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Tax Policy and the U.S. Economy

In the early 2000s, coming off the bursting of the dotcom bubble and September 11 terrorist attacks, President George W. Bush reached back to a Reagan-era stimulus strategy – tax cuts – as he sought to help the nation’s sputtering economy regain its feet. Debate over the tax-cut proposal was contentious, with one camp saying the cuts would create jobs and the other warning that the strategy would lead to growing budget deficits. In the end, the only way the tax-cut proposals could move through Congress was on a temporary basis. Congress passed two rounds of tax cuts – the first in 2001 and a second shot in 2003 – that are set to expire at the end of 2010.

Today, lawmakers and economists are grappling with what to do about the soon-to-expire tax cuts. Many are concerned that an increase in taxes for any sector of the economy could threaten the nascent and fragile economic recovery. But there’s also increasing public pressure and calls from critics on the left and on the right to do something – and soon – about the soaring federal deficit. Most agree that addressing the deficit will require a mixture of tax increases and spending cuts. But is the timing right? It’s an issue fraught with both economic and political pitfalls.

To gain some perspective on the future of federal tax policy, OUTLOOK spoke with Leonard E. Burman, Daniel Patrick Moynihan Professor of Public Affairs at Syracuse University. He is former director of the Tax Policy Center, a think tank that aims to provide independent analysis of current and longer-term tax issues. Burman also served in several positions with the U.S. Department of Treasury, including deputy assistant secretary, and worked nine years as a senior analyst for the Congressional Budget Office. In March, Burman testified on tax issues before a subcommittee of the House Ways and Means Committee.

Q: What are the tax changes that are coming up this year?

Leonard Burman: Almost all the Bush tax cuts enacted in 2001 and 2003 are expiring at the end of 2010. That means that, if there’s not a change in law, the top tax rate for families and individuals making more than \$300,000 will go from 35 percent to 39.6 percent, and all the other rates will go up as well. For instance, a new 10 percent bracket for those making less than \$8,375 per year would expire, with the lowest tax rate resetting to 15 percent. Another thing that will expire is the increase in the child tax credit as well as provisions that make more of it available to low-income families who don’t



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owe income tax. The alternative minimum tax – which was intended to make millionaires, with access to sophisticated tax shelters, pay at least some tax – will hit over 30 million households – most of them middle class – if Congress does not extend a provision protecting middle-class taxpayers. Barring a congressional fix, millions of middle class households would face higher taxes and a world of complexity.

In 2003, Congress cut the top tax rate on long-term capital gains from 20 percent to 15 percent and also applied that rate to dividends. Prior to that, if you earned a dividend, it was taxed at your ordinary income rate, up to 35 percent. If Congress doesn't do anything, the rate on capital gains will go back up to 20 percent; the rate on dividends back up as high as 39.6 percent.

Also, new education tax incentives that were put in place last year as part of the economic stimulus bill will expire at the end of 2010. There are a lot of things up in the air right now.

OUTLOOK: How significant could these tax changes be?

LB: If it actually happens, this would be a significant event from a tax perspective, raising taxes by over \$2 trillion over the next 10 years. If everything were allowed to expire at the end of 2010, people at all income levels would owe more taxes. The biggest increases would be at the top, but lower-income families would end up paying more taxes, too.

But I don't think that will happen. President Obama has said that he wants to extend all the middle-class tax cuts. He just doesn't want to extend the tax cuts for people at the very top. The Republicans would like to extend them all. In general, I think there is bipartisan support for extending most of these provisions. My big concern is that we can't afford these tax cuts, especially down the road. The debt is exploding and that will have dire consequences for the economy if not addressed.

OUTLOOK: Another significant tax change deals with the estate tax. What changes could we see there and what is likely to happen?

LB: The 2001 legislation phased out the estate tax. In 2010, it is gone. However, it will return with a \$1 million exemption and top tax rate of 55 percent in 2011, unless Congress acts. The President has proposed that the 2009 estate tax exemption and rate be extended permanently. That would exempt the first \$3.5 million of an estate from tax (up to \$7 million for couples) and set a top rate of 45 percent. However, Republicans are hoping for a higher exemption and lower rate, so negotiations are at a stalemate right now. My guess is that we'll end up with the president's proposal.

OUTLOOK: What is the outlook for business and corporate taxes?

LB: This is virtually all an individual income tax event. There were some corporate tax breaks as part of the economic stimulus bill – more generous depreciation deductions and things like that – but those are still relatively small compared to the individual income tax changes.

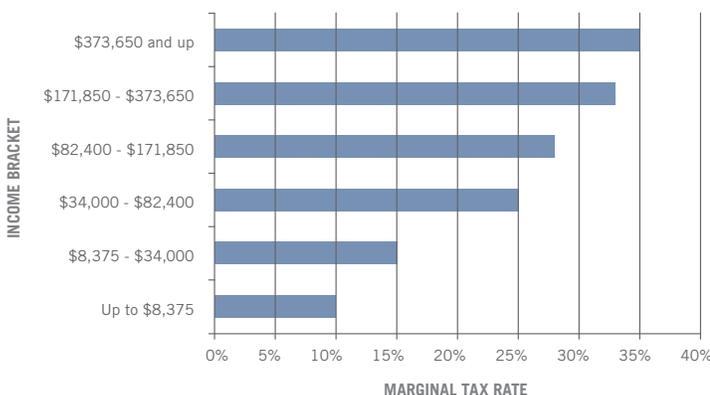
OUTLOOK: If the tax cuts for high-income earners are allowed to expire, some critics say this would cause those taxpayers to shift their income to another tax year. What are the implications if that happens?

LB: It could boost revenue in 2010 if people thought that the tax cuts were going to expire. Many high-income people can shift the timing of income so they pay taxes on that income in a preferred tax year. If you're in the very top brackets, as a matter of tax planning, it would make sense to accelerate income in 2010 and defer deductions to 2011, when tax rates will probably be higher. For most middle-income people, though, it is going to be a non-event, because there is bipartisan agreement to extend the middle-class tax cuts.

OUTLOOK: If the President is successful in seeing that the changes to dividend and capital gains taxes expire, how will that affect investor decision-making?

LB: You'd expect there to be a surge in capital gains at the end of 2010. In 1986, capital gains were double the previous year because investors sped up asset sales to avoid higher tax rates scheduled to take effect in 1987. However, the long-term effect will be very modest. The difference in tax rates will only be 5 percentage points. And evidence suggests that, while the timing of capital gains realizations are very sensitive to tax rates, permanent changes in rates have much smaller effects. A 5 percentage point increase in the tax rate on dividends may make some high-income investors less interested in holding stocks that pay dividends.

CURRENT MARGINAL TAX RATES



*For single filers, 2010 tax year

Source: Internal Revenue Service

OUTLOOK: We are tentatively coming out of a recession and are in a tricky transition period. The Fed has signaled the potential for higher interest rates in the next year, and there's increasing pressure on the Obama Administration and Congress to reduce stimulative spending. How do tax changes potentially impact the economic recovery?

LB: If we raise taxes too soon, it could push us into another recession. That's the big concern. Tax increases or spending cuts would be a really bad idea right now, because the economy is in such a precarious state. I've suggested that we should have a plan for getting the debt under control beyond 2012 as a way to reassure financial markets and prevent an economic disaster that could be occurring

Over the long term, we are going to need to raise taxes if we are going to get the budget under control.

down the road. Paul Krugman [a liberal economist, Princeton professor and winner of the Nobel Prize in economics] had an op-ed in the New York Times recently, where he expressed serious concern that entrenchment in Europe and the United States could do the same thing it did in 1937 during the Great Depression – when some New Deal spending programs were rolled back, creating a setback in the economic recovery. The same thing could happen now if we raise taxes or cut spending in the short term, potentially causing the economy to sink back into high unemployment and stagnant growth. I think it is a real concern.

OUTLOOK: Arthur Laffer – the godfather of supply-side economics – also predicted the potential for a double-dip recession if tax cuts for high-income earners are allowed to expire. What is his argument?

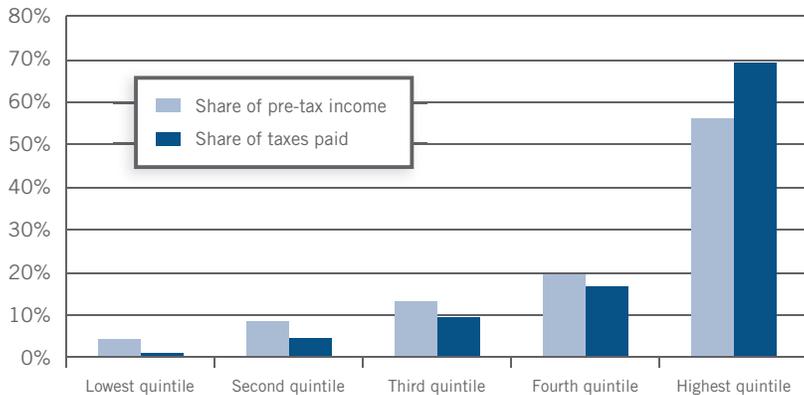
LB: He is concerned about the supply-side effect. He argues that if you raise taxes on high-income people that they'll make fewer investments and that it would hurt the economy. That concerns me a lot less than the effects of tax increases on middle-income people. High-income people are sitting on a lot of cash right now. For reasons that probably have nothing to do with taxes, they are not investing very much. The fact is that when you cut taxes or raise taxes on high-income people, it mostly just affects the amount of saving they do, which can affect the health of the economy over the long term. But it probably would not have much of an effect over the short term. For low-income people, if you raise their taxes, they are going to have to spend less, and that would tend to depress the economy pretty quickly.

OUTLOOK: In March, you testified before Congress on tax policy. What's the political outlook in Washington, D.C., for taxes?

LB: It's a sure bet that the middle-class tax cuts will be extended. The only thing that's been questioned is what's going to happen for the tax cuts at the top. President Obama has said he wants them to expire. To be honest, I don't know how that plays out. Some have suggested that all the tax cuts should be extended for a couple of years and that eventually we should re-evaluate the whole thing. I think that's a good idea. The political environment right now is such that it is really hard to find anybody in either party that's interested in tax increases. In the short term, that's the right answer. Over the long term, though, we are going to need to raise taxes if we are going to get the budget under control.

OUTLOOK: You wrote a piece recently called "Countdown to Catastrophe" urging lawmakers to get deficits under control or risk extremely dire consequences. The alternative, you say, is that we are headed for catastrophic budget failure and eventual economic meltdown that could threaten the nation's position as a global economic power. What's the event horizon for this? When does the

INCOME vs. TAXES PAID



*For the year 2007

Source: Congressional Budget Office

government need to take action to prevent this scenario?

LB: I wish I knew. The one thing we do know is that the sooner we deal with it, the easier it is going to be. I don't think anybody can tell you when the catastrophe will occur or when we pass the point of no return. A lot of people fear that the risk of permanent damage is already with us.

The U.S. is in some senses insulated because we're the biggest too-big-to-fail ever. The whole world would suffer if the U.S. suffered an economic catastrophe. For that reason, China and other countries who lend us money have an incentive to keep us afloat. The other thing is that

we are still a very rich country. Even though we've got more debt than we've had at any time since the aftermath of World War II, we can manage it if we adopt a program to cut spending and raise taxes.

But at some point, without a change of course, our debt would get to be so large that it would be beyond anyone's capacity to keep us solvent. At that point, we could have another Great Depression, possibly combined with hyperinflation. When countries have debt that is denominated in their own currency, as we do, and they get to the point where they can't pay it back, there's an irresistible temptation to print money. That would be an unspeakable economic catastrophe and really kind of unimaginable given that we are the richest country in history. Becoming deadbeat debtors would be an amazing reversal – but is completely avoidable.

OUTLOOK: In the equation for getting deficits under control, what's the balance between tax increases and spending cuts?

LB: It's really up to American voters. If we wanted to substantially renege on the promises we've made to seniors, we could cut spending to the point where we could finance government with the level of taxes we've had traditionally. It's not politically plausible, but it is from a matter of arithmetic. That would require draconian cuts in Medicare, Medicaid and Social Security.

But if we're going to meet the promises we've made to seniors, then we are going to need more revenue. We are also going to need to find a way to slow down the rate of increase for health care costs, which continue to grow faster than the rest of the economy. You don't need to be a math genius to figure out that it can't go on forever. The major component of our looming debt problem is demographics – the fact that baby boomers are retiring and going from being producers and taxpayers to being largely reliant on government to pay for their health care and Social Security.



Deficits are just deferred taxes. I don't think we have any moral right to say that, as a general rule, we are going to only pay for 75 percent or 80 percent of the cost of government and leave the rest of it to our children to pay for.

Spending cuts are inevitable, but practically, if we are going to continue to provide benefits for seniors, we going to need a combination of tax increases and spending cuts. As a rough approximation, my guess is that we'll get halfway there by cutting spending and halfway there by raising taxes, which means cutting loopholes in the income tax system and coming up with a new source of revenue.

OUTLOOK: As baby boomers retire and move out of the workforce, they'll be paying less tax. The generations coming up behind them are smaller in number. How will that affect the tax burden on working families?

LB: Sometimes people look at the dependency ratio, the ratio of workers to retirees. Currently that's close to 5-to-1. In 20 years, it will be less than 3-to-1. That's both because of the retirement of the baby boomers and also because people are living longer, so they are spending more time in retirement. Demographics alone would require higher taxes, even if health care costs weren't growing faster than the rest of the spending.

To put things in perspective, though, I don't think tax rates will go up to European levels, because they favor larger government and are willing to pay for it. But our taxes will have to increase if we are to avoid an economic disaster. And if we avoid making hard decisions and have a catastrophic budget failure, the consequence would be very, very high taxes – higher than anything we've ever imagined – just to meet our debt obligations.

OUTLOOK: You have advocated for comprehensive tax reform. What needs to change?

LB: Our current tax system is too complex, inequitable and inefficient. It's full of loopholes that engender tax sheltering. We should reform the tax system to raise adequate revenues so we do not leave a mountain of debt for our children. At the same time, we should make taxes simple, fair and more conducive to economic growth. I think that could be appealing, especially if people were convinced that the extra revenue wasn't going to fuel an expansion of government. But that's probably the hardest political sell – some people fear that more revenue will lead to more spending. If you could change that perception, I think people would be willing to accept higher taxes.

It used to be that people thought the income tax was the fairest tax, and now they think it is the least fair. That is because of this bipartisan effort to use the tax system as a tool for giving away goodies. There are hundreds

of credits and deductions, and the consequence is that, instead of people feeling grateful for all the wonderful benefits they get through income taxes, they feel that others are getting more than their fair share, which makes them unhappy. It creates both complexity and a sense of unfairness.

OUTLOOK: What should we be looking at instead?

LB: There were a lot of good recommendations made by President Bush’s tax reform panel. We’ve got seven or eight different tax breaks for education that are almost incomprehensible. They do very little good. I’d get rid of all of those. If we want to help people pay for education, then we should put more money into subsidized student loans or Pell Grants.

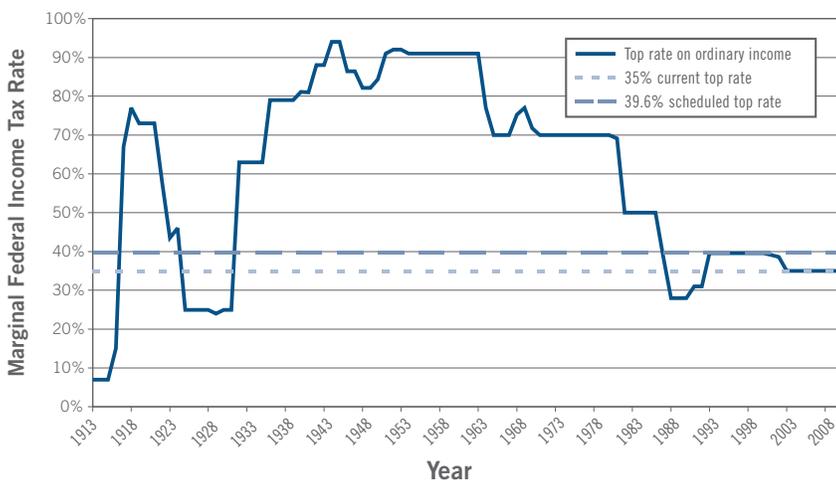
The mortgage interest deduction is the largest tax break and maybe the most popular. But it doesn’t do very much good. The mortgage interest deduction pushes up the price of housing, requiring people to pay more for housing than they would without the break. It hurts low- and middle-income people the most. The tax reform panel proposed turning that into a flat-rate tax credit, which would make it simpler, fairer and bring in some more revenue.

The tax exclusion for employer-sponsored health insurance encourages people to get more expensive insurance than they need. It is also poorly targeted, creating a huge subsidy for high-income people and very little subsidy for low-income people, the ones who most need help paying for health care. Sen. John McCain, when he was running for president, proposed getting rid of the tax exclusion and turning it into a credit for people to get

health insurance. That was a really good idea. That proposal would have made the health care system work better, would have been fairer and would have been progressive. There are a whole bunch of things like that.

Currently, there are more than \$1 trillion worth of “tax expenditures” – or tax breaks – in the tax code. That’s huge, about as much as we collected in individual income tax revenue in 2010. Every one of those tax breaks ought to be evaluated, just as the president says he is doing with direct spending programs, to see if they are meeting their objectives or are duplicative of other programs. We need to determine whether they’re worth the money. When it comes to tax expenditures, you should also ask whether the programs should be run by the IRS or some other agency. It’s ironic that we like to criticize the IRS for incompetence,

TOP FEDERAL INDIVIDUAL INCOME TAX RATE ON ORDINARY INCOME, 1913-2010



Source: Center for Tax Policy

but they've got more program responsibility than any other direct spending agency in the federal government. You've got numerous health and welfare benefits run through the tax code, you've got all sorts of subsidies for different businesses and industries, and the IRS doesn't have any special expertise for running these things.

But beyond simplifying the income tax code, we are going to need another source of revenue. A value added tax [similar to a sales tax] is used by every other major industrial country as a significant source of revenue. The advantage of a value added tax is that it doesn't tax savings, so it is more conducive to economic growth over the long term. It encourages savings and makes more capital available for businesses to invest. A broad-based value added tax could raise a relatively high amount of revenue at relatively low rates and with relatively little economic damage. The drawback is that it's regressive. The low-income people spend all of their income and high-income people only spend a portion of it. You can offset that through changes in the income tax code, or you could make the value added tax pay for government services that are valuable to low-income people.

OUTLOOK: Critics contend that a value added tax is not desirable because of the administrative burden it puts on business. How would you respond to that argument?

LB: There would be some additional burden on businesses, but it's pretty small if the tax is broad based. Businesses already keep track of all the information they'd have to report to the government. And if state and local governments conform their tax bases to the value added tax, business tax burdens could be much lower than they are now. Moreover, small businesses can be exempted from the value added tax at relatively little cost, because most of the tax is paid by others in the supply chain.

OUTLOOK: What should the general American public be feeling about what is going to happen with the tax system in the long term?

LB: Democrats and Republicans both care about their children and grandchildren, but the current system is going to ruin them. It could leave them an economy in ruins and could, ultimately, if debt catastrophe occurs, leave them facing taxes higher than anything we've ever seen in our lifetime and a government that can't provide even the most basic services or pay for an adequate national defense. It would be much better to fix our dysfunctional tax system, cut spending and find a way to pay for government that is fair, simple and conducive to economic growth. That's something we owe our children. Deficits are just deferred taxes. I don't think we have any moral right to say that, as a general rule, we are going to only pay for 75 percent or 80 percent of the cost of government and leave the rest of it to our children. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 5/31/10. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC & Blue Chip Economic Indicators **US Treasury Securities**

2009	GDP	CPI	Fed Funds	2-year	10-year
Q4	5.60%	2.60%	0.12%	0.90%	3.50%
2010	GDP	CPI	Funds	2-year	10-year
Q1	3.20%	1.50%	0.13%	0.90%	3.70%
Q2	3.20%	1.30%	0.20%	0.90%	3.60%
Q3	2.90%	1.90%	0.25%	1.00%	3.70%
Q4	3.10%	1.80%	0.25%	1.10%	3.90%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.54%	1.20%	1.70%	2.47%	2.99%	3.43%
0.25	0.96%	1.38%	1.91%	2.65%	3.13%	3.53%
0.50	1.42%	1.45%	2.10%	2.81%	3.26%	3.63%
0.75	1.85%	1.41%	2.28%	2.97%	3.39%	3.74%
1.00	1.26%	1.27%	2.42%	3.09%	3.47%	3.80%
1.50	1.27%	1.81%	2.85%	3.41%	3.72%	3.99%
2.00	2.17%	2.58%	3.33%	3.75%	3.98%	4.19%
2.50	2.68%	3.02%	3.65%	3.98%	4.16%	4.33%
3.00	3.08%	3.41%	3.93%	4.17%	4.31%	4.44%
4.00	3.71%	4.00%	4.30%	4.43%	4.52%	4.61%
5.00	4.11%	4.35%	4.50%	4.58%	4.65%	4.71%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	10	10	9	7
90	23	25	23	15
180	37	44	43	28
365	77	72	76	49

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

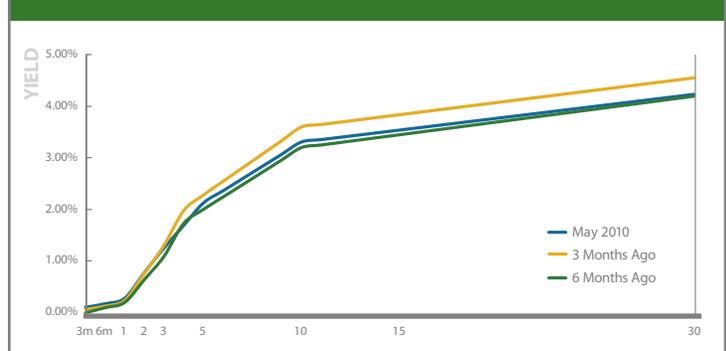
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE





About CoBank

CoBank is a \$58 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. In addition to serving its direct borrowers, the bank also provides wholesale loans and other financial services to affiliated Farm Credit associations and other partners across the country.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. For more information about CoBank, visit the bank's web site at www.cobank.com.

Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.

CoBank Works with Farm Credit Services of Mid-America, AgriBank to Support Tennessee Flood Relief

CoBank recently teamed up with Farm Credit Services of Mid-America and AgriBank to support flood recovery efforts in Tennessee and Kentucky. FCS of Mid-America, which is based in Louisville, Kentucky, donated \$25,000 to the Tennessee Farm Disaster Response Fund; CoBank and AgriBank each donated \$10,000.

Torrential downpours in late April and early May dumped up to 13 inches of rain and caused disastrous flooding in large portions of the region. According to some experts, it was a 500 or 1,000-year event. "The flood damage throughout the area has been very extensive," said David Lynn, FCS of Mid-America senior vice president. "For most of our farmers, early planting conditions had been ideal. But many have now lost not only their whole crops, but in many cases buildings, facilities and equipment."

To assist with cleanup and repair efforts, Farm Credit Services of Mid-America, AgriBank and CoBank made their \$45,000 in combined donations to the Tennessee Farm Disaster Response Fund, which is administered by the Tennessee Farm Bureau. Use of the money from the three Farm Credit System organizations will be determined based on affected communities' particular needs.

"CoBank has deep ties to the areas impacted by the flood, with many important and long-standing customers located along the Cumberland River and throughout Tennessee," said Derrick Waggoner, regional vice president in CoBank's Louisville, Kentucky, banking center. "I'm proud that CoBank is able to make this contribution to the Tennessee Farm Disaster Response Fund in support of its efforts to help individuals and communities who have been impacted by this devastating flood." CoBank supports 94 customers in Tennessee, with a combined revenue of more than \$30 billion.

The Farm Credit System's assistance has not been limited to monetary contributions. More than 150 Farm Credit System employees in Tennessee have volunteered to help with the cleanup.

"We are saddened by the devastation that hit Kentucky and Tennessee," AgriBank Chief Executive Office Bill York said. "AgriBank is honored to support those fighting through this adversity. We remain committed to serving rural America through the associations in the AgriBank District." ■