Originally published in **The Wall Street Journal**

May 12, 2010

Extend the Bush Tax Cuts—For Now

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This is not the time for a tax increase. But unless Congress acts, under current law the existing income tax rates will rise sharply at the beginning of next year. Congress should vote now to extend all of the current tax rates for two years, including the tax rates on dividends, interest and capital gains. Limiting the resulting tax-rate cuts to two years would reduce the projected future fiscal deficits. The sooner Congress acts, the stronger our prospects for continued economic recovery.

A tax increase next year could easily derail the current fragile expansion. The economic upturn since last summer has been nurtured by Federal Reserve credit like the mortgage purchase program and by the fiscal incentives such as the tax credits for car buyers and first-time home buyers that are now coming to an end.

Eighty percent of the latest quarterly GDP increase consisted of a rise in consumer spending that was the result of an unrepeatable sharp drop in the saving rate. Without that decline in the saving rate, the first-quarter annual GDP growth rate would have been less than 1%. A 2011 tax increase that reduces economic incentives and household spending would raise the risk of a new economic downturn.

President Obama proposes to increase tax rates on high-income households while making the existing tax rates permanent for taxpayers below the top tax brackets. While the increase would hit only a relatively small fraction of all households, that group represents a large share of total taxes and of private spending. Raising their tax rates would be a substantial blow to overall spending and therefore to GDP growth. Small business investment and hiring would also be adversely affected because half of all profits, including most of small business income, is taxed at personal rates rather than at the corporate rate.

Although it is important to avoid increasing the current tax rates until the recovery is well established, the enormous budget deficits that are now projected for the rest of the decade must not be allowed to persist. While legislation to reduce future government spending or faster-than-expected income growth could shrink the out-year deficits, it would be dangerous to depend on either of them.

It would be wrong therefore to commit to the permanent reduction in tax rates for all taxpayers below the top brackets that is called for in the Obama budget. Changing the Obama budget proposal to limit all tax cuts to two years would reduce the total deficits over the next decade by more than $2 trillion. No single policy change could do as much to limit the future deficits and the national debt.

Such a limit on the future tax cuts should be combined with policies to slow the growth of spending. According to the Congressional Budget Office (CBO), the president's budget implies that total federal spending, excluding interest on the government debt, will rise to 21.1% of GDP in 2020 from 17.9% in 2007. If Congress cares about future deficits, it will prevent that unprecedented rise in government spending. It will also do more to deal with the spending programs that are hidden in the tax law like the health-insurance subsidy, the child-care credits, and the deductibility of local property taxes.

Failure to cut future deficits would mean a weaker recovery and slower long-term growth. The CBO estimates that annual deficits under the Obama budget will average more than 5% of GDP between now and 2020, enough to absorb all of the current saving of households and corporations. If that happens, the U.S. will be forced to depend on a greater inflow of funds from the rest of the world to finance investments in housing and in business structures and equipment. The result is likely to be much higher interest rates, reducing investments and therefore slowing the growth of our standard of living.

According to the CBO, the large projected budget deficits imply that the government debt would rise to 90% of GDP by the end of the decade, about twice the debt-to-GDP ratio in 2008. Paying the interest on that government debt in 2020 would require about 40% of all personal income tax revenue. With half of the government debt already held by foreigners and with that share inevitably rising in the years ahead, there might well be a temptation to erode the real value of the debt with higher inflation.

The fragility of the economic recovery means that it would be dangerous to allow any taxes to rise in 2011. The inherent uncertainty about the out-year deficits means that it would be unwise to enact tax cuts that stretch beyond the next two years. Congress should move quickly to reassure taxpayers and financial markets that the current tax rates will be preserved for two years but that further tax cuts will depend on the future fiscal outlook.

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