

Another Look at Tax Policy

August 5, 2024

A recent editorial in the Wall Street Journal warned that no matter who wins the election for president in November, the outlook for tax policy is worrisome. From the Democratic side, the implied follow-through of letting the Trump tax cuts expire in 2025 would lead to a broad tax increase across the economy. The idea of dramatically raising taxes on the “rich” has proven ineffective time and time again, not only in the U.S. but worldwide. Yet, there continues to be a coalition of wealth redistributors committed to raising taxes. Then, there is the option offered by the Republicans, specifically Donald Trump, that he intends to substantially increase tariffs to help domestic producers compete with low-cost imports. We weren’t around in the Twenties, but the Smoot Hawley tariff was credited with the onset of the Great Depression. Tariffs do not seem like a sound economic policy to be implemented soon or at all, based on our experience.

In the traditional sense, the body politic is concerned about rising levels of spending and increased budget deficits. To solve this so-called problem, the politicians are discussing raising taxes and cutting spending. However, any economic slowdown brought about by such policies will likely increase the deficit because the economy will slow -- essentially, taxes slow the economy. From our perspective, increasing taxes on the wealthy will result in a slowing economy and decreasing, not rising, tax revenues. Remember that a growing economy generates more, not less, tax revenues through the income tax system that takes a piece of each transaction as a tax. Less growth means less tax revenues.

The main drawback to implementing higher tariffs is higher consumer prices, resulting in higher inflation. The Fed will respond with higher interest rates, and you know how that story goes. On the other hand, the idea that tax rates should remain low gets little support from the 40% of Americans who do not pay taxes. These people would prefer to see higher, not lower, taxes on the “rich” because they perceive it would benefit them. So, where do we go from here?

One option that gets some traction is the idea of a value-added tax. This tax is broadly used throughout Europe to generate higher tax revenues and appears to be successful. By imposing a tax on each level of production, the government is guaranteed a certain level of income, and more importantly, everyone pays the tax when items are purchased, not just a select few. There are no easy ways to avoid paying a value-added tax so the government can reduce the cost of enforcement. Since the tax also occurs at the final sales level (as many of us have found out when buying goods in Europe), such a tax can be low or high depending on adjustments to other tax rates to mitigate the additional impact of a tax increase. Assuming a tax increase is necessary to provide additional government services, a value-added tax appears less demanding than the one proposed by both political parties. Some good economic advice in this case would make a big difference.