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WILL THE TAX CUTS ULTIMATELY PAY FOR THEMSELVES?

by Richard Kogan

Summary

Administration officials and Congressional leaders have sometimes claimed that the 2001 tax cut, the Administration's new "growth package," or both will boost the economy to such a degree that the tax cuts ultimately will pay for themselves and cause no increase in long-term deficits. The President himself has made such statements.

Tax Cuts And Economic Growth

A companion analysis evaluates claims by Administration officials and other tax-cut supporters that the proposed tax cuts would substantially boost long-term economic growth. http://www.cbpp.org/3-3-03.tax2.htm

For example, President Bush said in November that the deficit would have been "much bigger" without the 2001 tax cut, meaning that the tax cut is substantially more than paying for itself. The White House explained the President believes the tax cut stimulates growth and thereby adds revenues.[1] Subsequently, in announcing his new "growth" package, the President said it would "lay the groundwork for future growth and future prosperity. That growth will bring the added benefit of higher revenues for the government — revenues that will keep tax rates low, while fulfilling key obligations…"[2]

Similarly, Vice President Cheney has said that the new "growth" package the Administration has proposed would ultimately more than pay for itself.[3] Likewise, the *Washington Post* reported that "on February 8, press secretary Ari Fleischer said the [new tax] plan would pay for itself."[4] In the same vein, *Congress Daily* reported on January 8 that House

[1] "Bush also defended last year's tax cut, asserting the deficit would have been 'much bigger' without it. But Bush also said the deficit was a result of declining revenues. According to a White House official, Bush attributes the decline in revenues to problems with the economy, while the tax cut stimulates growth and thereby adds revenues." *Congress Daily*, November 13, 2002.

[2] Transcript of Bush speech to the Economic Club of Chicago, January 7, 2003. Available at http://www.whitehouse.gov/news/releases/2003/01/20030107-5.html.

[3] "Eliminating the deficit is an important goal and the president's plan to expand the economy ultimately will reduce the deficit. … The president's growth package will reduce the tax burden on the American people by $98 billion this year, $670 billion over the next 10 years. But the actual impact on the deficit will be considerably smaller than the static projections, because the president's package will generate new growth, it will expand the tax base and thus *increase* tax revenue to the federal government ultimately [emphasis added]." Transcript of Cheney speech to the U.S. Chamber of Commerce, January 10, 2003.

[4] Dana Milbank, "For Bush Tax Plan, A Little Inner Dissent," the *Washington Post*, February 16, 2003, page A4.

Majority Leader Tom Delay, referring to the "growth" package, "told reporters that the long-term revenues generated by tax relief would more than cover the price tag of the cuts."[5] *Congress Daily* also reported that Senator John Sununu (R- NH) stated "that the tax cuts would actually bring long-term deficits down."[6]

Some advocates of large additional tax cuts do not directly claim that these tax cuts will pay for themselves but make the same claim *indirectly,* contending that economic growth will eliminate deficits over time, that the Administration's tax cuts would facilitate this result by increasing economic growth, and that the tax cuts thus would help to address the deficit problem over the long term. Such assertions essentially state that the tax cuts will lessen rather than enlarge long-term deficits and that the tax cuts consequently will more than pay for themselves.

Whether stated directly or indirectly, the proposition that tax cuts can pay for themselves — like most claims of a "free lunch"— is too good to be true. It does not withstand scrutiny. An array of analyses — including analyses conducted within the Administration — produce the same result: the tax cuts are expensive and will add significantly to long-term deficits rather than reduce them.

- The President's own Council of Economic Advisers does not believe the tax cuts will come close to paying for themselves. For a tax cut to pay for itself, the revenue generated by the added economic growth that the tax cut generates must equal or exceed the revenue losses the tax cut otherwise causes. In other words, the added revenue generated by stronger economic growth must equal *at least 100 percent* of the revenue loss that will otherwise occur. According to *Business Week,* Glenn Hubbard stated while chairman of the CEA (a post he held until the end of February) that as much as 40 percent of the cost of the Administration's "growth" proposal would be offset by higher economic growth."[7] If Hubbard is right, up to two-fifths of the revenue loss would be offset, but the other three-fifths of the cost would remain. The result thus would be substantial increases in deficits. Moreover, the *Economic Report of the President,* which the Council of Economic Advisers issued in February 2003, explicitly acknowledges that tax cuts are unlikely to pay for themselves.[8]
- Yet another indication that the Administration does not really believe that the tax cuts will pay for themselves is found in the revenue projections in the President's budget. The budget projects that under the President's policies, total federal revenues will grow *at a slower annual rate between 2001 and 2008 than in any comparable period over the last five decades*. OMB also projects that federal

[5] *Congress Daily,* January 8, 2003

[6] *Congress Daily,* January 8, 2003.

[7] "Gambling for Growth," *Business Week*, February 17, 2003, page 2-8.

[8] "The modest effect of government debt on interest rates does not mean that tax cuts pay for themselves with higher output. Although the economy grows in response to tax reductions (because of higher consumption in the short run and improved incentives in the long run), it is unlikely to grow so much that lost tax revenue is completely recovered by a higher level of economic activity." [8] See *Economic Report of the President,* pages 57-58.

Tax Cut Proponents Employ Contradictory Arguments to Sell Tax Cuts

One argument that supporters of the Administration's tax cut relied upon heavily in 2001 was that "if you leave surpluses in Washington, they'll just spend them." Another argument widely used in 2001 was that without the tax cut, the government ran the risk of paying off the debt too rapidly. These two rationales advanced an argument that the tax cut enacted in 2001 was needed in part to *reduce* revenues and projected surpluses — and thereby to ward off either spending increases or overly rapid debt repayment.

Today, some supporters of the Administration's new tax proposals contend that another round of large tax cuts is desirable and that these tax cuts can help reduce long-term deficits by spurring economic growth. If this is true, the tax cuts will *increase* rather than reduce government revenue.

Needless to say, both sets of arguments cannot be true. These tax cuts cannot reduce and increase government revenue at the same time. Such arguments directly contradict each other. This overt contradiction reflects the tendency of some supporters of the tax cut to use whatever fiscal or economic argument seems to work at the moment to sell the tax cut then on the table, regardless of the analytic merits of the argument or its consistency with previous arguments.

income tax revenues will grow at only one-sixteenth the annual rate they grew between 1990 and 2001.

- The long-term budget forecast in the President's budget is even more chilling. In President Bush's first budget, OMB projected the federal budget would remain in surplus at least through 2035. A year ago, OMB projected that surpluses would return in 2005 and remain through about 2025. But this year, OMB projects *no return to surplus at any time*. OMB now projects that under the Administration's policies, the budget will be in deficit *every year for the next 50 years*.

In short, both the analyses that the President's Council of Economic Advisers has conducted and the budget projections that the President's own budget office has issued are inconsistent with Administration rhetoric about the hefty revenue growth that its tax policies would generate.

Would there be *any* offset?

Furthermore, Glenn Hubbard's contention that the "growth" package would generate economic growth sufficient to offset as much as 40 percent of the revenue loss that it would otherwise cause is at odds with the views of many of the nation's leading economists, who expect *little or no* long-term economic growth to be generated by the "growth" package. If that is the case, *little or none* of the long-term cost of the "growth" package would be offset through higher revenues generated by stronger economic growth.

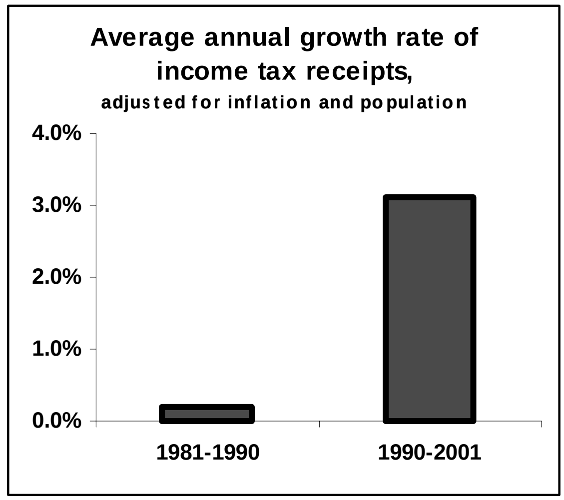
- For example, Macroeconomic Advisers, a leading economics consulting firm that developed the economic model that the Council of Economic Advisers itself uses, finds in a recent analysis that the long-term economic effect of the President's "growth" package is likely to be slightly *negative*.[9]

[9] See the companion paper, *Will the Administration's Tax Cuts Generate Substantial Economic Growth?* Center on Budget and Policy Priorities, March 3, 2003, pages 4 and 5.

- It also is of note that the Congressional Budget Office has concluded that the 2001 tax cut will have little or no effect on long-term economic growth and that whatever small effect the 2001 tax cut may have could be either a small negative or a small positive effect. Other leading studies of the economic impact of the 2001 tax cut, such as studies by economists at the Federal Reserve Board and the Brookings Institution, have produced similar findings and have concluded that the effects of the 2001 tax cut on economic growth are more likely to be negative than positive because of the role of the tax cut in swelling long-term deficits.

The Lessons of the 1980s and 1990s

Nor does history support the rhetoric that the tax cuts will pay for themselves. When the large tax cuts enacted in 1981 were being debated, many of the adherents of those tax cuts contended the tax cuts would more than pay for themselves. Conversely, when marginal tax rates on high-income individuals were raised in 1990 and especially in 1993, the claim was made that these tax increases would damage the economy and that income tax receipts consequently would grow more slowly in the 1990s than in the 1980s. In fact, income tax revenues hardly grew at all in the 1980s (after adjustment for inflation and increases in the size of the working-age population) and grew 13 times faster in the 1990s than in the 1980s.



Mounting Apprehension

For these reasons, economists and fiscal policy experts increasingly are expressing apprehension about the long-term fiscal impacts of the Administration's tax cuts. In a recent statement, ten Nobel laureates in economics, the President of the American Economic Association, and hundreds of other economists warned of substantial adverse effects from the growth package. The statement cautioned: "Passing these tax cuts will worsen the long-term budget outlook, adding to the nation's projected chronic deficits. This fiscal deterioration will reduce the capacity of government to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research." The increased deficits cited by the economists would come about precisely because the proposed tax cuts will *not* pay for themselves.[10]

Similarly, the Concord Coalition, a noted fiscal watchdog group headed by such individuals as former Nixon Administration Commerce Secretary Peter Peterson, has expressed strong concerns about the costs of the proposed "growth" package. Concord has noted that in his State of the Union address, President Bush declared, "… we will not pass along our problems to other Congresses, other Presidents, and other generations." Concord responded, "[T]urning that sentiment into reality requires making hard choices such as avoiding tax cuts we cannot afford…

[10] The full statement and list of signatories is available at http://www.epinet.org/.

Reducing the taxation on dividends may marginally improve personal savings but the loss in federal revenues adds directly to the federal debt and in the long run subtracts dollar-for-dollar from desperately needed national savings."[11]

In sum, in tax policy as in virtually all other aspects of policymaking, there is no "free lunch." The nation already faces the prospect of mounting deficits that threaten to reach dangerous levels when the baby-boom generation retires in large numbers. Rather than helping to prepare for this difficult challenge, the Administration's tax cuts would aggravate the problem by making long-term deficits more severe. The rest of this analysis examines some of these issues in more detail.

Do Tax Cuts Pay for Themselves? The Historical Record

Large tax cuts were enacted in 1981, with the centerpiece of the 1981 tax cut being a large reduction in marginal tax rates. If such tax cuts really pay for themselves, income tax receipts should have grown as rapidly in the 1980s as they did in the 1990s.

Indeed, in the 1980s, supply-siders argued that the economy would grow more rapidly because of the 1981 tax cut. They contended that a lower tax rate applied to a larger economy would produce at least the same amount of revenue. Then, when marginal income tax rates at the top of the income spectrum were raised in 1990 and especially when these rates were raised further in 1993, a number of supply-side advocates insisted this would harm economic growth. Presumably, higher tax rates applied to a smaller economy would mean that income tax receipts would not grow as much in the 1990s as in the 1980s.

Yet this is not what occurred. Income tax receipts grew noticeably *more slowly* than usual in the 1980s, after the large cuts in individual and corporate income tax rates in 1981. And income tax collections grew much more rapidly in the 1990s than in the 1980s. The graph and table on the next page illustrate this fact.

A comparison between the 1980s and the 1990s is quite instructive. (Data for the 1950s, 1960s, and 1970s are affected by several increases in payroll or excise taxes, numerous reductions in income tax rates, and uneven rates of "bracket creep" because the individual income tax was not indexed for inflation during those periods.) If economic growth — or voluntary tax compliance, another benefit that supply-side advocates claimed would occur after the large reduction in income tax rates in 1981 — would offset lower tax rates, income tax receipts should have grown in the 1980s at rates roughly approximating the historical norms. They did not. After adjusting for inflation and the increased size of the working-age population, income tax receipts grew hardly at all in the 1980s. In the 1990s, by contrast, income tax receipts grew at a pace similar to that in the 1950s and 1960s and much faster than in the 1970s or 1980s.

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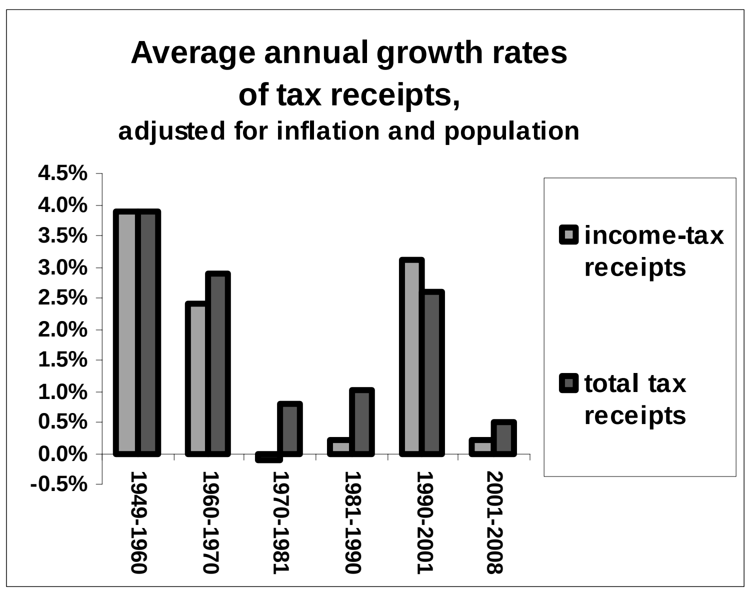
[11] Full-page statement of the Concord Coalition in the *New York Times* of February 2, 2003. Available at http://www.concordcoalition.org/federal_budget/030202nytad.pdf.

Average Annual Revenue Growth Rates over Selected Periods
Adjusted for inflation and the size of the population age 20-64
The end-points of each period are business-cycle peaks[12]

Fiscal year	Average annual growth rate of real income-tax receipts per working-age person	Average annual growth rate of real payroll and other tax receipts* per working-age person	Average annual growth rate of real *total* receipts per working-age person
1949 to 1960	3.9%	4.1%	3.9%
1960 to 1970	2.4%	4.0%	2.9%
1970 to 1981	-0.1%	2.2%	0.8%
1981 to 1990	0.2%	1.9%	1.0%
1990 to 2001	3.1%	1.9%	2.6%
2001 to 2010, CBO (baseline)	1.6%	1.1%	1.4%
2001 to 2008, OMB (Presidential policy)	0.2%	0.9%	0.5%
Addendum: 1949 to 2001	1.9%	2.8%	2.3%

* Payroll taxes are Social Security and Medicare taxes; other taxes include excise taxes on gasoline and tobacco, estate taxes, and miscellaneous taxes. Source: CBPP calculations from OMB Historical Tables (February 2003), CBO Baseline (January 2003) and U.S. Census.

The table also shows current CBO and OMB projections of tax receipts in the years ahead. The OMB projections, which reflect not only the ongoing revenue losses caused by the 2001 tax cut but also the new tax cuts proposed by the President in his 2004 budget, are of particular interest. *They show strikingly low rates of growth for federal revenues*. Under the President's budget, income taxes would grow at rates even lower than the very low rates of the 1980s, while total revenues would grow more slowly than in any comparable period of the last five decades. These OMB figures show that the Administration's own official projections contradict much of its recent rhetoric about strong revenue growth under its tax policies.



[12] In this table, the starting and ending date for each period is a business-cycle peak. A business-cycle peak occurs when the economy stops expanding and starts contracting, so it represents the size of the economy just before the start of a recession. Economists routinely measure economic growth from one business-cycle peak to another to show the average economic growth rate over a period while avoiding distortions caused by the business cycle. Because revenue collections by calendar quarter are extremely uneven, it is necessary to compare revenue collections in one entire fiscal year (rather than in one calendar quarter) with revenue collections in another entire fiscal year.

Administration’s Own Projections Show Permanent Deficits Under Its Policies

CBO, OMB, and GAO periodically issue long-term budget projections that cover as many as 50 to 75 years. These projections have long indicated that because health care costs in both the public and private sectors continue to grow faster than the economy and because the baby-boom generation will begin retiring early in this century, budget deficits eventually will start growing rapidly and reach troubling levels.

From 1997 through last year, however, the OMB projections have shown substantial periods of surplus — and declining or disappearing debt — before the long-term pressures force a return to deficits. With debt reduced or eliminated, the resulting savings in federal interest payments would partly ease the long-term budget pressures.

- President Bush’s first budget in 2001 showed that under his proposed policies, including his very large 2001 tax cut, *the budget would stay in surplus from 1998 through at least 2035* and the surpluses would peak at approximately four percent of GDP in 2011.[13]

- The President’s second budget showed that under his proposed policies — including further defense and homeland security increases in the wake of the terrorist attacks of September 2001, and with the economy in recession — the budget would return to surplus by 2005 and *stay in surplus through about 2025*, with surpluses peaking at approximately 1.3 percent of GDP in 2012.[14]

- This year, for the first time, OMB’s long-term projections show *no return to surplus at any time*. The projections, reflected in Table 3-2 and Chart 3-2 in the OMB volume *Analytical Perspectives,* explicitly show that under the Administration’s policies, *the budget will be in deficit every year for the next 50 years*. OMB projects that budget deficits will shrink as a share of GDP in the years immediately ahead but that deficits will never disappear and, by about 2013, will start growing again as a share of GDP.[15]

President’s Claim that Recent Tax Cuts Have Paid for Themselves Contradicted by His Economic Advisers

President Bush recently stated that the deficits we are now experiencing would have been “much bigger” without the tax cuts. A White House official explained that the President believes tax cuts stimulate growth and thereby boost revenues.[16]

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[13] OMB, *Analytical Perspectives*, Fiscal Year 2002, page 23.

[14] OMB, *Analytical Perspectives*, Fiscal Year 2003, page 43.

[15] OMB, *Analytical Perspectives*, Fiscal Year 2004, page 43.

[16] See footnote 1.

To assess this claim, let us assume that the 2001 and 2002 tax cuts stimulated growth sufficient to pay for themselves. (The President's statement implies that these tax cuts *more than* paid for themselves, which is why the 2002 deficit would have been "much bigger" without the tax cuts.) OMB tables accompanying the Administration's Mid-Session Review of July 2002 portray the 2001 tax cut and the 2002 "stimulus" bill as costing $73 billion in 2001 and $87 billion in 2002, using static estimates of the revenue loss. These OMB estimates of the revenue losses caused by the tax cuts do not necessarily contradict the President's view that the tax cuts boosted revenues. The President is saying that the *net* effect of the tax cuts was to raise revenues; revenues would decline because of lower tax rates and increased deductions and credits, but would increase because economic growth in 2001 and 2002 was higher with the tax cuts than it would have been without them.

- If the tax cuts simply paid for themselves, the tax cuts must have caused the economy to shrink less (or grow more) than it otherwise would have by a sufficient amount to generate $73 billion in extra revenue in 2001 and $87 billion in extra revenue in 2002. These extra revenues would be needed to offset the $73 billion and $87 billion that OMB says the tax cuts lost in these years through changes in tax law.

- The President's Council of Economic Advisers states in a recent white paper that each additional dollar the economy grows produces 19 cents in additional federal revenue.[17] At this 19-percent rate, to produce $73 billion in extra revenues, the 2001 economy would need to have been $385 billion larger than it would have been without the 2001 tax cut. Similarly, the 2002 economy would need to have been $459 billion larger than it would have been without the tax cut.

- These calculations indicate that for the tax cut to have paid for itself, the economy would need to have shrunk by 3.1 percent in 2001 in the absence of the tax cut. By 2002, the economy would need to have been 2.0 percent smaller, without the tax cut, than it was in 2000. (These figures adjust for inflation and represent real economic growth or contraction.)

To gain a sense of whether such effects are plausible, one can look at these results in historical context. If the President's statement is correct and the tax cuts generated enough extra growth to pay for themselves in 2001 and 2002, then the real decline in the economy would need to have equaled 3.1 percent in 2001 without the tax cut. This would have been the *largest economic decline since 1946*, when the government cut federal spending by 40 percent in its demobilization after World War II. Similarly, the economy would need to have been smaller in real terms in 2002 than it was in 2000, which would have represented the first time since 1946 and 1947 that the economy would have shrunk over a two-fiscal-year period. Stated another way, for the President's statement to stand up, the tax cuts would need to have caused the economy to be 4.0 percent larger than it otherwise would have been in 2001 and 4.6 percent larger than it otherwise would have been in 2002.

[17] Council of Economic Advisers, *Strengthening America's Economy*, White Paper, February 4, 2003, page 8.

For the President's belief about the efficacy of the tax cuts to be correct, the tax cuts thus need to have had extraordinary powers in 2001 and 2002. The question is whether effects of this magnitude are plausible and whether the economy really would have performed as badly as these figures indicate without the tax cuts. (Moreover, these calculations assume the tax cuts only paid for themselves; the President's statement suggests he believes the tax cuts more than paid for themselves, since he said that without the tax cuts, the deficit would have been "much bigger.")

The evidence is overwhelming that such effects are *not* plausible. In fact, the President's claim is directly contradicted by his own Council of Economic Advisors, which has estimated that the 2001 tax cut caused the economy to be 0.1 percent — not 4.0 percent — larger in fiscal year 2001 than it otherwise would have been, and 0.7 percent — not 4.6 percent — larger in fiscal year 2002.[18] For the President's statement to have been correct, the recent tax cuts would need to have caused at least *seven times* as much economic growth as the President's own economic advisers argue it did. Moreover, the CEA analysis itself portrays the tax cut as having a more robust economic effect than some other economic studies indicate.[19]

Conclusion

The notion that tax cuts can pay, or have paid, for themselves is refuted by the President's Council of Economic Advisers both in its analysis of the 2001 tax cut and in the *Economic Report of the President*. This notion also is contradicted by the abnormally low rate of revenue growth projected in the President's budget. And it is rebutted by the long-term budget projections in OMB's *Analytical Perspectives*, which show permanent deficits. Finally, history shows that the large reductions in income tax rates in 1981 were followed by abnormally slow growth in income tax receipts, while the increases in income-tax rates enacted in 1990 and 1993 were followed by sizeable growth in income-tax receipts. Leading economists are warning that the tax cuts the Administration is proposing will lose substantial revenue and damage the nation's long-term fiscal position. The idea that tax cuts can pay for themselves sounds too good to be true because it *is* too good to be true.

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[18] Council of Economic Advisers, *President Bush's 2001 Tax Relief Softens the Recession*, White Paper, February 14, 2002. The CEA estimated an (assumed) increase in real, annualized, quarterly economic growth over six quarters as a result of the 2001 tax cut. This analysis converts the CEA figures to their equivalent in higher annual levels of real GDP.

[19] See Matthew D. Shapiro and Joel Slemrod, "Did the 2001 Tax Rebate Stimulate Spending? Evidence from Taxpayer Surveys," NBER working paper 9308, October 2002.