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'Stop Messing With Federal Tax Rates'

By Edward C. Prescott

IT LOOKS LIKE politics is getting the best of things when it comes to tax policy. In order to avoid a logjam, the two sides have agreed to a compromise that will raise taxes on individuals and corporations in an attempt to gather more revenue and shrink the country's budget deficit. This comes at a time when the economy is beginning to show signs of renewed energy and looks to be poised for a solid run of growth that would expand business investment and get more people working.

Is this a grim assessment of the U.S. economic situation? No — such is the sad state of affairs in Germany, a country that just a few months ago seemed like it would finally emerge from the economic Dark Ages that have defined much of the Continent's situation in recent decades. Instead, one of Europe's most important economies may sink even further into its high-tax, high-unemployment and low-growth miasma. We can only hope that this economic power doesn't drag down too many of its neighbors. The flickering light of Europe's economic renaissance has been dimmed, alas, and a looming darkness yet pervades the great land.

But what of this country? If you were under the impression that the scenario I outlined in the first paragraph referred to the U.S., you weren't far off base. Congress has before it the question of whether to extend the tax reform package of 2003. The Senate recently passed a partial package that, among other things, would keep millions of U.S. taxpayers from paying the alternative minimum tax (AMT) next year, but its bill did not extend reduced tax rates for capital gains and dividends beyond 2008, when they expire. This is unfinished business. Currently at 15%, the failure to act will move the rates on capital gains to 20% and those on dividends to an individual's marginal tax rate.

The House is one step ahead, voting to extend the 15% rate for two additional years, to 2010. Better, but still well short of the mark.

Of course, part of the problem here is the same thing that is bedeviling the Germans right now — politics. Political parties have their own incentives and they don't necessarily line up with what may be the best economic policy. For example, when some politicians see the phrase "Bush tax cuts," they may have a very hard time getting beyond the first word. This is natural, I suppose, but not often helpful. So, it may be useful, for starters, for us to stop calling them the Bush tax cuts. That a particular president is in office when certain policies are passed is doubtless of significant political importance, but these considerations just muddy the economic debate, which should focus on the proper level of taxation.

In that spirit, let's drop the word "cuts," too. The problem with advocating a cut in something is that you are necessarily going to stir up political trouble from someone who will want to increase it again. So, even if you are fortunate enough to get your cut enacted, it is likely a matter of time before the political pendulum swings back and someone else gets their increase. And so we got the Reagan tax cuts, the Clinton tax hikes, the Bush temporary tax cuts and . . . who knows what is next? Both sides can't be right, which means something must be wrong.

In the meantime, taxpayers — both consumers and

businesses — are left to wonder and worry what the next tax package will look like, and they are forced to scurry and scheme to take advantage of a current law or to avoid the penalties of the next. Or vice versa. This is no way for a government to treat its citizens.

That our current tax system is complicated and burdensome and absorbs unnecessary amounts of our limited resources is well accepted by most everyone, and this issue was a primary concern of the Advisory Panel on Federal Tax Reform that recently released its recommendations. This problem deserves to be seriously addressed, but we could take a big step in the right direction if we just stop messing with federal tax rates. Maybe Congress should take a cue from the Federal Reserve, which learned a long time ago that oversteering with its policy corrections wreaks havoc with market expectations and impedes economic growth. Just as the Federal Reserve has made it clear that it will strive to maintain low inflation, which has allowed businesses and consumers to invest and plan accordingly, Congress should establish good tax rates and walk away. The people will take it from there.

So what are good tax rates? It's useful to begin with consideration of a simple principle: Taxes distort behavior. From this powerful little sentence comes the key insight that should inform our thinking about setting tax rates. Any tax, even the lowest and the fairest, will cause people to consume less or work less. Taxes that are inordinately high only exacerbate this reaction, and the aggregate accumulation of these individual decisions can be devastating to an economy.

Good tax rates, then, need be high enough to generate sufficient revenues, but not so high that they choke off growth and, perversely, decrease tax revenues. This, of course, is the tricky part, and brings us to the task at hand: Should Congress extend the 15% rate on capital gains and dividends? Wrong question. Should Congress make the 15% rate permanent? Yes. (This assumes that a lower rate is politically impossible.)

These taxes are particularly cumbersome because they hit a market economy right in its collective heart, which is its entrepreneurial and risk-taking spirit. What makes this country's economy so vibrant is its participants' willingness to take chances, innovate, acquire financing, hire new people and break old molds. Every increase in capital gains taxes and dividends is a direct tax on this vitality.

Americans aren't risk-takers by nature any more than Germans are intrinsically less willing to work than Americans. The reason the U.S. economy is so much more vibrant than Germany's is that people in each country are playing by different rules. But we shouldn't take our vibrancy for granted. Tax rates matter. A shift back to higher rates will have negative consequences.

And this isn't about giving tax breaks to the rich. The Wall Street Journal recently published a piece by former Secretary of Commerce Don Evans, who noted that "nearly 60% of those paying capital gains taxes earn less than $50,000 a year, and 85% of capital gains taxpayers earn less than $100,000." In addition, he wrote that lower tax rates on savings and investment benefited 24 million families to the tune of about $950 on their 2004 taxes.

Do wealthier citizens realize greater savings? Of course — this is true by definition. But that doesn't make it wrong. Let's look at two examples: First, there are those entrepreneurs who have been working their tails off for years with little or no compensation and who, if they are lucky, finally realize a relatively big gain. What kind of Scrooge would snatch away this entrepreneurial carrot? As mentioned earlier, under a good system you have to provide for these rewards or you will discourage the risk taking that is the lifeblood of our economy. Additionally, those entrepreneurs create huge social surpluses in the form of new jobs and spin-off businesses. Entrepreneurs capture a small portion of the social surpluses that they create, but a small percentage of something big is, well, big. Congratulations, I say.

Another group of wealthier individuals includes those who, for a variety of reasons, earn more money than the rest of us. Again, I tip my hat. Does it make sense to try to capture more of those folks' money by raising rates on everyone? To persecute the few, should we punish the many? We need to remember that many so-called wealthy families are those with two wage-earners who are doing nothing more than trying to raise their children and pursue their careers. Research has

shown that much of America’s economic growth in recent decades is owing to this phenomenon — we should encourage this dynamic, not squelch it.

But shouldn’t we worry about federal deficits? Isn’t it true that we need to raise the capital gains and dividends rate to capture more revenue and thus help close the widening deficit maw? The plain fact is that last fiscal year the debt-to-GDP ratio (broadly defined) went up only 0.2%. If the forecasted deficits over the next five years are correct, it will begin declining. Tax revenues will rise as economic activity continues to grow — indeed, this has been the case in 2005. Besides, to raise tax rates and thereby dampen economic activity seems a perverse way to improve our economic situation, including our level of tax receipts — 15% of something is better than 20% of nothing.

Congress has some unfinished business regarding these key tax rates. On the assumption that they do not resolve this issue prior to their holiday break, I invite the senators and representatives to speak frankly with folks back home — the small-time investor saving for retirement, the light manufacturer on the edge of town, the hardworking couple across the street — and ask them how these tax rates affect their lives. Our elected officials might be surprised, but they shouldn’t be.

Let’s not fall back into old patterns of oversteering and overtaxing. Let’s not keep trying to trick our citizens into accepting one tax one day, and another tax the next. Let’s not try to tax our way to prosperity. It won’t work for Germany, and it won’t work for us. ■

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