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MARKETWATCH

Tax Increases Could Kill the Recovery

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The barrage of tax increases proposed in President Barack Obama's budget could, if enacted by Congress, kill any chance of an early and sustained recovery.

Historians and economists who've studied the 1930s conclude that the tax increases passed during that decade derailed the recovery and slowed the decline in unemployment. That was true of the 1935 tax on corporate earnings and of the 1937 introduction of the payroll tax. Japan did the same destructive thing by raising its value-added tax rate in 1997.

The current outlook for an economic recovery remains precarious. Although the stimulus package will give a temporary boost to growth in the current quarter, it will not be enough to offset the combined effect of lower consumer spending, the decline in residential construction, the weakness of exports, the limited availability of bank credit and the downward spiral of house prices. A sustained economic upturn is far from a sure thing. This is no time for tax increases that will reduce spending by households and businesses.

Even if the proposed tax increases are not scheduled to take effect until 2011, households will recognize the permanent reduction in their future incomes and will reduce current spending accordingly. Higher future tax rates on capital gains and dividends will depress share prices immediately and the resulting fall in wealth will cut consumer spending further. Lower share prices will also raise the cost of equity capital, depressing business investment in plant and equipment.

The Obama budget calls for tax increases of more than $1.1 trillion over the next decade. Official budget calculations disguise the resulting fiscal drag by treating Mr. Obama's proposal to cancel the 2011 income tax increases for taxpayers with incomes below $250,000 as if they are real tax cuts. The plan to modify the Alternative Minimum Tax to avoid increases for some taxpayers is also treated as a tax cut.

But those are false tax cuts in which no one's tax bill actually declines. In contrast, the proposed tax increases are very real. And despite the proposed tax increases, the government's new spending and transfer programs would cause the annual budget deficit in 2019 to exceed $1 trillion, or 5.7% of GDP.

Mr. Obama's biggest proposed tax increase is the cap-and-trade system of requiring businesses to buy carbon dioxide emission permits. The nonpartisan Congressional Budget Office (CBO) estimates that the proposed permit auctions would raise about $80 billion a year and that these extra taxes would be passed along in higher prices to consumers. Anyone who drives a car, uses public transportation, consumes electricity or buys any product that involves creating CO2 in its production would face higher prices.

CBO Director Douglas Elmendorf testified before the Senate Finance Committee on May 7 that the cap-and-trade price increases resulting from a 15% cut in CO2 emissions would cost the average household roughly $1,600 a year, ranging from $700 in the lowest-income quintile to $2,200 in the highest-income quintile.

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Conclusion

Since the amount of cap-and-trade tax rises with income, the cap-and-trade tax has the same kind of adverse work incentives as the income tax. And since the purpose of the cap-and-trade plan is to discourage the consumption of CO2-intensive products, energy or means of transportation by raising their cost to consumers, the consumer-price increases would be the same for a 15% reduction in C02 even if the government decides to give away some of the CO2 emissions permits.

But while the cap-and-trade tax rises with income, the relative burden is greatest for low-income households. According to the CBO, households in the lowest income quintile spend more than 20% of their income on energy intensive items (primarily fuels and electricity), while those in the highest-income quintile spend less than 5% on those products.

The CBO warns that the estimate of an $80 billion-a-year tax increase could be significantly higher or lower, depending on how the program is designed. The Waxman-Markey bill currently before Congress calls for reducing greenhouse gasses 20% by 2020 and by an incredible 83% by 2050. As the government reduces the amount of CO2 that is allowed, the price of the CO2 permits would rise and the pass-through to consumer prices would also increase.

The next-largest tax increase -- with a projected rise in revenue of more than $300 billion between 2011 and 2019 -- comes from increasing the tax rates on the very small number of taxpayers with incomes over $250,000. Because this revenue estimate doesn't take into account the extent to which the higher marginal tax rates would cause those taxpayers to reduce their taxable incomes -- by changing the way they are compensated, increasing deductible expenditures, or simply earning less -- it overstates the resulting increase in revenue.

Since the projected revenue from this source is already designated to be used for Mr. Obama's health plan, some other tax increases will be needed. Moreover, Mr. Obama's budget characterizes the projected $634 billion outlay for healthcare reform as just a down payment on the program. The budget notes that there would be "additional resources and new benefits to be determined with Congress." Those additional resources would no doubt be even higher taxes.

The third major tax increase is the plan to raise $220 billion over the next nine years by changing the taxation of foreign-source income. While some extra revenue could no doubt come from ending the tax avoidance gimmicks that use dummy corporations in the Caribbean, most of the projected revenue comes from disallowing corporations to pay lower tax rates on their earnings in countries like Germany, Britain and Ireland. The purpose of the tax change is not just to raise revenue but also to shift overseas production by American firms back to the U.S. by reducing the tax advantage of earning profits abroad.

The administration is likely to be disappointed about its ability to achieve both goals. Bringing production back to be taxed at the higher U.S. tax rate would raise the cost of capital and make the products less competitive in global markets. American corporations would therefore have an incentive to sell their overseas subsidiaries to foreign firms. That would leave future profits overseas, denying the Treasury Department any claim on the resulting tax revenue. And new foreign owners would be more likely to use overseas suppliers than to rely on inputs from the U.S. The net result would be less revenue to the Treasury and fewer jobs in America.

It's not too late for Mr. Obama to put these tax increases on hold. If he doesn't, Congress should protect the recovery and the longer-term health of the U.S. economy by voting down this enormous round of higher taxes.

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