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The tax debate

# Someone will pay

But raising taxes on the rich alone simply won't fix the deficit

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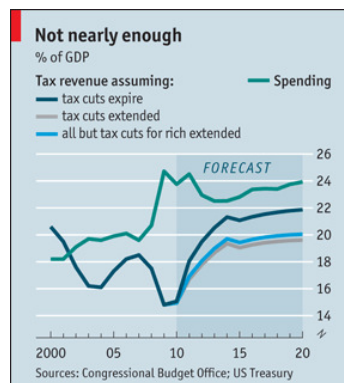
AMERICA'S mid-term elections are turning into a referendum on the role of the state, and George Bush junior's tax cuts are the litmus test. Barack Obama has attacked Republicans for wanting the cuts for the richest 2% of families to be made permanent, robbing the government of the means to invest in the economy. Harry Reid, the Democratic leader in the Senate, is mulling a vote on making only the middle-class tax cuts permanent, virtually daring the Republicans to vote no.

Republicans, for their part, portray the elections as the occasion for choosing between free enterprise and a suffocating welfare state of the European sort. Mitch McConnell, their leader in the Senate, has introduced a "Tax Hike Prevention Act" to make all Mr Bush's cuts permanent.

This has the makings of a disaster. If the two sides can't agree, everyone's taxes will rise sharply on January 1st, dealing a body-blow to the feeble economy. However, a compromise may be in sight. Conservative Democrats and moderate Republicans like Olympia Snowe, a senator from Maine, are open to extending all the cuts for at least another year, in effect kicking the decision down the road; and Mr Obama would probably not veto such an extension. On September 12th John Boehner, the minority leader in the House of Representatives, bent a little, telling a talk-show host that if the only way to extend most of the cuts was to relinquish those for the rich, he would acquiesce.

The irony in this drama is that the money at stake is, in the larger scheme, trivial. Raising taxes on the top 2% of households, as Mr Obama proposes, would bring in \$34 billion next year: enough to cover nine days' worth of the deficit. Indeed, the problem with the tax debate is not that Democrats and Republicans disagree, but that they mostly agree. Democrats think 98% of Americans should not pay higher taxes; the Republicans say 100% should not.

Taxes this year will come to less than 15% of GDP, the lowest share since 1950. The two reasons for this are the recession, which has left a diminished tax base, and the legacy of broad-based tax cuts in 1997, 2001, 2003 and 2009. Taxes are expected to rise to 19.6% of GDP in 2020 if all the tax cuts are extended; raising rates on the rich would lift the ratio to only 20% (see chart). That is nowhere near enough to pay for federal spending, estimated at 24% of GDP in 2020. "Citizens could be forgiven for forgetting that there is any connection between spending and taxes," says Len Burman, a tax expert at Syracuse University.



Mr Boehner's response is to propose rolling back government spending to its level in 2008. This, however, will require more than just rolling back Mr Obama's policies. To be sure, spending shot up from 21% of GDP that year to 25% last year. But the same thing happened in almost every OECD country, for the same reason: stimulus, bail-outs, and a smaller GDP.

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That spending is starting to wind down. Mr Obama cannot sell his investments in banks and car companies fast enough. Multiple extensions to unemployment-insurance benefits, already among the skimpiest in the OECD, will start to expire soon. Around 2015, spending will start a multi-year climb. To attribute that entirely to Mr Obama would be disingenuous. His health-care plan does contribute to it, but rising interest on the national debt and built-in health and demographic pressures are more important.

Government began growing under Mr Bush, largely because the public wanted much more security and more regulation. Mr Bush agreed to saddle financial companies with the Sarbanes-Oxley Act for much the same reason that Mr Obama backed the Dodd-Frank Act: the public demanded a response to corporate excesses.

Mr Obama took an American approach to health care, dismissing both a Canadian single-payer option and a broad federal safety-net plan to win support. One result is that 7% of Americans will remain uninsured, still the third-highest percentage in the OECD, after Mexico and Turkey. "This is way to the right of what [Richard] Nixon proposed," says Jonathan Gruber, a health expert at the Massachusetts Institute of Technology. American resistance to Canadian-style rationing is also why the reform provides so few serious cost controls. A recent study by the actuary of the federal agency that oversees Medicare and Medicaid found that the reform will do little to slow the growth in public and private health spending.

Mr Obama sees himself as an advocate not of bigger, but of smarter government: he sees the federal government as a lever to transform the entire American economy through "investments in education and clean energy, in basic research and technology and infrastructure," as he put it on September 8th. This, however, depends heavily on co-operation and money from business and state and local governments, and little of that is available at present.

As one example, Mr Obama, a fan of the high-speed intercity railways running in Germany and France, allocated \$8 billion in stimulus money to high-speed rail in America. This was seed money to leverage private and state contributions. California got \$2.3 billion to develop its ambitious Sacramento to San Diego line, for which voters had already approved a \$10 billion bond issue. But the line's future is cloudy. The estimated cost of building the first section, from San Francisco to Anaheim, has ballooned to \$42 billion. Several local governments are suing over the proposed route. A study commissioned by Alan Lowenthal, a state senator, casts serious doubt on how many passengers the line will carry, and thus on its ability to meet the bond issue's requirement that the train should get no operating subsidy from taxpayers. Once taxes are involved, people lose their enthusiasm for high-speed rail.

At some point, Americans at large will have to face a similar choice. Raising taxes on the rich alone will not fix the deficit. Both parties seem to think a deficit commission, due to report by December 1st, will provide the answer. Whether they have the courage to accept it is another matter.

United States

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