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Bolder strokes

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The reason President Bush's tax cut proposal is in trouble is not that it is too big, but because it is not bold enough in removing all taxes from saving and investment.

The tax cut debate has clearly shown that among opinion leaders and member of Congress, the split is roughly equal between those who understand how the economy works and those who don't (or choose not to understand). The president and his advisers felt that bringing forth a modest tax proposal that was a step in the right direction would reduce the political demagoguery of the opposition.

It has not. It has only diminished the size and enthusiasm of the coalition who favor the tax bill, and the economic benefits that would stem from a larger and properly structured tax cut.

Assume for the moment that you want a world where everyone has equal wealth. You notice that wealthier people have more savings — cash, stocks and bonds — than poor people. Hence, you decide to place a 100 percent tax on interest earnings, capital gains and dividends, and then give these tax receipts to the poor.

What would happen? Most people would give up their interest-bearing accounts and sell their stocks and bonds, and the government would have no extra revenue to distribute to the poor.

But it gets worse. Without a pool of savings, people wanting to start or expand businesses would not be able to borrow the necessary funds or sell stock and hence they could not hire people and buy the necessary equipment. Existing companies would go out of business because no one would have any incentive to hold their stock, and the managers of the business would eventually distribute the existing assets of the firm to the owners, which would soon be consumed. The result of such a tax policy would make everyone poor.

Those who advocate income redistribution schemes, such as those tried in many other countries, cannot point to a successful example. Despite our income disparities, the fact is the bottom 20 percent in the U.S. have on average higher real disposable incomes than the bottom 20 percent in any other country on the planet.

Do you think that most of this group would trade a lower living standard for more income equality?

Given the failure of the 100 percent tax on savings and investment, assume you decide to reverse course and not tax it at all — no tax on interest earnings, no corporate income tax, no death taxes and no tax on dividends and capital gains. What would happen? Suddenly people would have a much greater incentive to save and invest. With the bigger pool of savings, it would be easier for people to start a new business and obtain the necessary funds.

The result would be a larger demand for new plant and equipment and a big increase in demand for workers to staff the new businesses and produce the new equipment.

Existing businesses would find it easier to obtain loans or sell additional stock for expansion and then also hire more workers and buy more equipment. The increase in demand for workers would lower unemployment, create many more opportunities for new workers and bid up real wages. The additional financial capital available would spur research and innovation that would increase productivity, thus creating more wealth for everyone.

According to a recent paper by Nobel Prize-winning economist Robert E. Lucas Jr., where he carefully reviews the existing economic research, the single best thing we could do to improve the well-being of all Americans year after year, is to remove all taxes from savings and investment. Government could maintain or even increase its total tax take by moving to a consumption-based tax system. Almost all serious economic studies of the shift from taxing saving and investment to taxing consumption shows large increases in real after-tax incomes for virtually everyone. Critics will scream "giveaway to the rich," but the political fact is most Americans have savings accounts and own stocks and bonds, and care more about jobs and getting rich than punishing those who are already rich.

The Bush administration moved a step in the right direction by proposing the elimination of the double tax on corporate dividends.

But, if they had gone much further and proposed not only eliminating the tax on dividends, but also eliminating the tax on interest and capital gains, they would have broadened their constituency for the tax bill, while those in the opposition would have been no more shrill.

Now is a good time to eliminate interest and capital-gains taxes because of the existing low interest rates and depressed stock market prices. The revenue receipts from these taxes are currently low — and so the static revenue loss numbers will be modest. Even though these measures will increase the deficit in the short run, since the increase in private saving will fully offset the government decrease in saving, it will have no measurable effect on interest rates.

By removing taxes from saving and investment, the economy will grow faster and attract more and needed foreign investment funds (particularly if we avoid French inspired reporting proposals).

Governments are capable of making everyone poor. They are not capable of making everyone rich, but government can create an environment where almost everyone has the opportunity to at least become well off.

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