The Economic Case Against Bush's Tax Cut

by Edmund S. Phelps


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NEW YORK: Washington politicians are worried over signs that America's great structural boom of the past five years is over: a poorer outlook for profits, increased corporate debts, and a related slowing of business investment in fixed capital, new customers and new employees. If the boom is over, the structural unemployment rate – alias the 'natural rate,' or Nairu – will rise to a more normal 4.5 to 5%. Alan Greenspan, chairman of America's Federal Reserve, can help by avoiding tight money but he cannot undo this structural shift.

What is to be done? Talk in Washington portends a lurch away from the "sound finance" of the 1990s – the increased tax rates and tighter grip on spending that replaced budget deficits with budget surpluses. Republicans propose a massive tax cut while Democrats favor a package of greater spending and a lesser tax cut, but which has the same budgetary cost as the Bush plan. Either plan would blow a huge hole in this year's surplus. Future surpluses would disappear by the decade's end, if not sooner.

Several economists object to either course. We agree there may be some welcome effects in both the proposed Republican and Democratic tax cuts. Research – of mine and of others – confirms that changes in personal income tax rates (the largest part of President Bush's plan) do have an impact on structural unemployment, not just net paychecks. It's common sense that an income tax cut, in raising after-tax pay rates, boosts employees' and managers' incentives, reducing costs and raising profitability – in large part because the returns on workers' wealth mostly escapes income tax. What is at issue is the justification for the drug of income tax cuts, with its worsening counter-effects and serious side effects.

The oldest consideration weighing against a tax cut goes back to 1950s neo-Keynesians, who viewed tax cutting as anti-growth. That doubt remains valid. An income tax cut, in stimulating consumer demand, diverts resources from making non-tradable capital goods – plants and offices – to non-tradable consumer goods. In forcing US interest rates higher, such a tax cut would crowd out many other types of domestic investment, which can only serve to slow development of the Internet economy and slow productivity.

Another point against tax cutting echoes Paris economists in the 1980s. The proposed tax cut will boost the dollar. This real exchange rate appreciation will drive customers at American firms to seek suppliers overseas. As a result, more of overseas saving will take the form of net exports to the US. Less of that saving will be available to finance overseas domestic investment. The US government cannot be expected to stifle a once-in-a-generation boom to make life smoother overseas. It can be asked to refrain from willfully cutting into investment and growth in the rest of the world.

An optimistic premise of those who argue for tax cuts is that the income-tax cut they envisage will boost output and hence earnings so much that it will cause little loss of tax revenue. They point to Ronald Reagan's tax cut of 1981 as exhibit "A" supporting their case. But tax revenues were shored up back then by a Draconian closure of tax loopholes. Congress won't find enough loopholes left this time. So the tax cut would impose a burden on the future either in reduced public services from the start or else a public debt ultimately much increased (or net asset position much reduced). This burden may not be fatal, but it should make the tax cut vulnerable to several objections.

A serious objection is that, while the burden of the Bush tax cut would go on forever, its effectiveness would not. With time, the incentive effects would progressively weaken, and the structural lift to employment would disappear, as workers and managers grew wealthier in response to their higher after-tax wages. The Bush team cannot justify this temporary fix on the assumption that the structural deterioration is temporary – for all we know, the future is as likely to get worse as to get better.

Another objection is that, if public services (relative to national income) are not to be cutback, tax rates must sooner or later go higher than they would otherwise have done in order to deal with the increased public debt or decreased asset position (relative to national income) that results. Without foundation, President Bush seems to foresee a future with rates far lower than those prevailing now, thanks to productivity growth – a delight the present generation deserves to share.

On the calculations of experts like Laurence Kotlikoff, however, we must raise tax rates – more the longer we wait – if the government is to meet the Social Security entitlements of "baby boomers" who will retire two decades from now. Tax rates should be raised now to provide better guidance to households about how much they can really afford to spend.

The saddest thing about Bush's economic policy is that it turns its back on Americans' traditional desire to leave the country better off than when they found it. In the 1990s this ameliorist spirit was expressed in the policy of setting tax rates high enough to pay off the government's debts and to emerge with a positive net asset position – and the possibility of falling tax rates in the future. In Washington's lurch toward large tax cuts, even large spending increases, there is a profound – indeed, disquieting – shift in economic philosophy.