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Rational compassion
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How can we stimulate economic growth and create more jobs? Political leaders, economists, administration officials and media commentators have been opining on the matter and four alternative approaches have emerged. The first is for the government to spend more money. The second is to have a tax cut directed at low- and moderate-income people. The third is to cut corporate taxes, and the fourth is to do nothing.

Suppose you wanted to make a rational decision based on the evidence (a very un-Washington thing), which alternative would you choose?

The alternative of government spending more money has an appeal to those who like simple solutions without thinking about the consequences. Their argument is if the government spends more money on government workers and transfer payments, the recipients will have more money to spend on consumption and this will stimulate the economy and create jobs. What they ignore is the government can only obtain the money to spend by taxing someone else or borrowing the money.

If government obtains the money through increased taxation, it will take out of the economy an amount equal to what is spent plus an amount to cover the cost of tax collection both by the taxpayer and the government. In addition, the government will reduce the incentives for the taxpayer to work, save and invest. Hence, this approach is clearly a loser because it ends up not increasing but decreasing the number of jobs and economic growth. This effect can be seen in the tendency of countries with very large government sectors to have higher unemployment and lower economic growth rates than those countries with smaller government sectors. (This is one of the reasons socialism does not work.)

If government merely borrows the money to spend, the effects are a little less damaging than increasing taxes, but additional borrowing does take needed capital (the "seed corn") out of the economy. If this capital is invested by the private sector and not borrowed by government, it will almost always generate a higher return and create more jobs than if spent on government transfer programs.

The second major alternative that has been proposed is to have a tax cut aimed at low- and moderate-income people. However, most of them now pay very little if any income tax (the bottom 50 percent of the taxpayers pay only 4 percent of the tax). Thus, to give them a tax cut, it probably would be necessary to expand the existing low-income tax credits or add new ones. The effect of expanding these tax credits is almost identical to increased government spending. The costs to the economy again will be greater than the benefits. Remember, the main advantage of tax cuts is they reduce the disincentives to work, save and invest, and these effects are most powerful at high marginal tax rates (20 percent and above) and not at the low rates (10 percent to 15 percent) faced by most moderate-income people.

The third alternative is to reduce corporate tax rates. Corporate capital is now taxed at extremely high rates. First the corporation pays a 35 percent tax and then the individual stockholder often pays taxes on the same income at rates exceeding 40 percent when federal and state income taxes are paid on the dividend.

Assume you own a trucking company that pays corporate tax. If the tax rate is reduced, you have more money to buy new and more trucks. The new trucks will need new drivers. Replacing the old trucks means fewer breakdowns and more productivity. The increased profit from the new trucks could mean you might pay more tax even though the tax rate is lower. The new truck drivers will also be paying income tax. We know that most businesses have rates of return far higher than the cost of government borrowing money.

Therefore, if the rate of return on additional business investment is 10 percent and the cost of the government borrowing money is 5 percent, it is rational economic policy to reduce the tax on business to get more investment even though the deficit might be bigger in the short run.

There are many taxes whose reduction would bring more benefits than their costs over the long run, even though in the short run cutting them would add to the deficit. (At the moment there are a number of companies that are being sold for less than the cash they have in the bank. The only reason they are not shut down and the cash distributed to the stockholders, who could use it for great benefit, is the high tax on dividends.) The problem in understanding and achieving good tax policy is what sounds rational and compassionate often does not benefit the poor, and what seems to benefit the rich often provides greater benefits to the poor.

The last alternative is to do nothing. Doing nothing would do less damage than spending more money or giving low-income tax credits. But, given that we can do better than nothing — by removing counterproductive tax rates — it is responsible to do so.

In order to achieve better tax policy, the administration will need to spend more time educating members of Congress and the press about the real problems with the tax system and then propose appropriate changes. The administration also must realize that no matter what is proposed, the irresponsible will scream, "it is a give-a-way to the rich" — and the decibels of their screams will bear no relation to what is proposed.

Hence, the administration should propose the tax changes that will be most cost-effective in creating economic growth and new jobs. They then should enlist a number of highly regarded economists to help explain it to the opinion leaders and to help the people understand two things:

(1) To create more jobs and increase economic growth, taxes need to be reduced on those who already face high and even prohibitive tax rates.

(2) Increasing the deficit in the short run to finance the right type of tax cut is both rational and compassionate economic policy.

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