The End of the Beginning

For a moment, dodge the question of whether the administration’s current tax proposals are the best thing since Velcro or the worst thing since telemarketing. One thing seems certain. We are witnessing the end of the beginning for this administration’s tax policy. Essentially, the administration has shot all its cannons in the war against high tax rates, particularly on capital income. At the same time it has gotten rid of all the artillery generals who planned this strategy in the first place.

Whether or not these battles are won, the new forces to be confronted are not hard to see through the haze. From a budget standpoint, average federal tax rates are now lower than at any time since the middle of World War II, the budget doesn’t even reflect the long-run cost of the new Iraqi build-up, and the baby boom starts retiring within the 5- and 10-year budget windows. From the viewpoint of taxes, the administration’s 2002 policy of accelerating depreciation allowances will soon lead to a deceleration, huge fissures in the tax code remain regarding corporate tax shelters, and the alternative minimum tax is now an adolescent gorilla growing by leaps and bounds each year.

Two forces have dominated the administration’s domestic policy from the beginning. First, it has used the initial budget surplus, the recession, the terrorist attack, and the Iraqi situation as reasons to avoid budget choices that might take some tax or expenditure benefit away from anyone. Thus, it has not pushed to enact any systematic reform that almost inevitably creates losers as well as winners. Every significant enactment so far has involved losing revenues by more spending or more tax cutting — whether this issue has been domestic discretionary spending, defense spending, or tax cuts. So far few benefits, however unworthy, have been taken away from interest groups — as reflected by a dearth of base broadening tax proposals. Preferences sought by many groups — farmers, steel workers, and railroads, among others — have often been expanded.

The second force has been adherence to tax policy driven largely by a supply side orientation toward cutting statutory tax rates and lowering the cost of capital. This is where most all of the tax money has gone, and it was promoted mainly by Larry Lindsey at the White House and Glenn Hubbard at the Council of Economic Advisers, both now gone. The former adhered especially to supply side theory favoring lowering marginal tax rates, while the latter worried both about the cost of capital and addressed the more traditional tax policy concern of favoring one form of capital, such as debt, over another, such as equity. That is an oversimplification, but, still, those were the economic underpinnings to the administration’s tax policy of trying to remove distortions caused by higher marginal tax rates and by the taxation of capital income in general.

But let’s face it. Neither policy orientation is enough to fully define a domestic policy. Neither a policy of dishing out more government benefits or of lowering tax rates tells us how these changes will be covered. Everything the government does has a balance sheet side to it — someone pays for new benefits with higher tax rates; someone pays for lower taxes by receiving fewer expenditures. These are the issues that the administration has been trying to avoid up to the next presidential election.

But can it wait that long? The administration faces a dilemma for 2004. What is it going to do for an encore in an election year? It has appealed to tax cutting so often — as an answer for almost everything that has hit the economy and the nation — that the message is losing its cachet.

Government doesn’t exist to cut taxes. It exists for higher purposes. Among its main purposes is to provide certain necessary services to the public and then to raise the revenues necessary to provide those services. When government gets too large, the agenda can be dominated for awhile by paring and pruning — but even then, the hard work is in cutting out the excess growth of expenditures, not reducing the water supply of taxes.

Thus, it is okay to advocate a smaller government with lower tax rates. Others may disagree with that agenda, largely based on their opinion of the need for larger government. But my point is not over the merit of the agenda, merely that it is not enough. The more successful the administration is at establishing a tax-cutting agenda in the early years, moreover, the less important it becomes in later years. This involves the same classic economic reasoning that underpins the supply side argument behind lower tax rates. If the distortions of higher tax rates are lessened — economic theory indicates that distortions rise exponentially with the tax rate people pay on the next dollar earned — then other societal problems rise in relative importance.

Thus, governing — like most human activities — requires balance. Principles compete against each other, different problems and distortions must be at-
tacked at different times. The battle to remove very high tax rates has now largely been won, at least at the top of the income distribution, and wealthy taxpayers and businesses now often pay marginal tax rates that are lower than those faced by many people of lesser means. It’s time to move on.

Think ahead, then, to 2004. Can the administration get by with simply another set of proposals to reduce tax rates? Can it simply sit back that year and run on what it did in past years? In both cases, I think the answer is likely to be “No.” Thus, we are witnessing the end of the beginning.