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## Obamanomics Meets Incentives

### Why cuts in marginal tax rates increase economic growth, but cash for clunkers merely created a boom and bust cycle in auto sales.

By [ROBERT J. BARRO](#)

One memorable phrase from the Reagan administration is "supply-side economics." These catchy yet misleading words pertain not to supply versus demand but rather to incentives, good or ill. For income taxes the key point is that cuts in marginal tax rates spur the economy partly through enhanced supply (greater work effort, higher productivity) and partly through expanded demand (increased investment in plant & equipment and in R&D).

Reagan cut the average marginal income tax rate to 21.8% in 1988 from 29.4% in 1981. The GDP growth rate between 1982 and 1989 was a strong 4.3% per year, and I estimate that 0.6% per year of that seven-year growth came from the tax cuts. Similarly, George W. Bush cut the average marginal rate to 21.1% in 2003 from 24.7% in 2000. The GDP growth rate between 2001 and 2005 (including negative effects from the 2001 recession) was a respectable 2.7% per year, and I estimate that 0.5% per year of that four-year growth reflected the tax cuts.

Now the Obama administration is considering whether to maintain the Bush tax cuts or let them expire. Unfortunately, little of the administration's analysis refers to incentives. Rather the discussion is mainly about whether the poor or the rich spend a greater fraction of added disposable income, whether the rich can afford to pay more taxes, and so on.

From the standpoint of incentives, the important point is that higher marginal tax rates harm the economy. For example, if all of the 2003 Bush tax cuts (which alone reduced the average marginal rate by two percentage points) were undone for 2011, I estimate that GDP growth for 2011-12 would be reduced by 1.1 percentage points.

Incentive-based arguments imply that it is best to cut marginal rates where they are the highest—usually at the top of the income distribution but sometimes for poor people who lose transfer-payment eligibility by earning more money. A common suggestion is to cut the Social Security payroll tax, but this change is less effective than a cut in the federal individual income tax. In contrast to the income tax, the payroll tax is nearly a flat tax and therefore generates a lot of revenue compared to the marginal tax rate.

Some of President Obama's economic agenda does rely on incentives, a notorious example being cash for clunkers. The two main responses to this program were destruction of functional old cars and acceleration of purchases of new cars. Hence, used-car prices went up and automobile sales followed a boom-and-bust pattern. In other words, incentives worked but in an unhelpful manner.

A more favorable case is the recent proposal for accelerated depreciation allowances for business investment. This change has good economic incentives and ought to be a permanent part of the tax system. Unfortunately, the stimulative effects are likely to be weak in an economy where nominal interest rates are close to zero. With low interest rates, businesses value near-term depreciation allowances only a little more than far-off allowances.

Last year's extension of unemployment-insurance eligibility to 99 weeks had incentive effects as well, though not in the way it was intended. According to the most recent Labor Department statistics, 57% of all persons receiving unemployment benefits were on extended programs—persons unemployed more than 26 weeks—and the share of the unemployed getting benefits of some form was 67%.

We know from the U.S. Bureau of Labor Statistics (BLS) that in early August 6.25 million or 42% of the unemployed had been unemployed more than 26 weeks. If we subtract the 5.67 million getting extended unemployment-insurance benefits, we can estimate that 580,000 persons were unemployed more than 26 weeks and not getting benefits. That is, around 11% of the 4.93 million unemployed without benefits were in the greater-than-26-weeks category.

If more data were available, we could do serious research on the determinants of unemployment duration for those eligible or ineligible for benefits (by taking into account differences across the two groups in work experience and other characteristics). Yet even with the available data, it is not a great stretch to infer that the main reason for the sharply higher unemployment duration among those receiving benefits is the eligibility up to 99 weeks. In a weak economy, extended benefits incentivize unemployment even when the benefits offered by unemployment insurance replace only around 40% of previous wages.

My hope is that the administration will shift away from programs based on Keynesian reasoning and toward policies that emphasize favorable economic incentives. Extension of the full tax cuts of 2001-03 and a reduction in the period of eligibility for unemployment insurance would be good starts.

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