A CLOSER LOOK AT OBAMANOMICS

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If I told you that a prominent global political figure in recent months has proposed abrogating key features of his government's contracts with energy companies; unilaterally renegotiating his country's international economic treaties; dramatically raising marginal tax rates on the "rich" to levels not seen in his country in three decades, which would make them among the highest in the world; and changing his country's social insurance system into explicit welfare by severing the link between taxes and benefits; the first name that came to mind would probably not be the possible next President of the United States, Senator Barack Obama.

Despite his obvious general intelligence and uplifting and motivational eloquence, Senator Obama reveals this startling economic illiteracy in his policy proposals and economic pronouncements (on this, of course, he is not unique among candidates and Presidents). From the property rights and rule of (contract) law foundations of a successful market economy to the specifics of tax, spending, energy, regulatory, and trade policy, if the proposals espoused by candidate Obama ever became law, the American economy would suffer a serious setback. To be sure, Senator Obama has been clouding these positions as he heads into the general election; and, once elected, presidents sometimes see the world differently than when they are running, either forced to by events or by the perspectives and responsibilities arising from the presidency. Some cite President Clinton's move to the economic policy center following his Hillary health care and 1994 Congressional election debacles as a possible Obama model. But candidate Obama starts far further left on spending, taxes, trade and regulation than candidate Clinton. A move as large as Clinton's toward the center would still leave Obama on the economic left. Also, by 1995 the country had a Republican Congress to limit President Clinton's big government agenda, whereas most political pundits predict strengthened Democratic majorities in both houses in 2009. Because newly elected Presidents usually try to implement the policies they campaigned on, Senator Obama's proposals are worth exploring in some depth. I'll discuss taxes and trade, although the story on other Obama proposals is similar.

First, taxes. The table nearby demonstrates what could happen to marginal tax rates in an Obama administration. Obama would raise the top marginal rates on earnings, dividends and capital gains passed in 2001 and 2003 and phase out itemized deductions for high income taxpayers. He would uncap Social Security taxes, which currently are levied on the first $102K of earnings. The result is a remarkable reduction in work incentives for our most economically productive citizens. The top 35% marginal income tax rate rises to 39.6%; adding the state income tax, the Medicare tax, the effect of the deduction phase-out and Obama's new Social Security tax increases the total combined marginal tax rate on additional labor earnings (or small business income) from 44.6% to a whopping 62.3%. People respond to what they get to keep after tax, which the Obama plan reduces from 55.4 cents on the dollar to 37.7 cents, a reduction of one-third in the after-tax wage! Despite the rhetoric, that's not just on "rich" individuals. It's also on a lot of small businesses and two-earner middle aged middle class couples in their peak earnings years in high cost-of-living areas. (His large increase in energy taxes, not documented here, would disproportionately harm low income Americans. And, while he says he will not raise taxes on the middle class, he'll need many more tax hikes to pay for his big increase in spending.)

I was among the many who originally took Barack Obama's statements that he would "end the Bush tax cuts for the top incomes" too literally to mean a return to the pre-Bush tax rates of 39.6% on ordinary income and 20% on capital gains. The Obama campaign has now clarified that he proposes to do this for labor earnings, but not for capital gains and dividends. I am told that Mr. Obama would raise the rates to "no more than the Reagan rate," which apparently means 28%, from the current 15%. Senator Obama might thus raise the tax rate on capital gains by about three time as much as President Bush cut it, but he'd preserve at least some of the Bush reduction in the double-taxation of dividends.

The 28% rate on capital gains was the price President Ronald Reagan paid to pass the 1986 Tax Reform Act that lowered the top marginal tax rate on ordinary income (including dividends) to 28%. The capital gains rate was cut to 20% in 1997 under President Bill Clinton, and again to 15% in 2003. Mr. Obama would thus give us the worst of both worlds: a top tax rate on wages (also interest, rent and royalties) 40% higher than Reagan and a capital gains rate up to 40% higher than Clinton.

Raising the rate on capital gains to 28% would greatly reduce the ability of firms to minimize double taxation by returning cash to their shareholders through share repurchases. Nearly doubling the tax rates on capital gains and dividends to 28% is a terrible idea that would hit financial markets hard. After-tax returns to equity investment would decline by almost 20%. And it will be much harder for our financial institutions to raise the capital they need to shore up their balance sheets and start lending again, a vital link in restoring solid economic growth, if the returns to that capital are taxed at much higher rates. Finally, even a modest response of work and investment to their returns means that Senator Obama's tax rates, sooner or later, would seriously damage the economy.

On economic policy, the President proposes and Congress disposes, so presidents often wind up getting the favorite policy of powerful senators or congressmen. Thus, while Senator Obama also proposes an alternative minimum tax (AMT) patch, he could instead wind up with the permanent abolition of the AMT proposed by the Ways and Means Committee Chairman, Charlie Rangel, D-NY, a 4.6% additional hike in the marginal rate with NO deductibility of state income taxes.

Marginal tax rates would then approach 70%, levels not seen since the 1970s and among the highest in the world. The after-tax return to work – the take-home wage for more time or effort – would be cut by more than 40%!

Next, trade. In the primaries, Senator Obama was famously protectionist, claiming he would rip up and renegotiate the North American Free Trade Agreement (NAFTA). Since its passage (for which former President Bill Clinton ran a brave anchor leg, given opposition to trade liberalization in his party), NAFTA has risen to almost mythological proportions as a metaphor for the alleged harm done by trade, globalization, and the pace of technical change.

Yet since NAFTA was passed, and relative to the comparable period prior to its passage, manufacturing output grew more rapidly (and reached an all-time high last year); the average unemployment rate declined (as employment grew 24%); real hourly compensation in the business sector grew twice as fast; agricultural exports destined for Canada and Mexico have grown substantially and trade among the three nations has tripled; Mexican wages have risen each year since the peso crisis of 1994; and the two bi-national NAFTA environmental institutions have provided nearly $1 billion for 135 environmental infrastructure projects along the U.S.-Mexico border.

In short, it would be hard, on balance, for any objective person to argue that NAFTA has injured the U.S. economy, reduced U.S. wages, destroyed American manufacturing, harmed our agriculture, damaged Mexican labor, failed to expand trade, or worsened the border environment. But perhaps I am not objective, since NAFTA originated in meetings James Baker and I had with Pepe Cordoba, Chief of Staff to Mexico's President Salinas, early in President George H. W. Bush's administration.

Obama has also opposed other important free trade agreements, including those with Colombia, South Korea, and Central America. Obama has spoken eloquently about America's responsibility to help alleviate global poverty, even to the point of saying it would help defeat terrorism; but he has yet to endorse, let alone forcefully advocate, the single most potent policy for doing so, a successful completion of the Doha round of global trade liberalization. Worse yet, he wants to put restrictions into trade treaties that would damage the ability of poor countries to compete. And he seems to see no inconsistency in his desire to improve America's standing in the eyes of the rest of the world and turning his back on more than six decades of bipartisan American presidential leadership on global trade expansion. When trade rules are not being improved, non-tariff barriers develop to offset the liberalization from the current rules. So no trade liberalization means creeping protectionism.

History teaches us that high taxes and protectionism are not conducive to a thriving economy, the extreme case being the higher taxes and tariffs that deepened the Great Depression. While such a policy mix would be a real change, as philosophers remind us, change is not always progress.

NOTE:

The article above combines my two *Wall Street Journal* op-eds (July 29 and August 4, 2008) on Obamanomics. In what is now his fourth tax plan, Senator Obama has subsequently lowered his proposed tax rates on dividends and capital gains to 20%, a hike of 33 1/3% over the current rate of 15%. This compares to his year-long campaign to “end the Bush tax cuts for the rich,” widely interpreted as returning to the pre-Bush rates of 39.6% for wages and dividends and 20% for capital gains. He then said he would raise the rates on dividends and capital gains to “no more than the Reagan rate,” which was 28% after the 1986 Tax Reform Act, which also reduced the top tax rate on ordinary income, including wages, to 28%.

Mr. Obama also campaigned on “uncapping Social Security taxes, currently 12.4% on earnings capped at $102,000. He later amended that to say the uncapping would only be for those with income above $250,000. He now says he will levy an additional tax rate of 2-4% on such earnings, not the 12.4%.

Thus, to calculate the current Obama tax plan’s combined tax rates and after-tax returns to work and investment, these new rates should be substituted in the formulas in the table above, and likewise if the plan changes again. Also, Senator Obama proposes large spending increases and a pay-as-you-go rule for the budget in which all spending would be matched by cuts in other spending or tax increases. So Senator Obama appears to have an implicit large additional tax hike he has not specified. Senator Obama also says he will make Social Security solvent in the long run, be honest about its problems, not raise the retirement age, and look first to payroll taxes to solve the solvency problems. Since his 2-4% hike on those with incomes over $250,000 would close only a small fraction of the deficit caused by rapidly growing real benefits, he would also appear to have a large, general payroll tax hike implicit in his policy.

Finally, Mr. Obama’s claim that his proposals are a net tax reduction relies on his counting the refundable parts of his many new and expanded refundable tax credits as tax reductions, rather than outlays as is done in the federal budget. Under this scoring convention, a large tax increase on taxpayers, the proceeds of which were paid out to people who paid no tax, would count as neither taxes nor spending.

Obama's Tax Policies

Marginal Tax Rate On Earnings	**Current**	**Obama**
Top Federal Rate	35.0%	39.6%
+ State Income Tax Rate (California)	10.3%	10.3%
+ Phase Out Of Itemized Deductions		1.2%
= Combined Marginal Rate Net Of Any Deductibility (t)	41.7%	47.0%
+ Medicare Tax	2.9%	2.9%
+ Additional Social Security Tax above $250,000		12.4% [a]
= Combined Total Marginal Tax Rate (t)	44.6%	62.3%
After-Tax Return Per Dollar Of Earnings (= 1-t)	55.4%	37.7%
Percentage Change		-32.0%
Marginal Tax Rate On Dividends And Capital Gains[b] (Capital Gains Not Related To Corporate Income In Parentheses)		
Corporate Rate	35.0%	35.0%
Federal Rate: Ordinary Income	35.0%	39.6%
Dividends/Capital Gains	15.0%	28.0% [c]
State Income Tax Rate	10.3% [d]	10.3% [d]
Phase-Out Of Itemized Deductions	-	1.2%
Combined Marginal Rate [e]	49.1% (21.7%)	58.0% (35.4%)
After-Tax Return Per Dollar	50.9% (78.3%)	42.0% (64.6%)
Percentage Change		-18.1% (-17.5%)

a. Under the Obama plan, the additional Social Security tax above $250,000 could be as high as 12.4%. If Senator Obama states a different rate, adjust the figures.

b. Must be adjusted for the advantage of deferral and the disadvantages of limited loss offset and no inflation indexing.

c. "No more than Reagan", which was 28%. If he states a different rate, plug new figure into formula.

d. In California, capital gains are taxed at the ordinary income rate, 10.3%.

e. Equals corporate rate plus (one-corporate rate) times the sum of the other rates net of deductibility.

OBAMA'S TRADE POLICIES

NAFTA	Unilaterally renegotiate
CAFTA	Voted "No"
COLOMBIA	Against
SOUTH KOREA	Against
DOHA ROUND	Does not support