payroll tax cut comes to mind.

Regardless of the fate of the president's proposal, policy makers need to address the weakly recovering economy and build toward a sustainable long-term tax and fiscal solution.

Other Publications by the Authors

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