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IS THE HOUSE TAX BILL NEEDED TO AVERT A RECESSION?

by Peter R. Orszag

On March 1, the House Ways and Means Committee passed the Economic Growth and Tax Relief Act of 2001, which reduces income tax rates roughly in line with the Bush administration's tax cut proposal. (The Ways and Means legislation includes one change from the Bush budget: It would create an interim 12 percent bracket this year, accelerating a small part of the income tax cut.)

Many advocates of the tax cut, including members of the Bush administration, have argued that it will help to spur the economy out of its current period of sluggish growth and avoid a possible recession. Most economists are dubious of this argument. Even Treasury Secretary Paul O'Neill stated in his confirmation hearings that "I'm not going to make a huge case that this is the investment we need to make sure we don't go into a recession."[1]

The argument that the proposed tax cut is necessary to avoid a recession overlooks several key factors.

The Tax Cut Is Backloaded and Does Not Provide Much Stimulus In Short Run

The tax plan the Ways and Means Committee has passed would do little to lift the economy in the short run because its tax cuts are backloaded. Indeed, only 0.5 percent (or $1 out of every $200) of the cost of the legislation between 2001 and 2011 would occur in 2001.[2] Less than 5 percent of the total cost occurs before 2003, by which time economic conditions are very likely to be different than today. Fundamentally, such backloading is inconsistent with spurring the economy in the short run: The tax cuts would do little to boost families' spending power immediately and therefore do little to spur the economy in the months ahead.[3]

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1 Joseph Kahn, "Treasury Choice Varies from Bush on Tax Outlook, *New York Times*, January 18, 2001, Page 1.

2 The revenue cost in 2001 is estimated to be $5.7 billion, including the additional interest costs (because less debt will be reduced as a result of the tax cut). The 2001-2011 cost, with the additional interest costs, is estimated to be $1.2 trillion. (Before interest costs, the cost in 2001 is $5.6 billion and the 2001-2011 cost is $958 billion.)

3 Theoretically, such backloaded tax cuts may, if anything, impose a *drag*, rather than a stimulus on the economy in the short run for two reasons. First, tax cuts scheduled to take effect in the future can raise current long-term
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Another perspective on the size of the tax cut in 2001 is that it amounts to just 0.05 percent (or roughly $1 out of every $2,000) of Gross Domestic Product for the year, as estimated by CBO. This reduction is too small to have much macroeconomic impact in the short run.

As Alan Auerbach, a leading tax economist at the University of California, Berkeley, recently noted, the Bush tax package "was never designed to be a stimulus package, and it can't be made into a stimulus package unless you throw it away and start over. It has no effect in the short run."[4] The Ways and Means Committee did not throw out the Bush tax proposal and start over; the legislation it passed was not designed to be, and is not, an effective stimulus package.

The reason that the Bush tax cut is not designed to stimulate the economy in the short run is not only that it is backloaded but also that it is heavily tilted toward high-income earners. When fully in effect, the Bush tax cut would deliver nearly 40 percent of its benefits (including its estate tax reductions) to the top one percent of the population. This substantially exceeds the share of federal taxes this group pays. (The top one percent pays 24 percent of all federal taxes.) Moreover, the share of the tax cuts the top one percent of the population would receive when the Bush proposal is fully in effect is greater than the share the bottom 80 percent of the population would receive.[5] The distribution of tax benefits is significant because higher-income families are more likely to save some portion of their tax cut than are lower- and middle-income families.[6] If the objective is to spur the economy, the Bush tax cut is not well-designed for the task. Putting more money back in the hands of lower- and middle-income families would provide a greater "bang for the buck."

Tax Cuts Are Not an Effective Tool for Managing the Economy

Whatever the design of the tax cut, a large majority of economists believe tax cuts are simply not an effective tool for managing the macro-economy. In many cases, such tax cuts take effect after the economy has already started to recover. Even if the Ways and Means Committee legislation

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interest rates, since government debt would ultimately be higher than it would be in the absence of the tax cuts. The higher interest rates — which take effect almost immediately — can slow the economy, since they cause firms to invest less and households to cut back on their spending. Tax cuts in the future also may reduce economic activity today by inducing some people to wait until the tax cuts are in effect before making investments or increasing their work effort. If so, they could contribute to slowing the economy today, because some people will wait to undertake activities they otherwise would have undertaken now. In practice, however, this effect is likely to be very small.

4 Daniel J. Parks, "Bush Faces Concern That Tax Cuts Will Be Too Much, Too Late," *CQ Weekly*, February 24, 2001, page 419.

5 Robert Greenstein, "How Would Families at Different Income Levels Benefit from The Bush Tax Cut?," Center on Budget and Policy Priorities, February 7, 2001.

6 Karen E. Dynan, Jonathan Skinner, Stephen P. Zeldes, "Do the Rich Save More?"NBER Working Paper No. W7906, Sept. 2000.

were enacted, families would likely not receive any additional cash until the second half of the year.[7] By then, as William McDonough, the President of the Federal Reserve Bank of New York, was recently quoted as saying, the economy is expected to be "quite strong" even in the absence of a tax cut.[8] As discussed below, CBO similarly projects a strong, fairly prompt return to solid economic growth rates without a tax cut.

Most economists believe that monetary policy is more effective than fiscal policy in managing short-term problems in the economy. Alan Greenspan noted in testimony on January 25, "Lately there has been much discussion of cutting taxes to confront the evident pronounced weakening in recent economic performance. Such tax initiatives, however, historically have proved difficult to implement in the time frame in which recessions have developed and ended."

In most cases, the Federal Reserve can provide as much or more stimulus than Congress by increasing the money supply, which reduces interest rates. A tax cut is usually unnecessary, given the ability of the Federal Reserve to reduce interest rates and to act quickly. Paul Krugman, a well-known economist at Princeton, recently wrote, "almost all economists now agree with the position that monetary policy, not fiscal policy, is the tool of choice for fighting recessions."[9]

It Is Far from Clear That a Recession Looms

The seriousness of the economic slowdown remains uncertain. CBO projects that while economic growth will slow in 2001, the economy will avoid a recession, with GDP rising by 2.4 percent, after adjusting for inflation.[10] CBO also projects that the economy will then rebound and grow at a solid rate of 3.4 percent in 2002 and a rate of 3.1 percent throughout the rest of the coming 10-year period. CBO forecasts that the economy will avoid a recession, rebound from its current, slower rate of growth, and enjoy a higher subsequent growth rate, without a tax cut.

The Federal Reserve itself, in its February 13 monetary policy report to Congress, also predicted a return to stronger growth later this year in the absence of any fiscal policy changes. As the report stated, "Although the economy appears likely to be sluggish over the near term, the members of the Board of Governors and the Reserve Bank presidents expect stronger conditions to

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[7] Theoretically, a tax cut that was announced today but did not take effect until some point in the future could still affect spending patterns almost immediately. Some households might be willing to spend more today based on the expectation of a tax cut tomorrow. But this effect is likely to be small in practice: some households lack the available income to increase spending today, and others are unwilling to change their behavior before the tax cuts actually take effect.

[8] Albert Hunt, "A Tax Cut that Redistributes to the Rich," *Wall Street Journal*, February 8, 2001, page A23.

[9] Paul Krugman, "Reckonings: Getting Fiscal," *New York Times*, January 10, 2001, page A19.

[10] Technically, an increase in GDP for the year is not necessarily inconsistent with a recession occurring, if the recovery from the recession occurred quickly and was relatively strong. But it is highly unlikely that the economy would grow by 2.4 percent for the year as a whole if it experienced a recession during part of the year.

emerge as the year progresses. For 2001 overall, the central tendency of their forecasts of real GDP growth is 2 percent to 2-1/2 percent, measured as the change from the fourth quarter of 2000 to the fourth quarter of 2001."[11]

Private-sector forecasters similarly are doubtful the economy will enter a recession. The *Economist* magazine's most recent poll of private-sector forecasters suggests an average projected growth rate of 1.8 percent in 2001. The average growth forecast for 2001 among the forecasters included in the latest Blue Chip Economic Indicators, published February 12, is 2.1 percent. While these rates of growth are lower than those of recent years, they indicate that most forecasters do not believe a recession will occur.[12] The unofficial definition of a recession is two consecutive quarters of *negative* growth (that is, the economy contracts rather than continuing to grow).[13] Only five percent of the forecasters included in the Blue Chip report believed the economy is in a recession.[14] Moreover, the average Blue Chip forecast is for a strong rebound from the current growth slowdown, with a growth rate of 3.5 percent in 2002.

This uncertainty regarding whether the economy is in, or will enter, a recession provides another motivation for leaving macroeconomic management to the Federal Reserve: the Federal Reserve is better equipped to monitor the economic situation as it evolves than Congress is.

Conclusion

The Ways and Means tax cut is not well designed to address a possible economic slowdown since it is backloaded. The tax cut in 2001 is too small to be of much macroeconomic benefit in the short run and is also unlikely to be passed in time to address the current sluggishness in the economy. Most economists believe that with the exception of a significant recession, macroeconomic fluctuations such as a decline in the growth rate should be addressed primarily by the Federal Reserve.

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[11] Federal Reserve Board of Governors, "Monetary Policy Report submitted to the Congress on February 13, 2001, pursuant to section 2B of the Federal Reserve Act," available at http://www.federalreserve.gov.

[12] The ability of economic forecasters to recognize turning points (such as when the economy enters a recession) ahead of time is limited. Nonetheless, the best guesses from private-sector forecasters currently suggest that the economy is not on the verge of a recession.

[13] The official adjudicator of whether the economy enters a recession is a committee of experts at the National Bureau of Economic Research (the Business Cycle Dating Committee). That committee defines a recession simply as "a period of declining output and employment. A recession begins just after the economy reaches a peak of output and employment and ends as the economy reaches its trough." The unofficial definition of a recession, as two quarters of negative growth, provides only a rough guide to the Committee's deliberations.

[14] Martin Crutsinger, "Greenspan Addressing Congress," Associated Press, February 13, 2001.