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What's So Good about America's Tax Package?
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CAMBRIDGE –The tax package agreed to by President Barack Obama and his Republican opponents in the United States Congress represents the right mix of an appropriate short-run fiscal policy and a first step toward longer-term fiscal prudence. The key feature of the agreement is to continue the existing 2010 income-tax rates for another two years with no commitment about what will happen to tax rates after that.

Without that agreement, tax rates would have reverted in 2011 to the higher level that prevailed before the Bush tax cuts of 2001. That would mean higher taxes for all taxpayers, raising tax liabilities in 2011 and 2012 by about $450 billion (1.5% of GDP).

Because America's GDP has recently been growing at an annual rate of only about 2% – and final sales at only about 1% – such a tax increase would probably have pushed the US economy into a new recession. Although the new tax law is generally described as a fiscal stimulus, it is more accurate to say that it avoids a large immediate fiscal contraction.

The long-term implications of the agreement stand in sharp contrast both to Obama's February 2010 budget proposal and to the Republicans' counter-proposal. Obama wanted to continue the 2010 tax rates permanently for all taxpayers except those with annual incomes over $250,000. The Republicans proposed continuing the 2010 tax rates permanently for all taxpayers. By agreeing to limit the current tax rates for just two years, the tax package reduces the projected national debt at the end of the decade (relative to what it would have been with the Obama budget) by some $2 trillion or nearly 10% of GDP in 2020.

That reduction in potential deficits and debt can by itself give a boost to the economy in 2011 by calming fears that an exploding national debt would eventually force the Federal Reserve to raise interest rates – perhaps sharply if foreign buyers of US Treasuries suddenly became frightened by the deficit prospects.

The official budget arithmetic will treat the agreement on personal-income tax rates as a $450 billion increase in the deficit, making it seem like a big fiscal stimulus. But the agreement only maintains the existing tax rates, so taxpayers do not see it as a tax cut. It would be a fiscal stimulus only if taxpayers had previously expected that Congress and the administration would allow the tax rates to rise – an unlikely prospect, given the highly adverse effects that doing so would have had on the currently weak economy.

Even for those taxpayers who had feared a tax increase in 2011 and 2012, it is not clear how much the lower tax payments will actually boost consumer spending. The previous temporary tax cuts in 2008 and 2009 appear to have gone largely into saving and debt reduction rather than increased spending.

It is surprising, therefore, that forecasters raised their GDP growth forecasts for 2011 significantly on the basis of the tax agreement. A typical reaction was to raise the forecast for 2011 from 2.5% to 3.5%. While an increase of this magnitude would be plausible if a forecaster had previously expected tax rates to increase in 2011, it would not have been reasonable to forecast 2.5% growth in the first place with

that assumption in mind. So, either the initial 2.5% forecast was too high or the increase of one percentage point is too large.

What is true of the agreement is also true of the decision, as part of that agreement, to maintain unemployment insurance benefits for the long-term unemployed. This, too, is essentially just a continuation of the status quo. No new benefit has been created.

The most substantial potential boost to spending comes from a temporary reduction of the payroll tax, lowering the rate paid by employees on income up to about $100,000 from 6.2% to 4.2%. But, while the decline in tax payments will be about 0.8% of GDP, it is not clear how much of this will translate into additional consumer spending and how much into additional saving. Because this tax cut will take the form of lower withholding from weekly or monthly wages, it may seem more permanent than it really is, and therefore have a greater impact on spending than households' very feeble response to the previous temporary tax changes.

The final component of the agreement is temporary acceleration of tax depreciation, allowing firms in 2011 to write off 100% of capital investment immediately, in contrast to the current rule, which stipulates a 50% immediate write-off, followed by depreciation of the remaining 50% over the statutory life of the equipment. But, at a time when interest rates are very low and large businesses have enormous amounts of cash on their balance sheets, this change in the timing of tax payments is not likely to do much to stimulate investment.

A greater stimulus to business investment may come from the perception that Obama's agreement to extend the personal-income tax cuts for high-income individuals signals his administration's reduced antagonism to business and the wealthy. Obama's recent statement that he favors reforming personal and corporate taxes by lowering rates and broadening the tax base reinforces that impression. Let's hope that's true.

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