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The Lurking Dangers in the Hubbard Tax Hike Compromise

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Glenn Hubbard, dean of the Columbia Business School and until recently the top economist in the Romney campaign, opined in the *Financial Times* on November 13 that Congress and President Obama should seek to raise taxes on the well-to-do by means other than raising tax rates. Hubbard suggested scaling back the deductions available to upper-income taxpayers.

This formulation is sensible only if one presumes a tax hike. The troubles with Hubbard's argument are many, beginning with the presumption that a tax hike is inevitable.

The Hubbard Argument. The Hubbard argument is in three parts:

1. "Raising revenue is about raising average tax rates, not marginal tax rates." The perfectly valid point here is that scaling back deductions taken by upper-income taxpayers would be less damaging to the economy than raising marginal tax rates as the President demands.

2. "Tax increases should form only a modest part of the approach to deficit reduction, given the urgent need to curb spending by the federal government." Hubbard further notes that "federal spending as a share of gross domestic product has been elevated by as much as four percentage points relative to its long-term average." This rise in spending, of course, results from the Obama spending surge and cannot be deficit-financed indefinitely.

3. "Fiscal consolidations are less detrimental to growth when they are overwhelmingly about tax reform and spending reductions, particularly cuts in transfer payments." Quite so.

The Immediate Trouble with the Hubbard Argument. The immediate trouble is that Hubbard presumes a tax hike. To be sure, President Obama won a second term while calling for higher taxes on upper-income taxpayers. However, Republicans were also returned as the majority in the House of Representatives, and they uniformly campaigned against the Obama tax hike proposal. While the recent campaign produced a spirited contest of visions, it produced no mandate other than to return the two sides to the pre-election budgetary field of battle.

Approaching the field, the President once again insists on a "balanced approach" to deficit reduction. The inherent flaw in Obama's argument that must always been kept in mind is that the budget deficit today (and for years to come) is not due to a balanced imbalance in revenues and spending. On the contrary, revenues will return to normal as a share of the economy as the economy improves. Spending and spending alone—both the Obama spending surge and the entitlement wave now building—produces these deficits.

Spending is out of balance. Hubbard notes that spending "has been elevated by as much as four percentage points relative to its long-term average." Congress should return federal spending levels to normal as a share of the economy; once this is accomplished, the need for more revenues to produce a

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sustainable budget disappears. There is thus neither a political nor a budgetary necessity for raising taxes.

If one presumes a tax hike on upper-income taxpayers, then the rest of Hubbard's argument is nearly impeccable. Economically, it would indeed be far preferable to restrict deductions and exemptions for upper-income taxpayers than to raise tax rates. For example, reducing the exemption for employer-sponsored health insurance would reduce economic distortions. In other cases, paring back deductions would often create new distortions, but the resulting economic harm would pale in comparison to the damage wrought by higher tax rates.

Once again, however, there is an immediate problem. The various deductions and exemptions that might be scaled back as Hubbard suggests would materially raise taxes for upper-middle-income taxpayers, but they are largely irrelevant to truly upper-income taxpayers. If the President's goal is to soak LeBron James and Warren Buffett, the Hubbard solution fails and could well lead to a worse solution: scaling back legitimate deductions and raising tax rates.

The Long-Term Risks of the Hubbard Proposal. Long-term, the Hubbard solution has another problem. Tax policy should seek to raise the necessary revenues while preserving tax neutrality as much as possible; the tax system should to the least extent possible push the economy in one direction or another. A neutral tax system is most consistent with a strong economy, which is why Hubbard correctly emphasizes keeping rates down as the distortive effects of tax rates rise rapidly with higher rates.

However, getting the tax base wrong also produces damaging tax distortions. Scaling back the charitable deduction or the home mortgage interest deduction may create relatively benign distortions economically, but it would set a pattern of disregard for properly defining what is taxed—i.e., the tax base.

Over the years, policymakers have made remarkable progress in some respects moving toward a more neutral tax base. Evidence includes the continued build-out of savings vehicles such as 401(k)s for retirement, health savings accounts for health care, and 529 plans for higher education. Disregarding the importance of a correct tax base as Hubbard suggests could jeopardize and even reverse these gains.

For example, the inherent tension notwithstanding, it would be easy to imagine a proposal to restrict saving incentives while Congress sought to raise even more revenue by scaling back businesses' interest expense deduction. Ignoring the importance of the tax base could lead to a highly damaging gross income tax lacking any deductions, or it could press in the opposite direction in which the only perceived detriment to a distortive new tax credit is the revenue loss paid for with higher rates.

Fix the Real Problem. The problem giving rise to excessive budget deficits is excessive spending. Congress and the President should fix this problem.

The flaw in Hubbard's argument is that he presumes that somebody must pay more tax before Congress and the President can agree to the spending cuts Hubbard prefers. Hubbard's is ultimately not a budgetary judgment, because nothing about the budget compels higher taxes. It is not an economic judgment, because nothing about the economy suggests that it would be helped by a tax hike, as Hubbard would doubtlessly agree. On the contrary, Hubbard's presumption is an opinion about political realities—an opinion far from universally shared.

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