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Getting Taxes All Wrong

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Fiscal Policy: The president seems confused, to put it politely, about the role taxes play in the economy. Unfortunately, Americans are paying a price for his lack of knowledge.

Speaking to potential donors in liberal, high-tech Mountain View, Calif., President Obama said that low taxes are a recipe for backwardness.

"Right now, we've got the lowest tax rates we've had since the 1950 s," Obama told the well-heeled crowd. "And some of the Republican proposals would take it back -- as a percentage of GDP -- back to where we were back in the 1920 s. You can't have a modern industrial economy like that."

These comments, while few in number, encapsulate so many fallacies about taxes and economic growth that it's hard to know where to begin. Let's start with the comment that "we've got the lowest tax rates we've had since the 1950 s."

We're not sure what he means by that. If he means taxes as a share of GDP, in 2010 it was about 15%. But during the 2000 s, it's more like 17.6% -- close to the long-term average of 18.5%.

Taxes as a share of GDP are low right now for one reason only: The economy has been decimated after the financial crisis and nearly three years of Obamanomics.

If Obama is talking about marginal tax rates, which economists believe are most important, then he's simply wrong. Marginal tax rates in the 1950 s were much higher than they are today. For those at the top of the income distribution, the marginal rate for most of the 1950 s was a deadening 91%. Today, it's about 40%.

Maybe that's why we had four recessions from 1949 through 1961. History is clear: The booms of the '60 s, '80 s, '90 s and mid-2000 s were all built on cuts in marginal rates. Obama's comments simply ignore history.

Then there's Obama's comment about the 1920 s. Doesn't he know that the 1920 s were one of the greatest decades for the U.S. economy in our history -- a decade that began with massive cuts in spending, something Obama has refused to consider?

U.S. Treasury Secretary Andrew Mellon engineered major tax cuts in 1921, 1924 and 1926, slashing rates on the highest incomes from 73% in 1921 to 25% by 1929. It didn't "cost" the government a penny of revenue; in fact, the wealthiest Americans' share of total taxes rose from about a third to two-thirds over that time.

As for the impact of those tax cuts on the economy, Veronique de Rugy of the Cato Institute notes that from 1922 to 1929, real GNP grew at an annual average rate of 4.7%, while unemployment fell from 6.7% to 3.2%.

And this record was accomplished while cutting federal spending nearly in half over the decade.

Mellon himself explained it best in 1924: "(H)igh rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business."

Sound familiar? That's exactly our situation today. Ask Coca-Cola CEO Muhtar Kent. The top executive at the U.S.-based iconic global brand told the Financial Times "in many respects" it's easier to do business in places like communist China and Brazil than here.

"They're learning very fast, these countries," he said, citing the complex U.S. tax code as a major reason for America's lost competitiveness.

As Obama ponders raising taxes sharply on those at the highest income levels, he should perhaps be aware that, as Mellon knew all too well, higher taxes can severely hinder an economy's ability to grow.

And if he needs a more modern authority for that, he can just pick up the broadest study yet of U.S. tax shifts since World War II, which found: "Tax changes have very large effects . . . (a) tax increase of 1% of GDP lowers real GDP by roughly 2% to 3%."

Obama should know this because the study's co-author was Christina Romer, chairperson of his Council of Economic Advisers for his first two years in office.

The idea that a "modern industrial economy" needs high tax rates to be successful is a Keynesian fairy tale -- sadly, one that President Obama and his dwindling number of true believers seem to actually believe.

History's verdict on taxes is quite clear: Cut to grow. If only our nation's top elected official knew more economic history and a lot less progressive ideology, we might be growing right now.