

The Department of Economics resumes its *regularly-scheduled* series:

Current Issues in Economics: McCain and Obama on Taxes & Trade

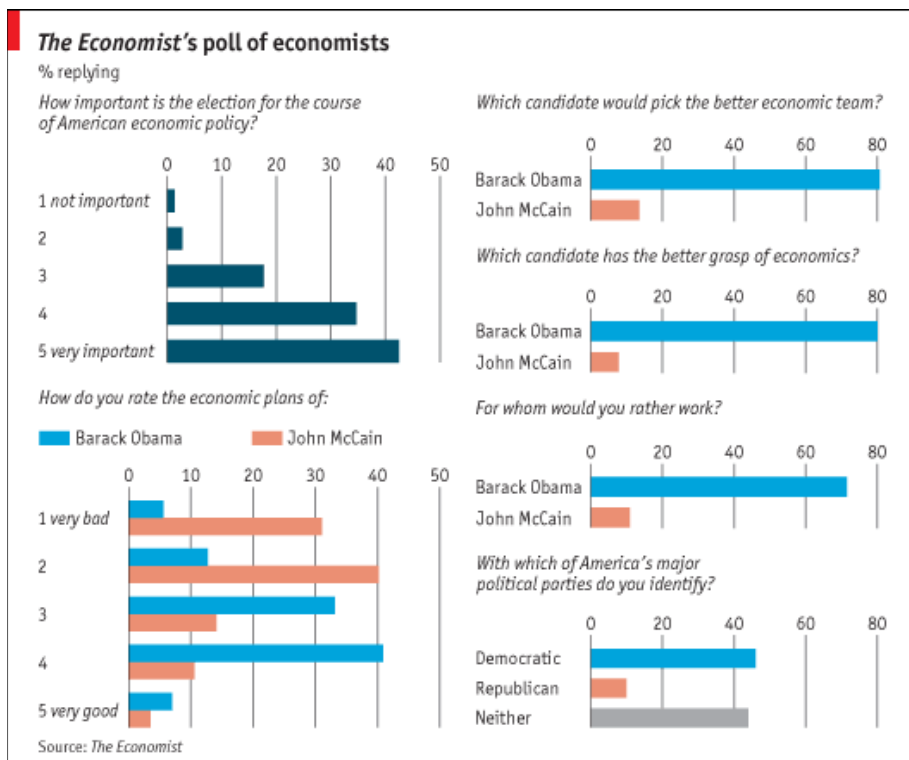
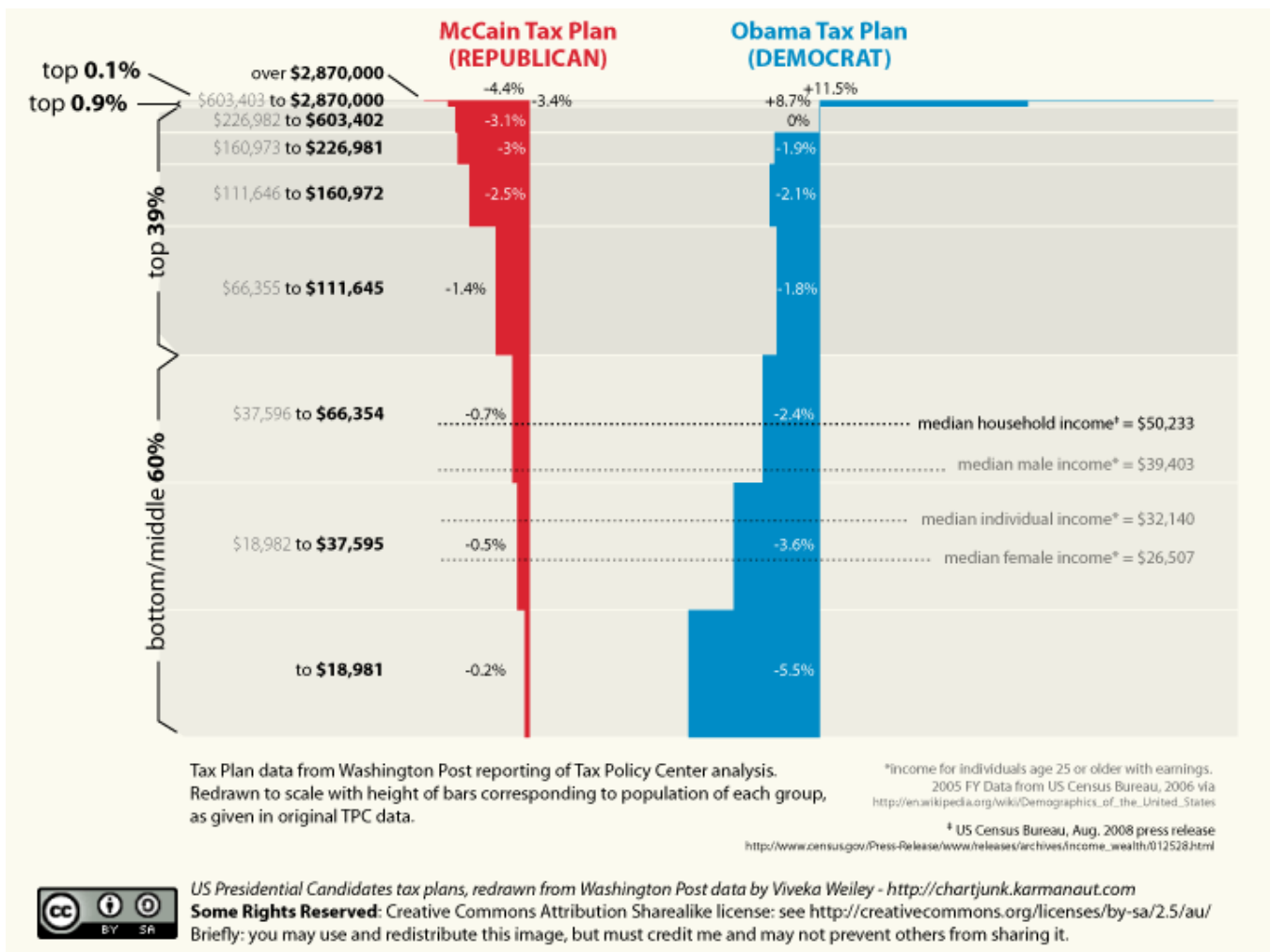
Tuesday, Oct. 28

4:30- 6:00

Farrell Room, St. Edmund's Hall

With financial crisis and the looming recession, voters are ranking the economy as their primary concern. How do the candidates plan to raise the massive revenues needed for the bailouts, ongoing costs like the Iraq war, and future costs associated with Medicare and Social Security? How do the candidates stand on the balance of trade, competitiveness, and outsourcing?

Patrick Walsh, Assistant Professor of Economics, and Reza Ramazani, Professor of Economics, will discuss McCain and Obama's proposals on taxes and trade. Questions & comments from the audience will be welcomed. Light refreshments will be provided.



It's the economy again, stupid

Jul 24th 2008 | WASHINGTON, DC
From The Economist print edition

John McCain and Barack Obama are offering profoundly different prescriptions, though economic and political realities will limit their ambitions

SIXTEEN years ago an American presidential election was fought against the backdrop of a weak economy and a grumpy electorate. In 1992, in the shadow of a recession and with Americans worried about their living standards, their health care and their country's ability to compete, a charismatic young Democrat won by focusing on middle-class America's economic angst and excoriating the "failed" policies of the Reagan and Bush eras. Candidate Bill Clinton promised an activist government that would tilt the scales towards workers, pledging wholesale health-care reform, big increases in public investment, tax cuts for middle-class families and higher taxes on the rich.

But the reality of Clintonomics was more centrist and less ambitious than promised. Taxes did go up for the rich, but large public investment plans were quickly ditched in favour of deficit reduction. His (or rather, his wife's) health-care scheme famously collapsed. In 1996, facing a Republican Congress, he declared that "The era of big government is over." And by the middle of the decade, Americans' malaise was morphing into triumphalism as productivity accelerated, unemployment fell and wages rose across the board.

One of the biggest questions facing America today is whether this dynamic is about to be repeated, whether the status quo will continue, or whether the country is on the brink of a more radical shift to the left. Once again, the economy is at the forefront of a presidential election and Americans are grumpy—grumpier, in fact, than they were in 1992. What's more, compared with 1992, voters face a starker economic choice. Though Barack Obama and John McCain sound similar on some big issues, mostly green ones, their economic philosophies are quite different.

Mr Obama promotes a more ambitious version of candidate Clinton's 1992 vision of activist government, with a dose of belligerent trade talk added on. He wants to spend money on public investment (primarily on infrastructure and alternative fuels); he has an ambitious and expensive plan for near-universal health-care coverage; he promises tax cuts for working Americans and sharply higher taxes for rich folk. During the primaries he threatened to pull out of the North American Free-Trade Agreement (NAFTA) unless it was renegotiated.

Mr McCain, in contrast, is a staunch free-trader, arguing that America should be pushing for more trade deals, not shrinking from existing ones. On domestic policy, he sounds more radical than George Bush senior ever was—and than he himself has been in the past. Gone are Mr McCain's long-standing worries about the wisdom of cutting taxes at the top. Instead he now offers the traditional Republican recipe for growth: tax cuts, freer markets and minimal government. Though he opposed George Bush's tax cuts, he now wants to make them permanent and add more. Rather than extend government's reach in health care, he wants to free up insurance markets and cut costs.

These differences have allowed the two campaigns to paint America's economic choice in dramatic terms. Republicans attack Mr Obama as a rank protectionist and big-spending liberal, who promises the biggest tax hike since the second world war. Democrats deride Mr McCain as an even more reckless tax-cutter than the current president, a man who will bust the budget and tilt the playing field even further against ordinary workers. But things are not exactly as they seem.

For anyone outside the country, the stakes appear highest on trade policy, particularly since the Democratic Party has become noticeably more sceptical since the Clinton era. Look carefully, however,

and 2008 is unlikely to mark as big a watershed as many fear. Mr McCain is a commendably committed free-trader. He also wants to overhaul America's safety net for those who lose out, promising to revamp unemployment insurance, streamline retraining programmes and provide more wage insurance for older workers. But the odds of more trade deals are slim. Regardless of the outcome of America's election, the Doha trade round is on life support. And at home a President McCain would almost certainly face a Democratic Congress that is chronically suspicious of trade deals, even those with sops for the losers.

By the same token, Mr Obama is less likely to pander to his party's protectionist wing than his primary rhetoric suggests. Within days of winning the nomination his tone changed. He told *Fortune* that his attacks on NAFTA were "overheated and amplified"; he wanted to "open up a dialogue" with Mexico and Canada, but disavowed the idea of unilateral withdrawal. An Obama presidency would doubtless bring more sabre-rattling than Mr McCain on everything from China's currency to the need for environmental and labour standards, and Mr Obama may face troubles of his own from Congress. But a look at his advisers, and his recent speeches, suggests a moderate approach.

Of taxing and spending

What about the faultlines on domestic policy? There, too, the differences shrink a bit on closer inspection. Mr Obama would doubtless tilt the regulatory environment to the left (pushing up the minimum wage again and signing laws to make union organising easier, for instance). Both candidates are likely to favour more government involvement in areas from housing to financial regulation. Both have talked, for instance, of regulating oil-futures trading. But neither candidate proposes a huge shift in the reach of government. Calculations by the Tax Policy Centre suggest that Mr McCain's tax plans would reduce the federal tax take to 17.6% of GDP by 2018, while Mr Obama's would yield 18.5%. America's post-war average is around 18%.

Nor is either candidate proposing serious tax reform. The expiry of Mr Bush's tax cuts in 2011 offers the opportunity to rewrite America's labyrinthine tax code in a way that could be both progressive (as Mr Obama wants) and pro-growth (Mr McCain's concern). But while Mr Obama has plans to simplify tax filing and Mr McCain talks vaguely of an optional alternative tax with lower rates and a broader base, neither really focuses on reform.

Both candidates take the framework of the Bush tax cuts as given. And both measure the effects of their tax and spending plans not against current law (which has Mr Bush's tax cuts expiring by the start of 2011) but against a world in which the cuts are all extended. Compared with that "baseline", Mr Obama's scheme raises some \$800 billion over the next decade—all of which he then spends on health care, infrastructure and other programmes.

Mr McCain's tax cuts, in contrast, would reduce tax revenue by about \$600 billion over ten years. He "saves" that money by promising to get tough on spending. Indeed, he says he can balance the budget by 2013. Although Mr McCain has some credibility as a small-government conservative—he was one of the few who voted against Mr Bush's reckless expansion of Medicare and, unlike Mr Obama, has consistently opposed farm subsidies—he offers few details on how this might be achieved. His speeches are peppered with pledges to get rid of earmarks (spending tagged for politicians' pet projects). But since all earmarks add up to less than \$20 billion a year, that will not yield much. For his numbers to add up, not only would discretionary spending need to be slashed from its current level of 7.6% of GDP, but spending on entitlements, such as Social Security and Medicare, would need to be cut too. If Mr McCain wants to do that, he has kept quiet about it.

Since both candidates score badly on reform and fiscal prudence, the tax debate is really about distribution within the current tax structure: and here there genuinely are big differences. Mr McCain's recipe is simple. He wants to keep all the Bush tax cuts (except eliminating the estate tax) and add a few

more. His plan doubles the size of the tax exemption for dependants. In his speeches he promises to abolish the Alternative Minimum Tax (a secondary system designed to prevent wealthy people avoiding tax, which now hits millions of taxpayers), though the campaign's fine print suggests patching rather than eliminating it. And, most of all, he wants to cut corporate taxes. The top rate of corporate income tax is to fall from 35% (one of the highest in the world) to 25%. Firms would be allowed to deduct immediately the cost of all spending on long-term equipment rather than depreciate it over time.

Mr Obama also wants to keep many of the Bush tax cuts that primarily benefit the 98% of households that make less than \$250,000 a year. He then adds an array of new tax cuts for those at the bottom and middle. Some make sense, like a big expansion of the Earned Income Tax Credit, which tops up the earnings of poor workers. Others, such as getting rid of income taxes for old people making less than \$50,000 a year, don't.

To pay for this largesse, and for his long spending wish-list, Mr Obama promises to raise huge sums from closing tax loopholes. He also pushes up tax rates at the top. America's top rate of income tax will rise from 35% to 39.5%, its level at the end of the Clinton era. The capital-gains tax rate will rise from 15% to between 20% and 28%. "Carried interest", the returns made by private equity and hedge-fund partners, will be taxed as ordinary income, rather than capital gains.

Separately, Mr Obama has also suggested that he would help fix Social Security's finances by raising the payroll tax on households earning more than \$250,000 a year. (Today, the 6.2% payroll tax contributions made by both workers and employers stop at earnings of \$102,000.) How much he would raise it is not clear. Adding on the full 12.4% would effectively take top marginal tax rates above 50%. Mr Obama offers no details, but his advisers hint that any rate rise would be much lower.

Exactly how these plans shift the tax burden is not obvious—who gains from a corporate tax cut, for instance, depends on whether lower corporate taxes merely boost shareholders' returns or also bring higher wages. But the big picture is clear. Both candidates cut taxes for all but those at the very top. For the richest fifth of the population, Mr McCain brings a lower tax bill than Mr Bush did while Mr Obama plans a big rise from the Bush years.

But whether that rise marks a watershed is less obvious. Though the level ends up the same, the rise in the top marginal income tax rate that Mr Obama is proposing is smaller than that signed by Bill Clinton in 1993 (which took the top rate of tax from 31% to 39.6%). And analyses of that hike seem to suggest that while it had a big short-term effect on revenues, there is little evidence of large, permanent damage to incentives.

The uncertainty with Mr Obama lies with the payroll tax. He has all but ruled out raising the retirement age or cutting pensions to plug the gap in America's public pension system. The gap cannot be filled simply by raising taxes on the top 2%. But if raising taxes on rich people is Mr Obama's only route to dealing with America's pensions problem, he will be far from an economic centrist.

A healthy debate

The main area where an Obama presidency could mark a break from the past is health. His plan is a version of the Democratic consensus: to provide near-universal coverage through subsidies, expanded government health schemes, a regulated insurance exchange, tough rules on whom insurance companies must insure, and taxes on employers who do not provide health coverage. Mr Obama has plenty of ideas for cost control, but his main aim is expanding coverage—at a cost of some \$50 billion–65 billion a year, though some estimates run much higher. Mr McCain's focus, in contrast, is cost control and competition. He wants to loosen the rules on insurance companies and end the preference for employer-provided health care. Everyone would get a \$2,500 refundable tax credit to buy health insurance.

The staunch opposition of an (almost certainly) Democratic Congress makes it hard to see Mr McCain's vision enacted. His plans are a somewhat improved version of those that Mr Bush has proposed, in vain, for several years. For Mr Obama, the headwinds are less likely to be political than economic. Getting a comprehensive and ambitious health-care plan through Congress will be an enormous undertaking. But a prolonged bout of economic weakness will sap the budget and divert focus from such far-reaching reform.

All told, the contours of the business cycle may be the main influence on whether 2008 proves a big turning-point for economic policy. Mr Obama's tax increases will seem more risky if demand is weak. Whoever is president will be more focused on short-term palliatives than big policy change. Paradoxically, voters' grumpiness may be a spur for radical change. But, just as in 1992, economic weakness may drive both sides to the centre.

Other sources of info comparing McCain & Obama's economic plans:

General:

<http://online.wsj.com/article/SB122497140074869661.html>

http://www.nytimes.com/2008/10/29/us/politics/29fiscal.html?_r=1&hp&oref=slogin

Taxes:

A good roundup of commentary on the candidates' tax plans:

http://taxprof.typepad.com/taxprof_blog/2008/07/more-on-the-mcc.html

An in-depth, stats-heavy comparison:

http://www.taxpolicycenter.org/UploadedPDF/411750_updated_candidates_summary.pdf

Obama:

Long article on Obama's economic philosophy:

<http://www.nytimes.com/2008/08/24/magazine/24Obamanomics-t.html?ex=1376971200&en=42e0ab705c487047&ei=5124&partner=permalink&exprod=permalink>

McCain:

<http://www.nytimes.com/2008/04/16/us/politics/15cnd-mccain.html?scp=5&sq=McCain%20economic&st=cse>

http://online.wsj.com/article/SB122031215585888783.html?mod=opinion_main_commentaries

http://www.nytimes.com/2008/06/18/business/18leonhardt.html?_r=1&oref=slogin

What if candidates pandered to economists?

<http://www.nytimes.com/2008/07/13/business/13view.html?scp=8&sq=McCain%20economic%20platform&st=cse>