Worksheet 19.1

Obama versus the Supply-siders

As the United States entered its mid-term election period in late 2010, one of the major issues being discussed in Washington D.C. was whether or not the 'Bush Tax Cuts' of 2001 and 2003 should be extended. In essence, the tax cuts under the previous president lowered America's marginal tax rates at all income brackets.

1. a new 10% bracket was created for single filers with taxable income up to $6,000, joint filers up to $12,000, and heads of households up to $10,000
2. the 15% bracket's lower threshold was indexed to the new 10% bracket
3. the 28% bracket would be lowered to 25% by 2006.
4. the 31% bracket would be lowered to 28% by 2006
5. the 36% bracket would be lowered to 33% by 2006
6. the 39.6% bracket would be lowered to 35% by 2006

President Obama was not proposing to repeal all of the tax cuts above, only the ones enjoyed by those in the highest income bracket. The 35% marginal tax rate only applies to households earning above $250,000 in the United States. This bracket includes less than 2% of American households. Obama proposed raising the marginal tax rate by 4% on income earned above and beyond $250,000.

The backlash against Obama's proposal was fierce. The main argument against raising taxes on the richest Americans came from the Republican party, who claimed that higher taxes on the rich would decrease the incentive for workers to produce more output and increase productivity to earn higher incomes. In addition, said the Republicans, it is the rich who are the investors, the capitalists, the firm owners in an economy. Increasing income taxes on the rich would only decrease their incentive to invest and thus decrease the overall demand for labor in the nation, leading to lower overall levels of employment and national output. This *supply-side* argument claims that higher taxes may in fact lead to less taxable income, thus lower tax revenues for the government.

With concerns over the level of the US national debt, Obama believed that higher taxes on the rich would help the US balance its budget and restore confidence in the private sector, thereby encouraging firms to invest and households to consume more.

By 2011, the unemployment rate in the US was still hovering between 9 and 10%, while the national debt grew to almost 100% of the nation's GDP. Interestingly, international demand for US government bonds remained strong and therefore the US government could continue to borrow money at just 2% interest, historically low borrowing costs, especially considering the uncertainty over future deficits.

Many in the US believe that the government should take advantage of the low interest rates and borrow more money for a second stimulus, but others argue that more debt will only increase uncertainty in the private sector and force a future government to raise taxes to eventually pay down the debt. Lower taxes and reduced government spending, argue the supply-siders, will encourage more private spending, return the economy to healthy growth, and eventually lead to more tax revenues as the nation's income rises due to a revitalized private sector.

The tradeoff may come down to this: higher taxes now, or higher interest rates AND higher taxes in the future. Raising taxes on the rich now will allow the US to achieve a more balanced budget in the future. This means less government borrowing, less government debt, and lower interest rates on government bonds and in the private sector. It also means that there will be less debt to pay interest on, which makes debt repayment (currently almost 10% of the government's budget each year), less of a burden in the future. A more balanced budget now means less debt in the future, lower taxes in the future, and lower interest rates in the future.

Questions:

1. Under what circumstances would a tax increase harm not only workers and firms, but reduce government tax revenue as well?
2. What would a Keynesian economist say about the wisdom of raising taxes at a time when unemployment is as high as it is in the United States right now?
3. How does achieving a more balanced budget now assure that Americans will have to pay less in taxes in the future?
4. The supply-side argument against higher taxes is that it reduces the private sector's willingness and ability to spend on investment and consumption. Do you believe higher taxes on the richest 2% of income earners in a nation will have a large negative impact on private spending? Why or why not?