Make the Tax Cuts Work

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New York Times, January 23, 2008—SINCE 2001, Washington's answer to every policy question has been the same. What should we do with a big surplus? Tax cuts. How do we beat back global terrorism? Tax cuts. Increase energy independence? Rebuild New Orleans? Expand health insurance coverage? Tax cuts, tax cuts, tax cuts.

Now comes another question that becomes more pressing each day that the markets lose ground—one to which taxes have long been at least part of the answer. How do we stimulate the economy to prevent or shorten a recession? One way would be to repeal the Bush tax cuts two years early, in 2009.

It's true that more tax cuts this year could help head off a recession in the short run. Washington could send taxpayers rebate checks or give businesses temporary breaks for new investments in equipment. President Bush is likely to propose both as part of his $150 billion package of emergency measures.

Similar efforts in 2001 and 2002 had mixed results at best, but so long as the tax breaks are temporary, they wouldn't do much long-term economic harm either. That said, the president's proposal would leave out 37 percent of households because they do not earn enough to pay income taxes. A credit against payroll taxes or, better still, increasing transfers to the low-income families most likely to spend the money—say, by temporarily increasing food stamps—would do more to energize the economy.

There's bipartisan agreement that something along these lines should be done, but the president has also argued for an extension of his tax cuts, now scheduled to expire at the end of 2010. This idea has met with less support. It would accomplish nothing in the short run, and most of the benefits would go to the very rich—the group least likely to spend a tax windfall.

But if they were repealed in a year, the Bush tax cuts could spur a burst of economic activity in 2008. If people knew that their tax rates were going up next year, they'd work to make sure that more of their income is taxed at this year's lower rates. Investors would likewise have a giant incentive to cash out their capital gains now to avoid paying higher taxes later. In 1986, stock sales doubled as taxpayers rushed to avoid the capital gains tax rate increase scheduled for 1987. If people pour their stock gains into yachts and fast cars, that's pure fiscal stimulus.

The money involved could be considerable. Capital gains in 2007 were something like $700 billion, representing well over $1 trillion in asset sales. It looks as if gains will be much lower in 2008, but a looming tax increase could easily spur an additional $500 billion in sales. If only 20 percent of that translated into extra spending, we'd have as much or more short-term stimulus as we could get from the package Congress and the president are considering.

Best of all, this is one stimulus proposal that would reduce the deficit — the single largest threat to the economy's long-term health. And that long-term benefit wouldn't depend on our getting the timing and amount of stimulus right, something policymakers are notoriously inept at.

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