Share the Burden, Share the Wealth
by Dan Jacoby

The American economy shrank by 3.8% in the last quarter. Over a million people lost their jobs. Housing prices, and housing values, are dropping. Businesses large and small are closing their doors forever. Everybody is getting hit hard.

Well, not everybody.

There are lots of people who, despite dramatic declines in the value of their investment portfolios, and perhaps the loss of some or all of their enormous bonuses, are not actually hurting. They are still making very large incomes, and will not only never miss a meal because they can't afford it, but also never have to pass up a vacation or the purchase of some trinket that catches their eye.

Those people make the overwhelming majority of the income in this country, and their percentage of total income has risen significantly over the last decade. It is time to call on these people to come to the service of our country. It is time to leverage the wealth they have accumulated to save our economy, getting us back on track in the short term, and putting us on track for long-term economic and social growth.

The simplest, most direct method by which our wealthiest members can help is by assessing a one-time tax on very high incomes. In 2006 about 8 1/2 million American workers made over $150,000.[1] Assuming similar numbers today, by adding a one-time 20% surtax on the income above $150,000 for the next two years, and only the income above that figure, we can realize $350 billion to help pay for the economic stimulus we need.

That 20% surtax will result in a temporary top federal income tax rate of 55%, which would be the highest rate in almost three decades. On the other hand, not only has the rate been much higher in the past (at times it was over 90%), but also this rate will be only a short-term fix for the current economic crisis; it will not be a permanent tax increase.

Many people will claim that a tax increase in the midst of a recession is the worst thing we can do. They are the same people whose economic plans got us into this mess, however, so it stands to reason that their views should be taken with a very large grain of salt – at least. Economic theories, like all theories, tends to look great on paper, but until it is tested in the real world, there are certain to be factors that weren't taken into account. As a result, the theories that looked so good on paper always need to be altered to fit the missing facts.

The truth is, we have never attempted this method to finance an economic stimulus plan, so we don't know what will happen. We do know, however, that without a surtax we will certainly have an enormous debt to pay – a debt that will cost us a lot more than the initial cost of the stimulus plan.

The longer-term method for keeping our economy on the right track is to raise the capital gains tax rate. Currently, the top rate on long-term capital gains is 15%, compared with a top income tax rate of 35%. This enormous disparity led to the "bubbles" that, when they burst, caused the economic crisis we are in now.

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[1] http://pubdb3.census.gov/macro/032007/hhinc/new06_000.htm

The reason for the bubbles is a simple application of the law of supply and demand. By lowering the capital gains tax rate well below income tax rates, we increase the supply of venture capital well beyond the level of demand. This imbalance lowers the price of capital, and results in too much investment in bad business ideas.

This is nothing new. In 1922, the top capital gains tax rate was lowered to 12.5%, less than one-fourth of the top income tax rate. The first bubble it created was the Florida land boom. When that boom went bust, the money then went into the second bubble, which was the stock market boom of the later 1920s. That bubble burst in October of 1929, and resulted in the Great Depression.

In 1993, the federal government raised the top income tax rate without a corresponding rise in the top capital gains tax rate. To make matters worse, in 1997 the top capital gains tax raised was lowered. The final blow occurred in 2003, when the top income tax rate was lowered slightly, but the top capital gains tax rate was lowered even further.

The first bubble created here was the “tech bubble,” as internet startups without a legitimate business plan were financed with the venture capital surplus. When this bubble burst, the money went into the mortgage boom, through the purchase of mortgage-backed securities. The end of that boom resulted in our current crisis.

By raising the top capital gains tax rate from 15% to 25%, so that it is much closer to the 35% top income tax rate, we can rebalance the supply/demand equation for venture capital and prevent the next bubbles from being created once the economy recovers. This, along with better regulation of the various investment markets, can help ensure that we will not face another crisis like this – at least until the fiscal “conservatives” take over again and reverse all the gains we will have made.

Finally, we need to look at the one regressive federal tax, the Social Security tax. Currently, workers are taxed at a 6.2% on the first $106,800 they make (a number than changes annually as median income changes), and are not taxed at all on any income above that level. By lowering that tax rate, we would permanently put more money in the hands of those who would most likely spend it, thereby boosting the economy. In addition, since employers are required to match the Social Security tax, a reduction in tax rates also lowers the cost of labor, which means more jobs can be created.

There is, of course, a price to pay for lowering the tax rate. For more details on how best to pay that price, go to my earlier column, #184, “A Private Little Retirement.”[2]

Meanwhile, we need to fund our current economic bailout. In order to do that, we can turn to Saudi Arabia and China, as we have been doing for years. It is far better to turn to Americans, specifically those Americans who benefited most from the economic upswing and are being hurt least by the economic downturn.

[2] http://www.danjacoby.com/politics/columns/writing/184_a_private_retirement_ii.htm