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The Cure to the United States' Economic Slowdown

Thomas Joseph Lonergan

Staff Writer

Abstract

Benjamin Franklin once said, "The only two certainties in life are death and taxes." This infamous saying is as true today as it was more than 200 years ago when it was coined; the only difference between taxes today and taxes in the days of Ben Franklin is the complexity of how taxes are managed. As the American economy teeters on the brink of its second recession in four years, tax reform may be the solution to the economic situation the United States finds itself in today.

Keywords: *tax reform, marginal tax rates, 2012 election*

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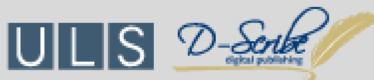

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The Cure to the United States' Economic Slowdown

Thomas Joseph Lonergan
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Benjamin Franklin once said, "The only two certainties in life are death and taxes."[1] This infamous saying is as true today as it was more than 200 years ago when he coined it; the only difference between taxes today and taxes in the days of Ben Franklin is the complexity of how the government manages taxes. As the American economy teeters on the brink of its second recession in four years, tax reform may be the solution to the economic situation the United States finds itself in today. As Andrew Mellon, the longest serving secretary of the Treasury in United States history, described in 1924 in his book *Taxation: The People's Business*, tax reform should consist of three main principles: gain revenue for the government; not burden those who are least able to bear it; and to be sustainable and not simply a band-aid for a few years.[2] All of the former Treasury secretary's key requirements for successful tax reform would be fulfilled through decreasing personal marginal tax rates. This particular reform would also accomplish much more for the economy of the United States in the process.

Over the last few months, discussion about tax reform as a means to stimulate economic growth and lower the growing national debt has increased. Tax reform will promote growth by increasing the amount of money available for the American people to put back into the economy through investment in business or consumption of goods and services.[3] Because of this economic growth, the tax revenue collected through the income tax on new jobs or corporate taxes on payroll and income will rise. This will in turn increase the funds available to the federal government to help lower the national debt. The key to lowering the deficit, though, will be a combination of both tax reform and incremental cuts in wasteful long-term spending by the government. The passage of a balanced-budget amendment would help ensure that the government spends revenue gained through tax system reform on reducing the national debt, rather than on continued deficit spending. Because almost a quarter of the country's gross domestic product (GDP) comes from government spending, the alternative of cutting short-term spending will initially limit the economy's economic growth.[4] Cutting spending and raising taxes would only go so far to lower the debt anyway because of the accumulated interest that must be paid. The growing cost of entitlement programs is preventing any one of these options alone from being a possible solution; this is where tax reform provides a solution.

It may seem counterintuitive that lowering taxes will increase government revenue, but increasing marginal tax rates in fact would have a greater negative effect on the economy. In response to tax increases, Americans change their consumption and investment patterns, choosing to save their money instead of spending it within the economy. This contraction of investment and consumption would reduce tax revenue earned through the income tax and corporate payroll taxes that come about from expansion of the economy and employment. This would ultimately result in a net loss of revenue for the government because the revenue raised by the increase in taxes would not exceed the revenue earned at a lower marginal rate. Additionally, tax increases solely on higher income citizens could have a destructive short-term economic effect. Instead of investing in the expansion of existing businesses or the creation of new businesses, high taxes would force high earners to choose more conservatives ways to invest and save their money.

With bipartisan tensions high in Washington D.C. over the best approach to help jumpstart the economy, the likelihood of Congress and the president working together to pass some kind of tax reform is low. Still, there is no cause for alarm. Historically, tax reform has been a difficult policy to pass in the United States.[5] Since the beginning of the 20th century, only three major tax reforms have taken place to cut personal

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marginal tax rates and change economic incentives: the Harding-Coolidge Reform in the early 1920s under then Treasury Secretary Andrew Mellon, the Kennedy-Johnson Reform in the mid-1960s, and the Reagan Reform during the mid-1980s. Periods of strong economic growth with significant increases in GDP, have followed these three reforms.

The 1920s reform was sparked by fear of a severe post-war recession following a steep decline in trade and production after World War I. In the eight years following the 1920s reform, the American economy grew by more than five percentage points per year, resulting in rapid industrial expansion and job growth within the United States. This set the groundwork for the United States to become the 20th century's dominant global economic force. The Kennedy-Johnson reform in the 1960s contributed to economic growth of almost five percentage points per year, which helped to further the United States' global economic supremacy in the postwar period. The Reagan tax reform in the early 1980s was driven by an economic lull that began during the Ford administration. In the seven years after these cuts, the economy grew by almost four percentage points per year while federal revenues rose by 26 percent. The measures taken by President Reagan to lower the marginal tax rate on personal income eventually paved the way for the economic boom of the 1990s under Presidents Bush and Clinton.[6] In 1994, President Clinton's Council of Economic Advisers summarized the Reagan tax reform's economic benefits, writing that it was "undeniable that the sharp reduction in taxes in the early 1980s was a strong impetus to the economic growth and expansion of that decade."[7]

After looking at the historical effects of lowering the marginal tax rate on personal income, it is evident that reform was a leading factor in sparking growth and bringing the United States out of economic slowdowns. In the present-day United States, there are many ways to promote economic growth through tax reform. During a joint address to Congress in September, President Obama called for reforming the corporate tax code to eliminate loopholes that allow corporations to pay very little in federal taxes. Republican Presidential Candidate Herman Cain has proposed a 9-9-9 Plan, consisting of a nine percent federal sales tax rate, a nine percent flat federal income tax rate, and a nine percent flat federal corporate tax rate.[8] However, to create quick and sustainable economic growth, Congress and the president must revamp the tax code.

The most efficient approach to tax reform is a process outlined by Glenn Hubbard, Dean of Columbia Business School and former Chairman of the Council of Economic Advisors under the Bush Administration, in an August 2011 *Wall Street Journal* article.[9] The first step is to broaden the tax base by making significant cuts in marginal personal tax rates in order to promote investment and spending. By reducing marginal tax rates on savings, capital gains, and dividends, purchases of capital and productivity will increase, resulting in higher wages for workers and greater output from businesses. According to an analysis of the United States tax policy by economists Alan Auerbach and Kevin Hassett, lowering the marginal tax rate and broadening the base will allow GDP to grow between a half and a full percentage point per year over the course of a decade, reducing the unemployment rate by creating jobs.[10]

The second step is to reform business taxation by eliminating double taxation on certain types of business investment. Double taxation occurs when businesses pay corporate income taxes on their profits and then the dividends paid out by the corporation to their shareholders or owners, in the case of small businesses, are also taxed. Owners of small businesses, collectively hit the hardest by double taxation, avoid double taxation by distributing profits among owners instead of leaving a percentage within the corporation as working capital. This has resulted in less working capital being left in the company, which could have been used to hire more employees, expand business, or reinvest. In order to move toward a system which treats all business income equally, tax experts have suggested the integration of individual and corporate tax systems. Under pure systems, known as full integration or the partnership method, retained earnings would be attributed to shareholders who would be required to pay

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taxes on this income. This system would ensure that businesses make financial decisions to hire new employees or expand their operation based on economic indicators rather than tightening budgets to anticipate tax increases.[11]

Third, there needs to be a shift of the United States economy away from consumption and towards production. Since the early part of this century, the economy has become increasingly dependent on consumption and government spending, which decreases investment in capital-intensive products and makes the US increasingly dependent on imports. Reorganizing and rebalancing the economy will require firms to shift towards investment in domestic production with a greater focus on exports as trade becomes increasingly globalized. Two main ways to do this would be to lower the corporate tax rate to make American firms more competitive around the world, and to eliminate the double taxation on businesses' equity while also offering incentives to businesses to invest and expand their business.

Congress has addressed the need for tax reform, most recently during the debt-ceiling crisis in July and August of 2011, but is it a realistic possibility with a highly contested presidential election in the near future that reform will occur? The newest push for tax reform has been in the creation of a bipartisan super committee that consists of six senators and six representatives.[12] Congress tasked the committee with constructing a plan for tax reform that would reduce the federal deficit, with specific targets for tax rates and what loopholes or deductions should be eliminated. The most likely scenario is that the battle over the specifics will be fought in Congress during the course of the presidential election in 2012. The winner of the election in November may ultimately undertake this proposed tax reform as one of his or her first initiatives in office, because of an abundance of political capital. Such an outcome would regrettably push possible economic growth associated with tax reform back until 2013 or later, and the American people would have to continue with the day-to-day effects of a stagnant economy characterized by high unemployment, a volatile stock market, and low investment.

The political climate in Washington also presents a potential impediment to tax reform. With the 2012 election quickly approaching, the Republican leadership in Congress has made it clear that their top political priority is to defeat President Obama in 2012.[13] This will make compromise on any potentially positive legislation difficult. Congress and the president must put their political agendas aside in order to push through the necessary tax reforms that will cause a return to economic growth and prosperity. Without Washington taking these steps, the United States economy could stay stagnant for years to come. In an August 2011 *Wall Street Journal* article, Stephen Moore stated, "there's an old saying that when dollar bills are lying on the sidewalk, someone picks them up. The big question is whether Barack Obama has good sense to do that on tax reform. It may save his presidency."[14]

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Notes

[1] Mark Twain popularized this phrase in the 19th century, but it originates from a letter Benjamin Franklin sent on November 13, 1789 to Jean-Baptiste Leroy; It states, "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes."

[2] Andrew W. Mellon, *Taxation, The People's Business* (New York: Macmillan, 1924), 9-10.

[3] Ezra Klein, "What would Republicans do for the economy? An interview with Rep. Paul Ryan," *The Washington Post*, Internet (accessed November 21, 2011).

[4] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011 to 2021," Congress of the United States of America, January 2011, Internet (accessed November 18, 2011).

[5] In 1913, the 16th Amendment created the United States' progressive tax structure, allowing for the creation of the federal income tax on the incomes of both corporations and individuals.

[6] These numbers were taken from the 1996 Kemp Commission, headed by tax reform proponent, Representative from New York, and former Vice Presidential Candidate Jack Kemp, which was formally known as the National Commission on Economic Growth and Tax Reform (1996).

[7] Christopher Firenze, "The Reagan Tax Cuts: Lessons for Tax Reform," The United States House of Representatives, April 1996, Internet (accessed September 29, 2011).

[8] A more detailed explanation of Herman Cain's 9-9-9 Plan can be found on http://www.hermancain.com/999plan.

[9] Glenn Hubbard, "Tax Reform Is the Swiftest Path to Growth: Broadening the tax base makes possible significant cuts in marginal rates," *The Wall Street Journal*, August 12, 2011, Internet (accessed September 24, 2011).

[10] Alan J. Auerbach is the Robert D. Burch Professor of Economics and Law, Director of the Burch Center for Tax Policy and Public Finance, and former Chair of the Economics Department at the University of California, Berkeley and Kevin Hassett is currently a senior fellow and director of economic policy studies at the American Enterprise Institute. He was John McCain's chief economic adviser in the 2000 presidential primaries and an economic adviser to both George W. Bush's 2004 presidential campaign and McCain's 2008 campaign.

[11] Jonathan Williams and Patrick Fleenor, "Options for Reforming the U.S. Corporate Income Tax," The Tax Foundation, May 8, 2006, Internet (accessed November 21, 2011).

[12] The Super Committee consists of Sen. Patty Murray (D-WA), Sen. John Kerry (D-MA), Sen. Max Baucus (D-MT), Sen. Pat Toomey (R-PA), Sen. Rob Portman (R-OH), Sen. Jon Kyl (R-AZ), Rep. Chris Van Hollen (D-MD), Rep. James Clyburn (D-SC), Rep. Xavier Becerra (D-CA), Rep. Jeb Hensarling (R-TX), Rep. Fred Upton (R-MI), and Rep. Dave Camp (R-MI).

[13] Manu Raju, "Mitch McConnell doubles down against President Obama," Politico, Internet, November 3, 2010, Internet (accessed November 18, 2011).

[14] Stephen Moore, "Tax Reform's Moment?" *The Wall Street Journal*, August 5, 2011, Internet (accessed December 6, 2011).