Tax Cuts Are Only Way to Economic Growth: David Blanchflower

By David G. Blanchflower - Aug 17, 2010 8:00 PM GMT-0300

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Bloomberg Opinion

If we don't act fast, a plunge into depression is a growing risk in both the U.S. and the U.K.

Quantitative easing will probably have to be started again this year in both countries. The so-called Bush tax cuts, which are scheduled to expire at the end of the year, should be extended as soon as possible.

In the U.K., the draconian public-spending cuts alongside the increase in value-added tax planned for the end of the year should both be scrapped. Now is the time to cut taxes, not increase them. Payroll tax holidays are the way to go.

U.S. unemployment remains worryingly high at 9.5 percent and initial jobless claims are up again. Banks are still not lending, especially to small businesses and even though mortgage rates are at historic lows, house prices show no signs of recovering. Consumer confidence is down and spending is slowing.

The recently announced trade figures were ghastly. U.S. exports in June were $150.5 billion compared with $200.3 billion of imports, which resulted in a goods-and-services deficit of $49.9 billion, up from $42 billion in May.

Talk of exit strategies for the Federal Reserve that we heard earlier in the year has now disappeared; the Federal Open Market Committee at its meeting last week confirmed that the recovery was slowing and downgraded its growth outlook.

Incentives to Hire

The announcement that the Fed will recycle the proceeds of maturing mortgage-backed securities into new purchases of long- dated Treasuries is welcome. But banks aren't lending and firms need incentives to hire, so the Fed move isn't enough, especially since quantitative easing will take time to work.

It's time for tax cuts, which have the added advantage that they work quickly. Firms respond to incentives. The American Enterprise Institute's suggestion that there should be a payroll tax holiday is a good one as it would boost household disposable income while encouraging firms to retain workers on payrolls.

The AEI estimates that if the payroll tax (of which households pay half directly) were suspended -- say, for a year or 18 months -- households would experience an immediate 3.5 percent increase in disposable income that they could employ to sustain consumption and pay down debts. And it would give an incentive to hire. This would inject an additional $625 billion a year and would jumpstart the economy.

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But the likelihood of this happening any time soon is slight, so in the meantime it makes no sense to repeal the Bush tax cuts, which would lower the amount of stimulus. It would be better to reform them to maximize their job-creating impact. But we need a lot more stimulus right now, not less.

Budget Cuts

And then there is the U.K. where the coalition government is planning on public-spending cuts of as much as 40 percent in some government departments' budgets and a loss of about 600,000 public-sector jobs alongside big tax increases, including raising the VAT from 17.5 percent to 20 percent in January.

Cutting public spending and raising taxes at this point in the cycle, is inevitably going to lower economic growth and raise the number of jobless. It's that simple. Recent evidence of this comes from Greece, which implemented its own austerity package: Gross domestic product shrank 1.5 percent in the second quarter, unemployment rose to 12.5 percent, and 10-year Greek government bond yields are still high at 10.7 percent. The picture is similar in Ireland.

'Bankrupt' Economy

It hasn't helped that members of the Liberal Democrat- Conservative coalition have been talking the economy down. Last week, U.K. Energy Secretary Chris Huhne said in a speech that the U.K. economy was "bankrupt" and "shattered," which it clearly is not. Economic Secretary to the Treasury Justine Greening described it as a "basket case" during a budget debate. The danger is that the coalition government's misguided policies will push the economy back into a recession.

Consumer and business confidence in the U.K. both started to plunge, coincident with the formation of the new coalition government in May. Of particular concern, in the most recent Nationwide survey, is the plunge in the expectations index -- which dropped to 76 in July from 89 a month earlier -- to its lowest level since April 2009. The index has fallen 31 points since April. A monthly European Union survey has also shown that people in the U.K. increasingly expect unemployment to rise during the next 12 months. This will inevitably hit spending.

The coalition government should scrap the austerity budget and its planned tax increases and start cutting taxes. This can be best done by reductions in National Insurance contributions, which are a tax on jobs. For 2010-2011, the Treasury projects this levy will raise 99 billion pounds. Employees pay 11 percent on weekly incomes of between 110 pounds and 884 pounds.

The contribution rate should be cut to a flat 5 percent in a two-year holiday for all income groups immediately. This would encourage individuals to spend more, and companies would boost hiring because of the lower price of labor.

This measure would revive economic growth and probably reduce the size of the budget deficit in the long run as it would increase government revenue.

It's time for tax cuts, not tax increases.

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