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TOO GOOD TO BE TRUE

"Tax cuts don't need to be paid for [with offsets] — they pay for themselves."

House Budget Committee Chairman Jim Nussle
Quoted in BNA Daily Tax Report, March 17, 2004

By Richard Kogan, David Kamin, and Joel Friedman

Do tax cuts pay for themselves? This past week, the House Budget Committee approved legislation that would require all expansions of entitlement programs to be paid for with offsetting cuts in spending. When asked by a reporter why a similar "pay-as-you-go" requirement was not applied to tax cuts, Chairman Nussle responded that "Tax cuts don't need to be paid for [with offsets] — they pay for themselves."[1]

At the heart of Chairman Nussle's response is the belief that tax cuts generate so much economic growth that they pay for themselves — that is, that the economy expands so much as a result of tax cuts that it produces the same level of revenue as the economy would produce without the tax cuts. This belief is one of the most powerful and enduring myths in public finance. No reputable economist — liberal or conservative — has ever shown that tax cuts pay for themselves. The assertion that tax cuts pay for themselves is little more than wishful thinking, and is rejected by virtually every serious economist and budget analyst.

Do Tax Cuts Pay For Themselves? Economists Say No.

- President Bush's own Council of Economic Advisers concluded in its *Economic Report of The President, 2003,* that "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 revenue is completely recovered by the higher level of economic activity."[2] Conservative economist Glenn Hubbard was chairman of the CEA at the time.

- N. Gregory Mankiw, the current chairman of the President's Council of Economic Advisers and a Harvard economics professor, has written in his well-known 1998 text book that there is "no credible evidence" that "tax revenues … rise in the face of lower tax rates." He goes on to compare an economist who says that tax cuts could pay for themselves to a "snake oil salesman who is trying to sell a miracle cure."[3]

- Both the Congressional Budget Office and the Joint Committee on Taxation have been tasked with analyzing the "dynamic" economic effects of recent tax cuts. These non-partisan bodies, currently headed by Republican appointees, both have

found that recently enacted tax cuts would have very small effects — which could be either positive or negative — on economic growth. Their studies conclude that the tax breaks enacted since 2001 would generate little, if any, offsetting increase in revenues.[4]

- Even the conservative Heritage Foundation has found that the tax cuts proposed by President Bush would not pay for themselves.[5]

Do Tax Cuts Pay For Themselves? History Says No.

In 1981, Congress approved very large supply-side tax cuts, featuring much lower marginal income-tax rates. In 1990 and 1993, by contrast, Congress raised marginal income-tax rates on the well off. We can thus compare two decades with contrasting tax regimes. Such a comparison shows:

- There was no discernable difference in economic growth rates during those two decades.

- Even though the rates of economic growth were virtually indentical during the two decades, growth in real income-tax revenue was nearly three times as high in the 1990s (when taxes were increased) as in the 1980s (when taxes were decreased). See Table 1.

Table 1:
Comparing the 1980s and 1990s

	Avg. real *economic* growth	Avg. real *income-tax* growth
1981-90	3.3%	1.5%
1990-01	3.2%	4.2%

Notes: To avoid distortions, economic growth is measured from one business-cycle peak to the next. Tax figures include individual and corporate income taxes. If receipts from capital gains were not included, the annual growth of income taxes would have averaged 1.1 percent in the 1980s and 3.9 percent in the 1990s. Sources: Bureau of Economic Analysis, OMB Historical Tables.

These results confirm common sense: tax cuts lose revenue, tax increases raise revenue, and the general effect on economic growth (beyond temporary effects during an economic slump) is slight.

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[1] Bud Newman and Nancy Ognanaovich, "Nussle's New Budget Enforcement Bill To Apply To Spending, Not To Tax Cuts," Bureau of National Affairs Daily Tax Report, March 17, 2004.

[2] Council of Economic Advisers, *Economic Report of the President*, February 2003, pp 57, 58.

[3] N. Gregory Mankiw, *Principles of Economics* (Fort Worth, TX: Dryden, 1998), pp. 29-30.

[4] In its August 2003 *Budget and Economic Outlook*, CBO finds that the revenue measures enacted since 2001 could "…boost the level of potential GDP by as much as 0.3 percent or reduce it by as much as 0.1 percent over the years 2004 to 2008. From 2009 to 2013, it could reduce the level of potential GDP by about 0.4 percent." In regard to the macroeconomic effect of the 2003 tax bill, the Joint Committee on Taxation reached similar conclusions. See: CBO, *The Budget and Economic Outlook: An Update*, August 2003, p. 45; JCT, "Macroeconomic Analysis of H.R. 2: The Jobs and Growth Reconciliation Tax Act of 2003," *Congressional Record — House of Representatives*, May 8, 2003, pp. H3829-H3832.

[5] William W. Beach, Ralph A. Rector, Alfredo Goyburu, and Norbert J. Michel, "The Economic and Fiscal Effects of the President's Growth Package," Heritage Foundation, April 16, 2003.