Insight

Growth Through Taxes

DOUGLAS HOLTZ-EAKIN | NOVEMBER 8, 2010

Over the last several years, presidential administrations and congresses have engaged in a number of Keynesian fiscal measures: stimulus checks for households, “cash for clunkers,” tax credits for homebuyers, and the gargantuan 2009 stimulus bill. As I testified to the Senate Finance Committee in July, these efforts probably helped stop the sharp decline in economic activity triggered by the financial crisis. But they did not provide so-called “multiplier effects”—increases in economic activity that exceeded the government’s original outlay. Nor did they provide incentives for private business hiring and expansion or otherwise lay the foundation for strong private-sector growth.

America is in desperate need of that growth. True, the economy is growing already: GDP has been rising since the third quarter of 2009, and it grew at an annual rate of 2 percent in the third quarter of 2010. Employment is up from its deepest trough in December 2009. The National Federation of Independent Businesses’ small-business confidence index is up from its March 2009 nadir. Consumer confidence has also risen from its lowest point. The Institute for Supply Management’s closely watched manufacturing and non-manufacturing indices have risen above 50, signaling growth.

However, the pace of growth remains sluggish. This isn’t surprising: economic expansions after severe financial crises tend to be slower than recoveries from conventional recessions, as Carmen Reinhart and Kenneth Rogoff show in *This Time Is Different: Eight Centuries of Financial Folly*. That’s why government policy—in particular, tax policy—should focus on encouraging faster growth, which will slow the increase of the federal debt, help unemployed Americans find work, and generate the resources needed to provide the next generation with a standard of living that exceeds our own.

But where might growth come from? To answer that question, recall that there are four potential sources of GDP growth: households, governments, businesses, and international trade. (I will focus on the first three, noting in passing that the United States has been on the sidelines of international trade agreements for far too long.)

It would be unwise to expect households, the first of these potential sources of growth, to expand the economy robustly. As everyone knows, the bursting of the U.S. housing bubble left many households in mortgage distress. The financial crisis further destroyed household wealth, wiping out $11 trillion in net worth since 2007. So far, the pace of the post-crisis expansion has yielded only modest income growth, so it isn’t surprising that in the third quarter of 2010, household spending grew at a modest 2.6 percent annual rate. Households need to repair their damaged balance sheets as quickly as possible, so tax policy should try to support savings and balance-sheet repair, which would eventually allow consumers to resume spending. (The right policy, by the way, would not be a one-time “stimulus” in the form of tax cuts or income transfers, which would contribute little to these goals.) But even if households are encouraged to get their affairs in order, it may be years before they are able to drive the economic growth that the country needs.

If we can’t count on households to boost growth, what about governments? Federal, state, and local governments face enormous budgetary difficulties, largely because of long-term pension, health-care, and other spending promises, coupled with recent program expansions. Consider the federal budget. Over the next ten years, according to the Congressional Budget Office's analysis of President Obama's budgetary proposals for fiscal year 2011, the deficit will never fall below $700 billion. In 2020, the deficit will be 5.6 percent of GDP—roughly $1.3 trillion—of which over $900 billion will be devoted to servicing debt on previous borrowing.

This dire budget outlook isn't the result of a projected revenue shortfall. The CBO's figures assume that the economy will fully recover over the next decade—indeed, that government revenues in 2020 will be 19.6 percent of GDP, rather than their historic norm of 18 percent. Rather, the reason for the massive future deficits is spending. Federal outlays in 2020 are expected to be 25.2 percent of GDP—about $1.2 trillion higher than the postwar era's customary 20 percent. The consequences of this spending binge will be heavy. For one thing, by 2020, public debt will be 90 percent of GDP, according to the CBO, and a debt-to-GDP ratio of 90 percent or higher is traditionally associated with the risk of a sovereign debt crisis. Also, the CBO analysis projects that in 2015, the federal government will devote 14.8 percent of its revenues to paying down debt—and the credit-rating agency Moody's, in a recent report, has threatened to downgrade the United States from its current AAA rating once the ratio passes 14 percent.

The lesson for our purposes is that Washington must dramatically reduce spending growth and control its debt. No sensible economic growth strategy can be built on greater government spending.

With households and governments facing the task of repairing their balance sheets, America's hope for economic growth lies with business-sector spending and net exports. In the third quarter, fixed investment—that is, spending on physical capital—rose at a meager 0.8 percent rate, held down by the residential sector. But even non-residential investment rose at only a 9.7 percent rate. What's needed now is a tax policy that encourages businesses to spend at a faster rate on innovation, workers, repairs, and new plants and equipment.

The place to start is the corporate income tax, which harms our international competitiveness in two important ways. First, the 35 percent rate is far too high: when combined with state-level taxes, American corporations face the highest tax rates among our developed competitors. The rate should be reduced to 25 percent or lower. Second, the United States remains the only developed country to tax corporations based on their worldwide earnings. Our competitors follow a territorial approach in which, say, a German corporation pays taxes to Germany only on its earnings in Germany, to the U.S. only on its earnings here, and so forth. If we were to adopt the territorial approach, we would place our firms on a level playing field with their competitors.

Proponents of the worldwide approach argue that because it doesn't let American firms enjoy lower taxes when they invest abroad, it gives them no incentive to send jobs overseas. Imagine two Ohio firms, they say: one invests $100 million in Ohio, the other $100 million in Brazil. The worldwide approach treats the profits on these two investments equally, wisely giving the company that invests in Brazil no advantage over its competitor. But this line of reasoning ignores two points. First, because firms all over the world will pay lower taxes than the two Ohio companies, the likeliest outcome of the scenario is that both firms will fail, unable to compete effectively with global rivals. Second, when American multinational firms invest and expand employment abroad, they tend also to invest and expand employment in the United States. In the end, healthy, competitive firms grow and expand, while uncompetitive firms do not, meaning that our goal should be to make sure that American companies don't end up overtaxed, uncompetitive, and eventually out of business.

The corporate tax should be reformed further. At present, companies must depreciate their capital purchases over time. Instead, they should be allowed to deduct immediately the full cost of all investments, which would provide a dramatic incentive for spending. We should also consider phasing out the tax-deductibility of the interest that companies pay on their borrowing. Because this interest is deductible and the companies' own dividends are not, firms have an incentive to borrow excessively. Removing that incentive—making a firm's tax liability dependent not on its financial decisions but on its real economic profitability—would discourage financial engineering and focus corporations on their core mission.

A more competitive corporate-tax system would be a good start in our effort to encourage private-sector growth. But a lot of private-sector economic activity in the U.S. isn't affected by the corporate tax at all. Activity that takes place in sole proprietorships, partnerships, and other "pass-through entities"—organizations whose income is treated solely as that of their investors or owners—is instead affected by the individual income tax. Congress's Joint Committee on Taxation projects that in 2011, $1 trillion in business income will be reported on individual income-tax returns.

It's important to note that nearly half of that $1 trillion—$470 billion—will be reported on returns that, if the Bush tax laws are allowed to sunset, would be subject to the top two income-tax rates of 36 percent and 39.6 percent. A conservative estimate is that more than 20 million workers would be employed by firms directly targeted by those two tax rates. So letting the Bush tax cuts expire would have direct, negative effects on employment. And temporarily extending the cuts would merely keep businesses uncertain about future tax policy. Such uncertainty may itself contribute to businesses' desire to hoard cash instead of spending it.

The way to encourage private-sector growth is thus to make the Bush tax cuts permanent. Not only would this step establish clear expectations and permit long-range business planning; it would also provide immediate short-term economic benefits, as businesses stepped up their spending to match the improved long-run outlook. Note, however, that not all components of the Bush tax laws are equally likely to foster growth. Marginal tax rates and the taxation of dividends and capital gains directly affect companies' decisions about innovation, investment, and savings. But refundable tax credits, marriage-penalty relief, and other targeted incentives within the Bush laws make no contribution to growth. These provisions may become unaffordable luxuries.

Americans—from homeowners to small businesspeople to the millions of unemployed—are in desperate need of faster and prolonged economic growth. Congress should therefore evaluate tax proposals based on whether they're likely to trigger and support that growth. Tax policy can play a key role in spurring an economic recovery—but not without sustained reform of both the corporate and individual income-tax systems.

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