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How to Really Save the Economy

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THE United States is in the third year of a grand experiment by the Obama administration to revive the economy through enormous borrowing and spending by the government, with the Federal Reserve playing a supporting role by keeping interest rates at record lows.

How is the experiment going? By the looks of it, not well.

The economy is growing much more slowly than in a typical recovery, housing prices remain depressed and the stock market has been in a slump — all troubling indicators that another recession may be on the way. Most worrisome is the anemic state of the labor market, underscored by the zero growth in the latest jobs report.

The poor results should not surprise us given the macroeconomic policies the government has pursued. I agree that the recession warranted fiscal deficits in 2008-10, but the vast increase of public debt since 2007 and the uncertainty about the country's long-run fiscal path mean that we no longer have the luxury of combating the weak economy with more deficits.

Today's priority has to be austerity, not stimulus, and it will not work to announce a new \$450 billion jobs plan while promising vaguely to pay for it with fiscal restraint over the next 10 years, as Mr. Obama did in his address to Congress on Thursday. Given the low level of government credibility, fiscal discipline has to start now to be taken seriously. But we have to do even more: I propose a consumption tax, an idea that offends many conservatives, and elimination of the corporate income tax, a proposal that outrages many liberals.

These difficult steps would be far more effective than the president's failed experiment. The administration's \$800 billion stimulus program raised government

demand for goods and services and was also intended to stimulate consumer demand. These interventions are usually described as Keynesian, but as John Maynard Keynes understood in his 1936 masterwork, “The General Theory of Employment, Interest and Money” (the first economics book I read), the main driver of business cycles is investment. As is typical, the main decline in G.D.P. during the recession showed up in the form of reduced investment by businesses and households.

What drives investment? Stable expectations of a sound economic environment, including the long-run path of tax rates, regulations and so on. And employment is akin to investment in that hiring decisions take into account the long-run economic climate.

The lesson is that effective incentives for investment and employment require permanence and transparency. Measures that are transient or uncertain will be ineffective.

And yet these are precisely the kinds of policies the Obama administration has pursued: temporarily cutting the payroll tax rate, maintaining the marginal income-tax rates from the George W. Bush era while vowing to raise them in the future, holding off on clean-air regulations while promising to implement them later and enacting an ambitious overhaul of Wall Street regulations while leaving lots of rules undefined and ambiguous.

Is there a better way? I believe that a long-term fiscal plan for the country requires six big steps.

Three of them were identified by the Bowles-Simpson deficit reduction commission: reforming Social Security and Medicare by increasing ages of eligibility and shifting to an appropriate formula for indexing benefits to inflation; phasing out “tax expenditures” like the deductions for mortgage interest, state and local taxes and employer-provided health care; and lowering the marginal income-tax rates for individuals.

I would add three more: reversing the vast and unwise increase in spending that occurred under Presidents Bush and Obama; introducing a tax on consumer spending, like the value-added tax (or VAT) common in other rich countries; and abolishing federal corporate taxes and estate taxes. All three measures would be enormously difficult — many say impossible — but crises are opportune times for these important, basic reforms.

A broad-based expenditure tax, like a VAT, amounts to a tax on consumption. If the base rate were 10 percent, the revenue would be roughly 5 percent of G.D.P. One

benefit from a VAT is that it is more efficient than an income tax — and in particular the current American income tax system.

I received vigorous criticism from conservatives after advocating a VAT in an essay in *The Wall Street Journal* last month. The main objection — reminiscent of the complaints about income-tax withholding, which was introduced in the United States in 1943 — is that a VAT would be a money machine, allowing the government to readily grow larger. For example, the availability of easy VAT revenue in Western Europe, where rates reach as high as 25 percent, has supported the vast increase in the welfare state there since World War II. I share these concerns and, therefore, favor a VAT only if it is part of a package that includes other sensible reforms. But given the likely path of government spending on health care and Social Security, I see no reasonable alternative.

Abolishing the corporate income tax is similarly controversial. Any tax on capital income distorts decisions on saving and investment. Moreover, the inefficiency is magnified here because of double taxation: the income is taxed when corporations make profits and again when owners receive dividends or capital gains. If we want to tax capital income, a preferred method treats corporate profits as accruing to owners when profits arise and then taxes this income only once — whether it is paid out as dividends or retained by companies.

Liberals love the idea of a levy on evil corporations, but taxes on corporate profits in fact make up only a small part of federal revenue, compared to the two main sources: the individual income tax and payroll taxes for Social Security and Medicare.

In 2009-10, taxes on corporate profits averaged 1.4 percent of G.D.P. and 8.6 percent of total federal receipts. Even from 2000 to 2008, when corporations were more profitable, these taxes averaged only 1.9 percent of G.D.P. and 10.3 percent of federal receipts. If we could get past the political fallout, we could get more revenue and improve economic efficiency by abolishing the corporate income tax and relying instead on a VAT.

I had a dream that Mr. Obama and Congress enacted this fiscal reform package — triggering a surge in the stock market and a boom in investment and G.D.P. — and that he was re-elected.

This dream could become reality if our leader were Ronald Reagan or Bill Clinton — the two presidential heroes of the American economy since World War II — but Mr. Obama is another story. To become market-friendly, he would have to abandon most of his core economic and political principles.

More likely, his administration will continue with more of the same: an expansion of payroll-tax cuts, short-term tax credits, promises to raise future taxes on the rich, and added spending on infrastructure, job training and unemployment benefits. The economy will probably continue in its sluggish state, possibly slipping into another recession. In that case, our best hope is for a Republican president far more committed to the principles of free markets and limited government than Mr. Bush ever was.