Extending the Bush Tax Cuts is the Wrong Way to Stimulate the Economy

A Report by the Joint Economic Committee Majority Staff
Chairman, Senator Charles E. Schumer
Vice Chair, Rep. Carolyn B. Maloney
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THE JOINT ECONOMIC COMMITTEE, ESTABLISHED UNDER THE EMPLOYMENT ACT OF 1946, WAS CREATED BY CONGRESS TO REVIEW ECONOMIC CONDITIONS AND TO ANALYZE THE EFFECTIVENESS OF ECONOMIC POLICY.

EXTENDING THE BUSH TAX CUTS IS THE WRONG WAY TO STIMULATE THE ECONOMY

The Bush tax cuts, which disproportionately benefited the wealthiest Americans, were justified with a series of claims about their economic effectiveness. Seven years after the first tax cuts were passed, the evidence is clear that these claims were false, and in reality, these tax cuts have been bad economic policy. They have done little to stimulate the economy. The economic expansion earlier in the Bush administration was one of the weakest on record, and the economy has once again fallen into recession. While having limited economic effect, the tax cuts led to massive increases in the national debt and created an enormous windfall for the very wealthiest Americans at the expense of the middle class and future generations. Making the Bush tax cuts permanent would compound these long-term structural problems while doing nothing to address the immediate problems of the economy.

FACTS ABOUT THE BUSH TAX CUTS:

- Through 2008, the federal government has borrowed ***$1.6 Trillion*** to pay for the Bush tax cuts.
- Even the Chairman of the President's Council of Economic Advisors said he "would not claim that tax cuts pay for themselves."
- The tax cuts are heavily tilted to the wealthiest Americans. In 2007, one third of the total benefits of the tax cuts went to the top one percent of households.
- Approximately 20 percent of total benefits went to 0.3 percent of households earning $1 million or more per year. These households received an average tax cut ***103 times larger*** than that of middle-income households.
- Investment and economic growth in this business cycle have been lower than average, indicating that the tax cuts have not had strong economic effects.

IF THE BUSH TAX CUTS WERE MADE PERMANENT:

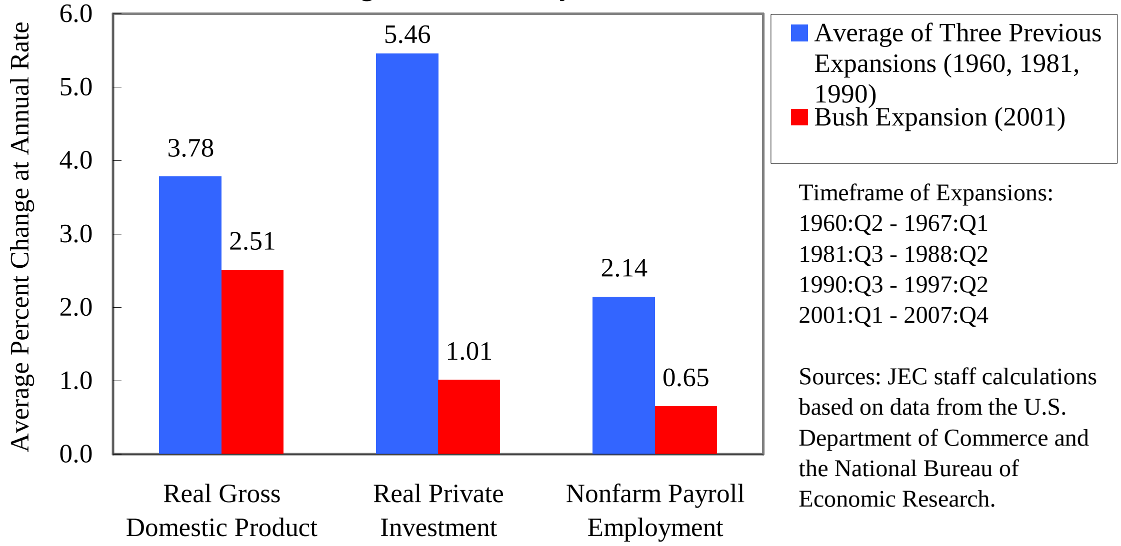
- Making the cuts permanent would cost the federal government ***an additional $3.4 Trillion*** over the next decade, if they were funded by borrowing.
- Permanent tax cuts would create revenue losses ***over three times larger*** than the long-term Social Security funding gap. The windfall received by the top one percent of taxpayers alone would be sufficient to close the Social Security funding gap through 2075.
- Using optimistic assumptions, the Administration's estimates of the possible long-term economic benefits of the tax cuts find that they would boost economic growth by a negligible four one-hundredths of one percent per year. These long-term growth benefits would only occur if tax cuts are funded through reductions in Federal spending.
- If tax cuts were funded by spending cuts, they ***would actually reduce net after-tax income for almost 75 percent of American households***, while income among households earning $1 million per year or more would increase by almost 8 percent.

THE TAX CUTS HAVE NOT INCREASED ECONOMIC GROWTH *NOR* STIMULATED INVESTMENT.

- The Bush administration has claimed that its tax cuts drive investment and therefore create jobs and growth in Gross Domestic Product (GDP). As Chart 1 demonstrates, however, the economic expansion following the Bush tax cuts has showed substantially *lower* growth in GDP, employment, and investment than previous economic expansions.

Chart 1: The Bush Economy Lags Behind

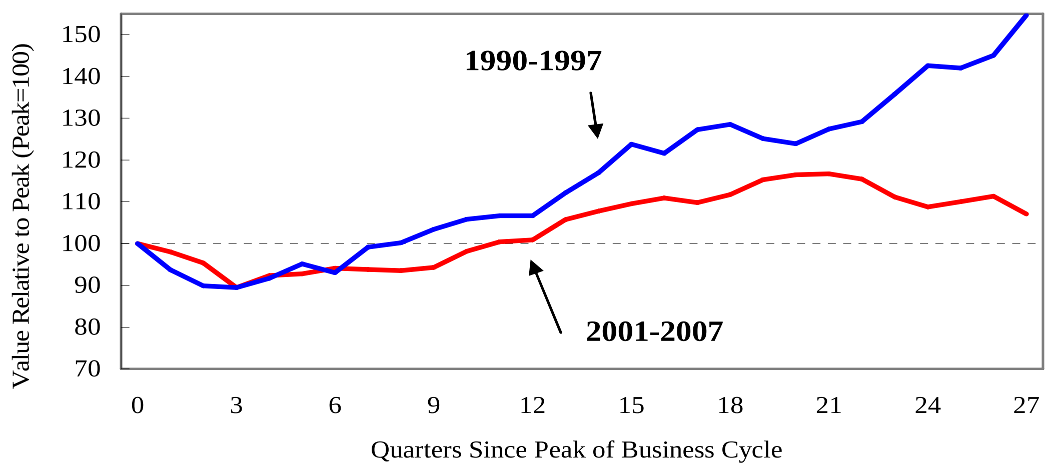
Percentage Increase In Key Economic Indicators



Sources: JEC staff calculations based on data from the U.S. Department of Commerce and the National Bureau of Economic Research.

- In fact, the Bush tax cuts have been followed by markedly low investment growth. Chart 2 shows that growth in investment during the Bush economic expansion was much lower than during the expansion of the 1990s. This is despite the fact that the 1990s economic expansion was not marked by tax cuts, but actually featured a tax increase.

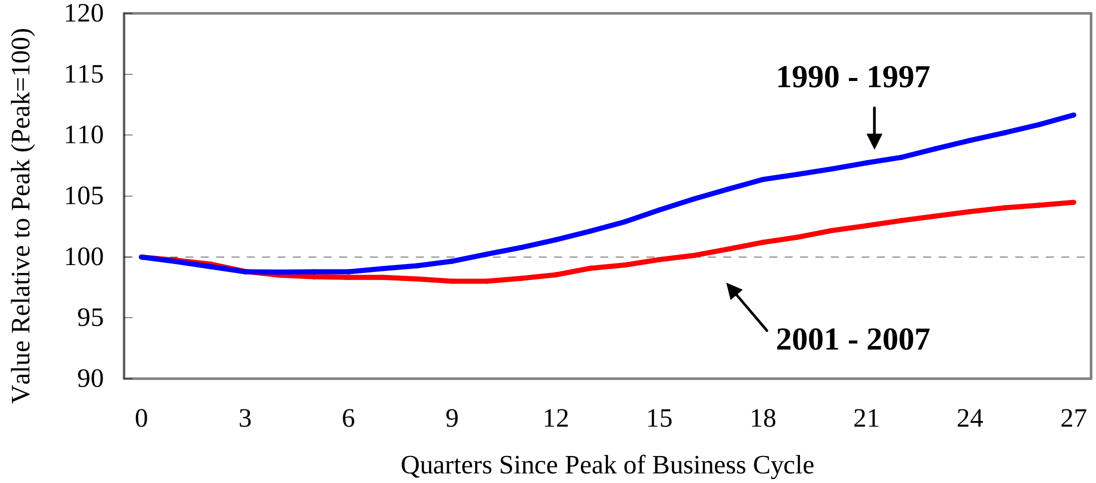
Chart 2: Private Investment Under Bush Lags Behind Clinton



Sources: JEC staff calculations based on data from the U.S. Department of Commerce and the National Bureau of Economic Research.

- Chart 3 demonstrates that the 1990s expansion also created higher levels of employment growth than the brief expansion period following the Bush tax cuts.

Chart 3: Employment Following Business Cycle Peaks
Under Bush and Clinton



Sources: JEC staff calculations based on data from the U.S. Department of Commerce and the National Bureau of Economic Research.

Any Long-Term Effects of the Tax Cuts on Future GDP Growth Will Be Small at Most, and Could Be Negative.

1. Major studies have found that the long-term growth effects of the tax cuts range from negative to small.

- Expert analyses by the non-partisan Congressional Budget Office and the Joint Committee on Taxation, as well as those by outside organizations, have found that under many sets of assumptions the long-term growth effects of the tax cuts would be negative, and will at most be quite small (CEA, 2008; JCT, 2006; CBO, 2004; Labonte, 2008; Auerbach, 2002; Elmendorf and Reifschnyder, 2002).

- The Bush Administration's own Treasury Department found that even under the most optimistic assumptions, the tax cuts would at best only increase annual economic growth by a miniscule 0.04 percent (CEA, 2008; Furman, 2007; Treasury, 2006).

- The effects of the tax cuts cannot be directly observed in the economy, and thus must be simulated in complex models that are heavily reliant on assumptions (Labonte, 2008).

2. So far, the tax cuts have been financed with borrowed money. Any positive growth impacts depend on paying for tax cuts with spending cuts.

- Tax cuts that are deficit-financed will likely lead to negative long-term impacts on economic growth (Gale and Orszag, 2005). Any positive economic effects found in the studies cited above were based on the assumption that tax cuts would eventually be financed through government spending cuts.

- However, if tax cuts are financed through spending cuts, the majority of Americans would likely experience a net loss in income (Gale, Orszag, and Shapiro 2004). This issue is discussed further below.

The Tax Cuts Unfairly Favor the Wealthiest Americans.

1. Tax cut benefits are heavily weighted toward the wealthy.

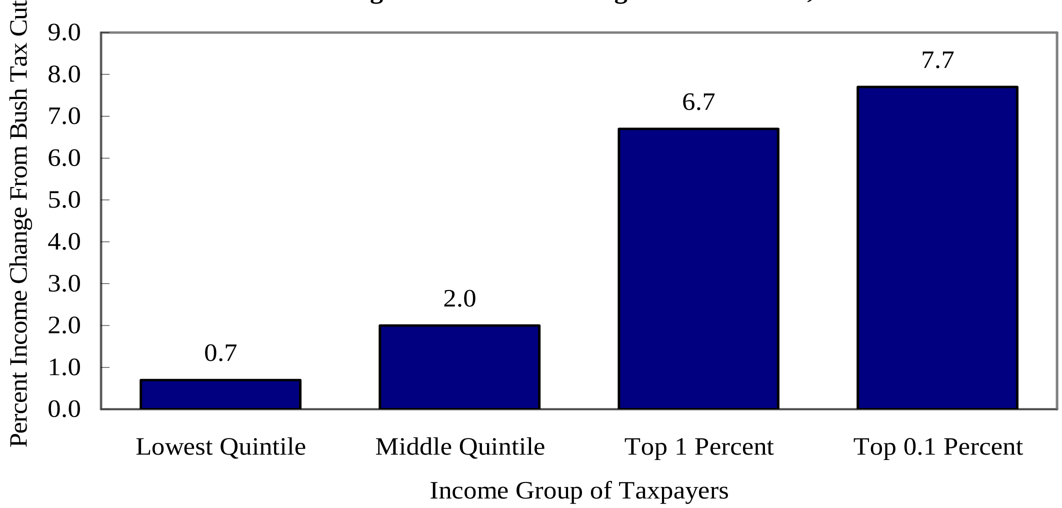
- In 2007, one-third of the total benefits of the tax cuts went to the top one percent of households. Approximately 20 percent of total benefits went to the top 0.3 percent of households earning $1 million or more per year (TPC Tables T07-0077, T07-0078).

- In 2007, families making $50,000-$75,000 per year got a total tax cut of $1,100, while families earning $1 million or more per year got a total tax cut of $120,000 – over one hundred times higher (TPC Table T07-0077).

- Chart 4 shows that middle- and low-income families experience small income gains when the tax cuts are in effect through 2012. Households in the top one percent income bracket – all of whom earn well over $1 million per year – increase their income by 7.7 percent, almost four times the 2 percent rise in middle- and low-income incomes.

Chart 4: Tax Cuts Produce Largest Income Gains At The Top

Percent Change in Income Resulting From Tax Cuts, 2012



Source: JEC staff calculations based on data from the Brookings/Urban Tax Policy Center.

2. Tax cuts may end up reducing middle-class incomes if they are financed by reductions in spending.

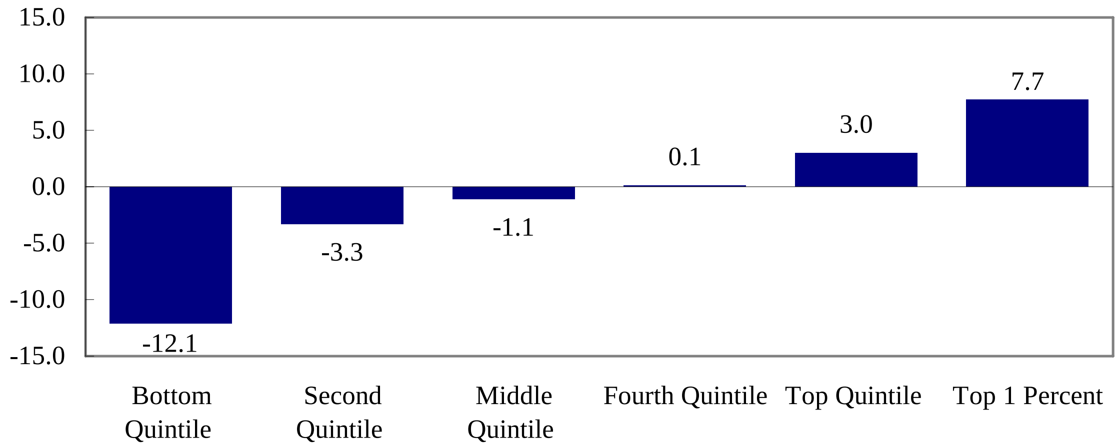
- These tax cuts are financed with borrowed money – a loan from future generations to today's taxpayers. Depending on how this loan is repaid, the net effect of fully-funded tax cuts would likely reduce most middle-class incomes.

- Administration estimates of the long-term impacts of the tax cuts assume that in the long run, tax cuts will eventually be paid for through large cuts in government spending. Unlike the tax cuts, Federal spending provides more income to the middle-class than the wealthy.

- If this tax cut-related debt is offset by across-the-board spending cuts, the after tax income for 75 percent of American households will be **reduced** (Gale, Orszag, and Shapiro, 2004; Furman, 2007).

- Only the wealthiest households benefit from the Bush tax cuts, even using the Treasury Department's estimates for long-run growth effects, as show in Chart 5.

Chart 5: Bush Tax Cuts Result in No Net Benefits for Most Americans
Percent Change in After-Tax Income Due To Combined Tax Cut and Spending Reduction



Sources: Brookings / Urban Tax Policy Center Microsimulation model. Simulation includes dynamic income effects of economic growth due to tax cuts, as estimated by U.S. Department of the Treasury.

THERE IS NO CREDIBLE EVIDENCE THAT THE TAX CUTS WILL EVEN COME CLOSE TO "PAYING FOR THEMSELVES."

1. ECONOMISTS AND ANALYSTS AGREE THAT ANY REVENUE FEEDBACK EFFECTS FROM THE TAX CUTS WILL BE SMALL COMPARED TO THE DIRECT COSTS OF TAX CUTS.

- Simulation studies by non-partisan tax analysts at the Congressional Research Service, the Congressional Budget Office, and the Joint Committee on Taxation all show small revenue feedback effects from the tax cuts (Gravelle, 2006; CBO, 2005; JCT, 2006). These studies almost always find that any pro-growth effects of the tax cuts would offset 10 percent or less of the revenue losses due to the tax cuts. Even under the most optimistic possible assumptions, growth effects from the tax cuts could offset no more than 30 percent of the total revenues lost.

- The current chairman of the President's Council of Economic Advisors, Edward Lazear, stated in testimony before the Joint Economic Committee that "I certainly would not claim that tax cuts pay for themselves" (Lazear, 2006).

- Greg Mankiw, the former chairman of the Bush Council of Economic Advisors, wrote in his macroeconomic textbook that there is "no credible evidence" that tax cuts pay for themselves, and that an economist who makes such a claim is a "snake oil salesman who is trying to sell a miracle cure" (Mankiw, 2001).

2. BECAUSE ANY OFFSETTING REVENUE GROWTH IS SMALL, THE BUSH TAX CUTS HAVE AND WILL GENERATE MASSIVE COSTS TO THE FEDERAL GOVERNMENT. THESE MUST BE EITHER BORROWED OR PAID FOR THROUGH CUTS IN OTHER SPENDING.

- The Bush tax cuts have so far increased Federal borrowing by $1.6 trillion through 2008, and will cost an additional $3.4 trillion over the next decade if they are made permanent.[1] The great majority of this $5 trillion in lost Federal revenue would not be offset.

- Over the long run, the revenue losses due to making the tax cuts permanent would be enormous. For example, through 2075 these revenue losses would be more than three times greater than the amount necessary to close the long-term funding gap in Social Security. Just the revenue losses resulting from the tax cuts given to the top 1 percent of taxpayers alone would be sufficient to close the entire Social Security funding gap through 2075 (Cox and Kogan, 2008).

- Federal revenues as a percentage of the economy remain far below the level they reached prior to the passage of the tax cut, and significantly below the level necessary to fund government spending (OMB, 2008).

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1. Costs through 2008 are from the Brookings-Urban Tax Policy Center, and include interest on additional Federal borrowing due to the tax cuts. Costs from 2009-18 are from CBO 2008A, and also include debt service costs. Revenue losses include the portion of AMT reform that would be affected by extending the Bush tax cuts.

EXTENDING THE TAX CUTS WOULD *NOT* STIMULATE THE ECONOMY, AND COULD ACTUALLY WEAKEN IT.

1. BECAUSE TAX CUT EXTENSION WILL NOT TAKE PLACE UNTIL 2011, MAKING THE TAX CUTS PERMANENT WILL HAVE NO IMMEDIATE STIMULUS EFFECT AND MAY BE COUNTERPRODUCTIVE.

- Policy changes that increase long-run government deficits can potentially increase long-term interest rates, which can counteract growth effects of tax cuts (Gale and Orszag, 2005). Making the tax cuts permanent will be a strong signal that the government intends continued borrowing which create long-run deficits, while it would have no immediate effect on tax rates.

- Former Treasury Secretary Lawrence Summers recently agreed that permanent tax cuts could easily create a drag on the economy by driving up long-term interest rates in anticipation of future increases in government debt (Summers, 2008).

2. IF THE TAX CUTS ARE EXTENDED AFTER 2011, THEY WOULD HAVE A MUCH SMALLER STIMULUS EFFECT THAN POLICIES THAT WERE BETTER TARGETED TO THE MIDDLE CLASS.

- It is well known that fiscal stimulus measures vary with respect to their “multiplier” or “bang for the buck.” Stimulus that is targeted to income-constrained or credit-constrained households is most likely to be spent rapidly, producing a proportionately larger effect. For this reason, government payments to high-income households produce little stimulus effect (Johnson, Parker, and Souleles, 2006; CBO, 2008B).

- Since the tax cuts are targeted heavily on higher income households, with one-third of benefits going to the top 1 percent of taxpayers, they will therefore produce only a limited stimulus effect stimulus effect.

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