CENTER ON BUDGET AND POLICY PRIORITIES

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MARGINAL TAX RATE REDUCTIONS AND THE ECONOMY: WHAT WOULD BE THE LONG-TERM EFFECTS OF THE BUSH TAX CUT?

On March 15, the Center on Budget and Policy Priorities released an analysis, *Marginal Tax Rate Reductions and the Economy: What Would Be the Long-Term Effects of the Bush Tax Cut?* The analysis was prepared for the Center by Peter Orszag, who is president of Sebago Associates (an economic consulting firm) and a former senior economist at the President's Council of Economic Advisers and the National Economic Council. Orszag will join the Brookings Institution this summer as a senior fellow in economics.

The Center's analysis examines the academic literature to assess the claims made by proponents of the Bush tax plan that marginal tax rate reductions would promote economic expansion by improving incentives to work, take risks, and save. The analysis finds that these claims are substantially exaggerated and that the proposed tax cuts might not be beneficial for the economy.

Evidence on Effects of Marginal Tax Rates

The first part of the Center analysis examines the historical and academic evidence on the effects of marginal tax rates.

- The historical evidence is not consistent with the belief that taxes have a large effect on economic growth. For example, in 1993, the top marginal tax rate increased from 31 percent to 39.6 percent. When these marginal tax rate increases were passed as part of the 1993 budget agreement, many prominent conservatives predicted an economic disaster would result. Instead, the economy experienced its longest economic expansion in history during the 1990s. Real GDP grew by an average of 4 percent per year from 1993 through 2000, almost 50 percent faster than the average from 1973 to 1993. Furthermore, income gains were significantly larger in the 1990s among the top five percent of tax filers — the only group affected by the increase in marginal tax rates in the early 1990s — than among the rest of the population. As the Congressional Budget Office recently noted, "the income of households facing the higher rates [from the 1990 and 1993 increases] rose much more rapidly over the decade than did overall income."

- Studies examining the specific effects of marginal tax rates on work, saving, and entrepreneurship tend to find modest effects. For example, numerous economic studies have found that lower tax rates do little to encourage work effort among working-aged males — who already are generally working full time — although they may provide some additional incentives for women to enter the labor force or men to delay partial or full retirement. As economists Joel Slemrod and Jon Bakija of the University of Michigan have written, "overall, labor supply is not greatly affected by taxes." Marginal tax rates similarly seem to have only modest effects on private saving and risk-taking.

Estimate of Net Impact of Proposed Bush Tax Cut

The second part of the Center analysis estimates the likely overall impact of the proposed

	Percentage Point Effect on GDP in 2012
Positive effect from tax reductions	+0.4 to +0.5 percent
Minus: Negative effect from reduced national saving	-0.6 to - 0.9 percent
OVERALL EFFECT	-0.1 to -0.5 percent

Bush tax plan on the economy. It concludes that the overall effect in the long run may, if anything, be slightly negative.

- The Center's analysis emphasizes two offsetting effects of the Bush tax plan: It would reduce marginal tax rates (which could expand the economy modestly in the future), but it would also reduce national saving, as compared to a course of action of saving the projected surpluses (because most of the tax cut will be consumed, rather than saved). Reducing national saving would cause a decline in output in the future. In evaluating the impact of the proposed tax cuts on the economy, one must include *both* the potential positive effects from reducing marginal tax rates *and* the negative effects from reducing national saving.

- The Center analysis uses the results from a recent study by Jonathan Gruber of M.I.T. and Emmanuel Saez of Harvard, the most recent and rigorous analysis of the effects of marginal tax rate changes, to examine the impact of the marginal rate reductions in the proposed Bush tax cut. The results of that study suggest that a reduction in marginal rates such as President Bush has proposed would raise Gross Domestic Product in the long run by slightly less than four-tenths of one percent (0.4 percent), a relatively modest improvement. Other changes in the Bush tax plan would have only minimal effects on GDP in the future, perhaps amounting to about one-tenth of one percent (0.1 percent).

- The Bush tax plan also would reduce national saving relative to the Congressional Budget Office baseline, under which all the surpluses are assumed to be saved. As explained in the Center analysis, the reduction in national saving caused by the tax cut could reduce GDP over the long run by between 0.6 percent and 0.9 percent.

- The overall effect of the Bush tax plan thus is likely to be a small *reduction* in GDP by the end of the ten-year period, because the benefits of the marginal tax rate changes are too small to offset the costs of the fall in national saving.

- While these estimates are necessarily uncertain, they raise serious questions about whether a tax cut should be expected to produce a large long-term gain to the economy. They also suggest that at the margin, scaling back the tax cut and undertaking more national saving would likely be beneficial from the perspective of raising future GDP. It would likely produce a modestly larger economy than enacting a large tax cut and saving less.