The unproven case for tax cuts

George Bush's justification for his proposed across-the-board reductions in income tax fails to convince **Edmund Phelps**

PERSONAL VIEW

Last year, George W. Bush proposed a broad tax cut on the grounds that budgetary surpluses were an illegitimate taking: "It's your money." Now President Bush presents his plan as a cost-free remedy for a subdued US economy.

But a tax cut has to be justified by some weighing of costs as well as benefits, present and future. And on existing prospects, near-term and long-term, a tax cut has no justification. America's economic prospects today are very different from the circumstances that lent justification to Ronald Reagan's tax-cutting programme in the 1980s.

Defenders of the Bush tax cut began badly. When they said lower income taxes would add to the flow of money chasing goods – to effective demand – the reply was that the US Federal Reserve could do that too by further reducing interest rates. When they said that tax rates ought to be low in recessions, high in booms, economists recoiled at the hazards of trying to iron out every twist and turn – including the obstacles to getting rates back up.

To begin on the right foot, the Bush team must argue that a permanent shift of real market forces has dealt the economy a structural setback, over which the Fed has no power, and that the broad tax cut proposed would give a structural lift.

To be fair, there is a view in financial circles that behind the gathering downturn is the end of – or at least a big pull-back from – the structural boom in the second half of the 1990s. The sharp declines last year in both share prices and forecast corporate earnings growth in several industries may reflect a fall-off in the expected future returns from investing. If so, these industries will slow their investments in new employees, new customers and fixed capital to a more normal pace. Then the structural unemployment rate – alias the natural rate – will return to a more normal level of between 4.5 per cent and 5 per cent.

Moreover, there is evidence that cuts in personal income tax rates, which are the largest part of the Bush package, do in fact have an impact on the path of structural unemployment, not just on net pay. A cut of 2 percentage points in the income tax rate might reduce the current unemployment rate by half a percentage point. (A crucial factor is that income tax lowers after-tax pay without hitting most after-tax returns on workers' wealth.)

It is a start, then. Yet these steps in the argument are not sufficient to justify the tax cut. There are issues of fairness and efficiency.

It is not appreciated that if tax rates were cut, say, permanently, the structural lift to employment would fade – counteracted by the extra wealth workers would build up to match their higher take-home pay. Mr Reagan, facing the malaise of a productivity slowdown hoped to be temporary, could defend his tax cut as effective when it was most needed: future generations would bear the cost, as they do for past wars. But Mr Bush cannot demand a temporary fix, pleading relatively hard times, as if the extraordinary boom will resume later.

With the 1981 Reagan tax cut, enough loopholes were closed – an accretion of decades – to replace the revenue lost from the cuts. (The enlarged deficits can be laid to the increased spending on the cold war and entitlements.) It is doubtful if Congress could find nearly enough loopholes this time. If reduced tax rates entailed a net revenue loss each year, they would lead to a larger public debt (or smaller net creditor position) and therefore ultimately increased tax rates to service the larger debt. It is robbing future Peter to pay present Paul. That would be fine if projected future rates were lower than rates now. But they are not.

When Mr Reagan took office, it was credible that future rates would be lower than the rates inherited: the cold war was expected eventually to end. Now, on standard calculations, tax rates will have to rise, sooner or later, for the government to meet commitments under Social Security – America's pension system – to baby-boomers without a whopping increase of future tax rates over present levels. A doctrine known as fiscal neutrality suggests that taxes should be high enough to signal any impending bulge in future public outlays, lest misguided households consume too much now and too little later. A theory of optimal taxes finds that tax rates are best programmed to be level over time.

At his inauguration, Mr Bush envisaged a "nation of justice and opportunity" where "everyone deserves a chance". To that end, the administration ought to jettison a net tax cut and instead pursue two targeted tax reforms, both crafted to hold total revenue unchanged.

A tax credit to encourage start-up companies would create new opportunities over the whole economy. A tax credit for firms employing low-wage workers would boost the chances – the opportunities for employment and self-support – of the less advantaged, which would benefit all society and buttress the enterprise system itself.

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