Opinion

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Can Obama's tax cut package promote a faster recovery?

Why the Bush Tax Cuts Worked

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<STRONGJeffrey A. Miron is a senior lecturer and the director of undergraduate studies in economics at Harvard University and a senior fellow at the Cato Institute. He blogs at jeffreymiron.com and is the author of "Libertarianism, from A to Z."

Extending the Bush tax cuts — permanently — is a crucial step in restoring economic growth. The Bush cuts provided lower taxes on ordinary income, especially for taxpayers at the high end of the income distribution. These are some of the most energetic and productive people in society; raising tax rates would discourage their effort and entrepreneurship. High-income taxpayers also have multiple ways of avoiding high tax rates, so any revenue gain from raising rates would be modest.

To stimulate work, saving, and investment, tax cuts to favor the taxpayers who respond most to taxes -- the higher income earners.

The Bush cuts also lowered taxes on dividend and capital gains income; maintaining these lower rates is even more important for economic performance. Capital is mobile: when it is taxed heavily here, it flees somewhere else, meaning lower investment and employment in the United States. And because capital income taxes discourage investment or drive it overseas, they generate little if any tax revenue.

Opponents of the tax cuts do not seriously dispute these claims about the productivity benefits of lower rates. Instead, their real objection is that the Bush tax cuts (allegedly) favor the wealthy.

This claim is true in part; lower tax rates on the high income earners are obviously beneficial for those earners. Yet this is only part of the story. To stimulate work, saving, and investment, tax cuts have no choice but to favor the taxpayers who respond most to taxes, as well as those likely to save and invest. That means high income earners. So policy must accept some inequality in exchange for more efficiency.

And in the case of dividend and capital gains taxation, the economy can have its cake and eat it too. These taxes appears to hit wealthy capitalists, but in reality they fall partly on consumers, via higher prices, and on workers, via lower demands for their services when corporations shut down or move overseas. So low taxation of dividends and capital gains helps both low and high income taxpayers.

President Obama is opposed to extending the Bush tax cuts and is instead proposing to allow full write-off of business investment through 2011. This proposal is reasonable, but the impact is likely to be small; this policy merely allows businesses to deduct investment now rather than later as depreciation. Given currently low interest rates, this shifting of expenditure is not worth much.

A different problem with the president’s approach is that it emphasizes short-run stabilization, not long-run efficiency. To prosper over the long haul, the economy needs certainty about taxes, rules, and regulations, not ever-evolving policy initiatives.

Likewise, markets want an emphasis on productivity, not on redistribution. Yet most administration policies have paid off liberal constituencies, from unions to teachers to the green lobby. It may be this tilt that explains the anemic recovery. To restore vitality to U.S. capitalism, the president needs to show real faith in that capitalism. Extending the Bush tax cuts is a good place to start.

Topics: Business, Economy, economic stimulus, taxes