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Economic growth options

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Federal Reserve Chairman Alan Greenspan said recently that the economic slowdown might last despite the Fed rate cuts. His comments notwithstanding, there is no reason for us just to sit like toads and wait for some favorable alignment of the stars. We can revive high growth if we so choose.

Tax changes can be made, that would not reduce tax revenue over the long run but would give the economy and the financial markets an immediate boost. Congress should reduce the capital gains tax rate from 20 percent to 15 percent. Congress should also improve the treatment of business depreciation rules by passing the High Productivity Investment Act (HPI), proposed by Reps. Philip English, Pennsylvania Republican, and Richard Neal, Massachusetts Democrat.

The capital gains tax rate is above its "revenue maximizing rate," which means we can actually increase revenue from the tax by reducing the tax rate. Individuals and businesses have a great deal of discretion as to when they choose to realize their capital gains, and therefore make such decisions in part based upon the tax consequences. If they perceive that the rate is too high, they will choose not to sell until they have offsetting capital losses. This is known as the "lock-in effect."

Over the past 30 years, the government has raised and lowered the capital gains tax rate at least six times. Each time the federal government has lowered the capital gains tax rate, capital gains tax revenues have risen. Each time the rate has been raised, capital gains tax receipts have fallen. Both the theoretical and empirical evidence strongly indicates that another cut in the rate will increase government revenues, cause a jump in stock values, and increase economic growth.

Some leading Republicans and Democrats have indicated they would be receptive to a capital gains rate cut, and thus the administration should call upon the Congress to pass one in the next few weeks. There will be a few who will claim the reduction in capital tax rates is unfair because it "benefits the rich." Such individuals are either ignorant or demagogues because it is those without jobs or who might lose their jobs that have the most to gain from the economic dynamism caused by a capital gains tax rate reduction.

An analysis of the HPI by the highly regarded Institute for Research on the Economics of Taxation (IRET) concluded that the effect of the HPI would result in "higher labor productivity, wages, and employment." The HPI would enable business to deduct the cost of their capital equipment faster than is currently allowed. Such a change in the law is not a tax cut, but merely a reduction in the interest-free loans businesses are forced to give government because of existing unfair depreciation rules. Former senior Treasury Department official Stephen Entin, who is president of IRET, states the HPI is "projected to cost between $280 and $320 billion over 10 years, on a static basis" (i.e., assuming no change in behavior as a result of the tax change). "But because faster writeoff of equipment has historically been one of the strongest growth-inducing tax changes, the dynamic result of the HPI would be little or no revenue reduction for the federal government. State and local governments would experience a revenue increase. Family income would jump."

The administration should also scrap the Qualified Intermediary rules (QI), and IRS reporting rules on foreign investment into the U.S., which the Clinton administration implemented during their last several months in office. The QI rules force foreign institutions that invest in the United States to report the nationality of each of their investors. The IRS reporting rule would require the IRS to report to foreign governments how much interest and dividend income their citizens have made by investing in the U.S. There is evidence these rules may be driving hundreds of billions of dollars out of the US, thereby reducing the value of our stock markets, which in turn reduces our economic growth and job creation. These rules were designed to catch a few U.S. and foreign tax evaders but, by reducing needed investment, the result has been to hurt American investors and workers, and to destroy legitimate financial privacy for many individuals.

If a few on the left begin their predictable whine over who seems to benefit from these tax changes, the president and the pro-growth members of Congress need to say in blunt terms: "Get over it, stop acting like children, and look at who benefits most from the long term effects of these tax changes, not just who gets the immediate benefit." Pro-growth politicians need to stop being defensive about acting like adults. They should demand from all of the nay-sayers, including those in the media, to specifically name the growth maximizing tax rate for each tax. Most of them are incapable of answering the question in a responsible manner, and thus they ought to be told to do their homework or be quiet. Too many have suffered far too long from bad policies brought to us by economic illiterates.

In the past, the Office of Tax Analysis in the Treasury and the Congressional Joint Tax Committee staff have often grossly underestimated the dynamic effects of capital gains and depreciation tax changes, resulting in very bad revenue forecasts. Both agencies totally missed the big surge in tax revenues that led to the budget surplus. If these agencies cannot get the numbers right, then the staff should be dismissed for incompetence, and the revenue-estimating task should be turned over to private forecasters who have been much closer to the mark.

Again, as Mr. Entin has noted: "Doing nothing to rejuvenate the economy will condemn us to a prolonged period of suboptimal economic growth. Family incomes would languish. Federal, state, and local government revenues would deteriorate, and the condition of the Social Security and Medicare programs would all suffer." The tax changes proposed above, coupled with a noninflationary or deflationary monetary policy from the Federal Reserve, will quickly lead us back to high growth. With these changes, no one will be disadvantaged and all will gain, except those who thrive on dependency, discord and despair.

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