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Robin Hood Can't Lead Us Out of the Debt Hole

Obama's obsession with higher tax rates on the rich is not helpful.

By ROBERT J. BARRO

The impasse over the debt ceiling has our federal government on the verge of default, according to President Obama. Yet one obstacle to reaching a sound agreement on fiscal policy is Mr. Obama's recurring Robin Hood obsession. No matter what is at stake in terms of fiscal stability, economic growth and even unemployment, he always returns to his desire to take more from our nation's famously odious millionaires and billionaires.

Frankly, raising marginal tax rates on the highest-income earners is not helpful for creating a meaningful economic recovery.

Our present fiscal situation grew out of the events of the past three years. In the wake of the financial turmoil of 2008, massive bailouts by the U.S. and other countries were unfortunate but necessary. The depression threat was too serious to allow the collapse of systemically important institutions. Allowing Lehman Brothers to fail was an error. And it was a lesson quickly learned by the government, which did not let it happen to AIG, Morgan Stanley, Citigroup and other large financial institutions.

What came after the financial crisis was a different matter, especially the Obama administration's $800 billion-plus stimulus package of 2009. This intervention was largely a waste of money and has sharply enlarged the hole facing the U.S. economy.

The Obama administration has consistently overestimated the beneficial effects of government spending by using an unrealistically high spending "multiplier" of two or more. According to this Keynesian logic, government expenditure is more than a free lunch. By spending a dollar, we not only get back that dollar but also another dollar of free consumption or investment. This idea, if correct, would be even more brilliant than the magic of creating mounds of AAA mortgage-backed paper out of heaps of underlying garbage. With unemployment at 9.2% and consumption still at abysmal levels, it's clear the Keynesian magic did not work.

Moreover, the Obama administration's deficit financing has led to a sharp increase in our debt-to-GDP ratio, which the Congressional Budget Office now projects will soar to 70% by the end of

this year—the highest percentage since shortly after World War II. This much public debt eventually requires higher taxes (unless future spending is cut by even more). But higher taxes lead to additional decreases in future economic growth.

While running budget deficits was appropriate during the Great Recession, reductions in marginal tax rates—to enhance incentives for investment and economic growth—would have been better than more spending. Unfortunately, the Obama administration's only recognition of the importance of marginal tax rates came in the December 2010 agreement. This preserved the income tax rate structure enacted by President Bush in 2001-03 and introduced a reduction in the Social Security payroll tax.

So where do we go from here?

The excellent report released last December by the bipartisan National Commission on Fiscal Responsibility and Reform—and the pressure from widespread fears about fiscal instability—provide some hope that the U.S. government will eventually reach a rational agreement. Reductions in the long-term path of entitlement outlays have to be central, with increases in ages of eligibility for Social Security and Medicare a part of any solution.

Nevertheless, the inevitable growth of the main entitlement programs means that federal revenues will have to increase in the future. To be sure, a return to healthy economic growth will supply some of this, but there will have to be tax reforms as well.

One possible package of reforms would include setting the U.S. corporate and estate tax rates permanently to zero. These taxes are inefficient and generate little revenue. Also, to restore a more efficient allocation of capital across the economy, we should phase out—gradually—tax preferences for home-mortgage interest, state and local income taxes, and employee fringe benefits. Marginal income tax rates should also be lowered across the board. Finally, to raise additional revenue to meet entitlement obligations, we could adopt some kind of broad-based, flat-rate consumption tax such as a value-added tax of the kind used in Europe. In this country, a rate of 10% with few exemptions should raise around 5% of GDP annually.

The political danger of a value-added tax is that it is so efficient at raising money it will encourage governments to grow even larger. That's why it only makes sense as one component of a fiscal reform, including reductions in the long-term path of entitlement outlays.

We also need sharp reductions in spending programs initiated or expanded by Mr. Obama and his extravagant predecessor, President Bush. Obvious candidates for cutting include ethanol and farm subsidies, education spending under No Child Left Behind, outlays for high-speed rail, and expansions of Medicare and Medicaid.

Republicans have been using an increase in the debt ceiling as a lever to persuade the president and congressional Democrats to accept major reductions in spending without raising marginal tax rates. This strategy seems sensible, and it's a red herring to argue that the debt ceiling should be raised immediately in a "clean" fashion to avoid default.

A default on U.S. government bonds would be awful, but there's no way it has to happen. In fact, Treasury Secretary Tim Geithner should take this issue off the table by announcing that if the debt ceiling is not raised he would use the available federal revenue first to cover the required payments on U.S. bonds. Any other course of action would be deeply irresponsible.

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