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In Defense of Obamanomics

History shows that the president's tax plans are consistent with strong economic growth.

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If leadership is defined as recognizing a crisis, addressing its challenges, and setting new directions while remaining true to one's values, then Barack Obama is already demonstrating his strengths as a leader. He has inherited an economic crisis worse than any the nation has experienced since the Great Depression. Within fewer than 50 days in office he has signed a historic stimulus package to bolster demand and create 3.5 million jobs. Governors, business leaders and economists from both the left and the right have applauded the stimulus. Friday's distressing employment numbers indicate that much more may be needed.

President Obama has also proposed a 10-year budget that is faithful to the progressive vision he articulated during his campaign. His budget includes significant investments in health care, energy, the environment and education, and a tax cut for the middle class. It also calls for higher taxes on the top 3% of income earners to finance his priorities and reduce the deficit. Not surprisingly, a budget plan this ambitious is triggering strong and well-organized opposition on numerous fronts.

The opposition begins, predictably, with taxes, so it is important to understand the major tax changes President Obama is proposing and their underlying rationale. President Bush's tax cuts are scheduled to expire at the end of 2010. At that time, assuming the economy has entered a recovery, President Obama's budget will restore the top two marginal income tax rates to their 1990s levels of 36% and 39.6% for individuals earning more than $200,000 and couples earning more than $250,000. These changes will affect only the top 3% of taxpayers, the group that has enjoyed the largest gains in income and wealth over the last decade. In addition, for these taxpayers the tax rate on capital gains will increase to 20%, the lowest rate in the 1990s and the rate President Bush proposed in 2001, and the tax rate on dividends will increase to 20%, a rate lower than the rate of the 1990s and nearly 40% lower than that proposed by President Bush in 2001.

Critics charge that President Obama's tax rates for high-income earners will strangle small business and stifle economic growth. Such claims are misguided or disingenuous. A full 97% of small businesses will see their rates unchanged or enjoy additional tax benefits under the Obama plan. And the strong expansion of the 1990s proves that the tax rates on income, capital gains and dividends in the Obama budget will support rapid economic growth and substantial income gains at the top. Moreover, the higher tax revenues resulting from these rates will reduce the deficit by about $750 billion, bringing it down to an average of 3.9% of GDP over the next 10 years and to 3.1% of GDP by the end of the decade. This compares to an average deficit of 3.6% of GDP between 1982 and 1997, when the Dow Jones

Industrial Average increased by 835%.

In addition, the president proposes to limit the deductions for dependents, charitable contributions and other expenses to 28%, the top rate for such deductions under Ronald Reagan. Some critics claim this is class warfare. But why should a family in a higher tax bracket get a bigger break on expenses than a middle-class family? And restoring this limit to its Reagan level will raise enough revenue to cover about half of the $634 billion reserve President Obama needs to finance health-care reform with the other half coming from savings in health spending. These savings include competitive bidding in order to reduce Medicare payments to private insurance plans, increasing the Medicaid rebate for brand-name drugs, and strengthening Medicare pay-for-performance incentives for hospitals.

Those who stand to lose from these changes are already protesting. But like the 28% limit on deductions, these savings are fair and reasonable ways to finance the twin goals of achieving universal health-care coverage and moderating the growth of health-care spending. The rising cost of health care per patient not just for Medicare and Medicaid but throughout the health-care system is the principal driver of the government's long-term deficit and debt problems. For more than 40 years, this cost has grown much faster than the overall economy and if the current rate continues, by 2050 Medicare and Medicaid will account for about 20% of GDP, and the national debt will soar to 300% of GDP. These are unsustainable outcomes. Health-care costs must be contained through significant investments in health information technologies, disease management techniques, and wellness and prevention programs. And these investments must begin now. The stimulus package contains over $20 billion for such investments and they are major priorities in the budget.

Reducing the nation's dependence on foreign oil and cutting carbon emissions are also priorities, supported by overwhelming scientific evidence on the risks and costs of climate change. Economists agree that establishing a price for carbon emissions either through a carbon tax or a cap-and-trade system is essential to achieving these goals. The Obama administration has opted for the latter. The system will impose a limit on the amount of carbon that businesses are allowed to emit each year. Firms will be required to purchase permits from the federal government through an auction and will then be free to buy and sell them.

Critics of a cap-and-trade system are correct when they claim it will raise the prices of goods and services whose production and use emit carbon. That's exactly the point: Higher prices are necessary to encourage energy efficiency and the development of renewable energy, to discourage carbon emissions, and to reduce the societal costs of global warming. The Obama auction plan will also generate substantial government revenues, about 80% of which will be used for financing a refundable tax credit of up to $400 for individuals and up to $800 for families. The result will be tax cuts for 95% of working Americans. The remaining 20% of the auction revenue will be used to finance investments in energy efficiency, clean energy and smart-grid technologies.

Even the investments in education contained in the Obama budget will galvanize critics. Some will oppose the expansion of the federal government's funding for early childhood education despite evidence that it is among the best investments the government can make not only for children but for the economy as a whole.

Others will oppose expanding the tax credit for college tuition to $2,500 a year and making it permanent and partially refundable; increasing the Pell Grant to $5,500 a year; and eliminating subsidies to banks participating in the student-loan program, cutting $50 billion from the 10-year deficit. But, again, the returns to higher education are substantial for both the individual and the overall economy. Too many American students are forced to forego these returns because they cannot afford a college education, with deleterious effects on the nation's competitiveness.

The president's budget is progressive and ambitious. It will not, however, explode the size of government as some critics warn. If the economy recovers as projected, over the next decade taxes as a share of GDP at around 19% will be lower than they were during the second half of the 1990s, government spending as a share of GDP at around 22.5% will be about where it was under Reagan, and nondefense discretionary spending at around 3.6% of GDP will fall to its lowest level since that data was first collected in 1962.

The real risk lies in the possibility that the economy's recovery starts later and is much weaker than the economic assumptions in the budget. In this case, by no means remote, President Obama will have to adjust his plans while remaining true to his values. In a very few days in office, he has already demonstrated that he has the leadership skills to rise to the challenge.

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