Raising taxes on high earners is sound policy

By Mark Zandi

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Unless Washington acts, we all will pay more in taxes next year. Few think that's a good idea, but there is little consensus on how to change it. President Obama has proposed freezing tax rates for everyone making less than $250,000 a year. His GOP opponent, Mitt Romney, wants not only to include high-income households in the freeze, but also to cut rates further. Who is right?

Before I answer the question, consider some history. President George W. Bush cut tax rates on personal income just before Sept. 11, 2001, to stimulate the economy after the technology-stock bubble burst. It's hard to believe now, but the federal government then was running a budget surplus and the nation's debt was shrinking. The president thought we could afford the tax cuts, but agreed to let them expire at the end of the decade just in case we couldn't.

Some supporters thought the lower tax rates would spur much stronger economic growth, and a few even hoped there would be so many new, high-paying jobs that tax revenues would actually increase, despite the lower rates.

There is no evidence that this happened, however. The nonpartisan Congressional Budget Office recently estimated that the Bush-era tax cuts cost the U.S. Treasury $1.6 trillion during the 2000s. Combined with the $1.2 trillion spent on the Iraq and Afghanistan wars and the $1.8 trillion needed to fight the Great Recession, this put the federal government deeply into the red. The nation's debt load today is as heavy as it has been since the 1940s and getting heavier.

As the Bush-era tax cuts neared their first expiration date at the end of 2010, most economists (myself including) thought Congress should postpone the deadline. The economy, just recovering from the Great Recession, was too fragile to withstand a tax increase, even on only the highest incomes. Obama and the Republican House agreed to extend the tax cuts for two years.

That extension is now nearing its end, and we must decide whether to extend the current rate cuts for everyone again, or only for those making less than $250,000, or to cut taxes even more.

My answer: Extend the tax cuts for everyone except high-income taxpayers. The economy isn't great, but it is strong enough to handle higher tax rates on the wealthy. And we need the extra revenue, which under reasonable assumptions would reduce the federal deficit by nearly $1 trillion over the next decade.

There is appropriate concern that a tax increase will hurt small businesses, many of which are taxed as their owners' personal income. But only a small percentage of small-business owners make enough to be affected by the proposed tax hike, and these do not create many jobs. Most new small-business jobs are created at start-ups, which aren't making much money yet and thus are unlikely to see their taxes rise.

To be sure, raising taxes on high-income households will do some economic damage. But there will be much more economic damage if we don't address our long-term fiscal problems, and this can't reasonably be done without additional tax revenue. Only 3 percent of households will pay the higher tax rates, and most have substantial resources to make up for it. Besides, no group would suffer more if the nation's long-term fiscal problems aren't resolved and the United States suffers a fiscal crisis like the one currently plaguing Europe.

Raising tax rates on wealthier households is necessary, but so, too, are more cuts in government spending. Washington last summer agreed to cut $1 trillion over 10 years as part of the deal to raise the Treasury's debt ceiling. Even with $1 trillion in additional tax revenues from affluent households, it will take an additional $2 trillion in cuts, under reasonable assumptions, to get our fiscal house in order. Given how politically difficult this will be, any agreement to raise taxes on the wealthy should also include more cuts in government spending.

If policymakers follow this script, federal tax revenues will eventually rise to equal just over 19 percent of the nation's GDP, and government spending will fall to the equivalent of 21.5 percent of GDP. These are roughly the average ratios seen since 1980. In other words, government's role in our economy and our lives will be about what it has been for the last three decades. The deficit will still equal 2.5 percent of GDP (21.5 percent minus 19 percent); while more than ideal, this will be manageable, given the economy's expected growth.

What are the odds that any of this will happen? Close to zero before the presidential election, but pretty good early next year, after the Bush-era tax cuts expire and Washington feels intense pressure to act. And this is regardless of how the election is decided.

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