Originally published in **The Financial Times**

March 19, 2012

Obama's tax hikes threaten a new US recession

By MARTIN FELDSTEIN

The recent payroll gains and the declining unemployment rate in the United States have raised hopes that the economy will now start growing faster than the tepid 1.7 per cent rate of last year. Optimists are expecting growth rates as high as three per cent for this year and next.

I hope they are correct. The recession that began in December 2007 was deep and painful and the recovery that began in June 2009 has been slow and grinding in spite of unprecedented fiscal outlays and an even larger monetary stimulus. House prices have continued to fall and housing construction remains dormant because of the Obama administration's failure to reduce the large number of homeowners whose mortgage debt exceeds the value of their homes. Business investment has been depressed by the anti-business rhetoric and policies of Mr Obama's government.

While payroll employment has been rising by more than enough to absorb the growth of the labour force, the expansion in gross domestic product has been weak and most of that increased production has gone into inventories rather than into final sales to households, businesses and foreign buyers. The latest official estimate indicated GDP grew at 3 per cent in the fourth quarter of last year but final sales constituted only 1.1 per cent of that, with the rest going into inventories. Estimates by Macroeconomic Advisers for January indicate an annualised GDP growth rate of 2.5 per cent, but also suggest that final sales declined.

The jump in the consumer price index for February resulted in real average hourly earnings falling in that month. Higher prices and falling real incomes caused the Michigan consumer sentiment survey to decline this month.

Looking to the future, there are strong headwinds that will make it difficult to achieve a robust recovery. Higher petrol prices will reduce real incomes and cut spending on domestic goods and services. The weaknesses in many European economies will lead to reduced US exports to those countries.

But the most important cloud on the horizon is the large tax increase that will occur next year unless legislation is passed to block it. The Congressional Budget Office predicts that, under current law, the revenue of the federal government will rise from $2.4tn in the current fiscal year, which ends in September, to $2.9tn in the following fiscal year. That increase of $512bn is equivalent to 2.9 per cent of GDP, bringing federal revenue as a share of GDP from 15.8 per cent this year to 18.7 per cent next year.

The higher revenue would reflect an increase in personal tax rates, higher payroll taxes, as well as higher taxes on dividends, capital gains and corporate incomes. Revenue would continue to rise in future years – as a share of GDP it would increase to 19.8 per cent in 2014 and would stay above 20 per cent for the remainder of the decade.

A sustained tax increase of that magnitude would push the US into a new and deep recession next year. So, it is important to recognise that legislation is required to prevent such a tax rise.

Getting that legislation passed will be difficult. Mr Obama has said he wants to keep the high rates for upper income taxpayers and to raise total taxes on corporations and other businesses. The Republicans in Congress and the Republican presidential candidates have indicated they want to avoid all of the increases that are specified in the current law and to start a process of tax reform. So the 2013 tax rates will depend on the outcome of the presidential elections in November.

Many political analysts predict that Republicans will maintain control of the House of Representatives and become the majority in the Senate but that Mr Obama will be re-elected. While this “most likely” outcome may not occur, the potential tax consequences pose a serious risk to the economy not only in 2013, but this year as well.

A Republican Congress could vote to eliminate the tax increases but a re-elected President Obama could veto the legislation. While neither party would want to see the economic downturn that would result from failure to achieve a compromise, political accidents do happen.

The risk of dramatic tax increases and an economic downturn next year affects the behaviour of businesses and households today. Companies that expect large tax hikes in 2013 and potentially another downturn in the near future will be reluctant to invest or hire this year. And individuals who think their personal taxes may rise next year will also cut back on current spending on “big ticket” and other discretionary items.

America needs to reform its tax rules and entitlement programmes. But we can do this in a way that strengthens confidence and raises the rate of economic growth. The dramatic rise in federal revenue starting next year that is built into current law would undermine the economy and threaten this year’s rate of expansion. The political choice has never been more important for the nation’s economic outlook.

The writer is professor of economics at Harvard University and was President Ronald Reagan’s chief economic adviser