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EVIDENCE SHOWS THAT TAX CUTS LOSE REVENUE

The claim that tax cuts “pay for themselves” — i.e., cause so much economic growth that revenues rise faster than they would have without the tax cut — has been made repeatedly in recent years and is one of the many tax policy issues that is likely to receive renewed attention in light of the upcoming election. As explained briefly below, this claim is false. The evidence shows clearly that tax cuts lose revenue.¹

The 2001 and 2003 tax cuts have not paid for themselves. There is no evidence that the tax cuts caused *any* increase in economic growth, let alone growth sufficient to offset their cost. In fact, the 2001-2007 economic expansion was among the weakest since World War II with regard to overall economic growth.² Moreover, *revenue* growth was very poor during 2001-2007. Real per-capita revenues fell deeply in 2001, 2002, and 2003 and have since risen to barely 2 percent above their 2001 level. Over the course of other postwar economic expansions, they grew by an average of 12 percent.³

Previous tax cuts did not pay for themselves either. In 1981, when Congress substantially lowered marginal income tax rates on the well-off, supporters claimed the cuts would boost economic growth. In 1990 and 1993, when Congress *raised* marginal income tax rates on the well-off, opponents claimed the increases would harm the economy.

In fact, the economy grew at about the same rate in the 1990s, following tax increases, as in the 1980s, following a large tax cut.⁴ And revenues grew *twice as fast* in the in the 1990s (3.5 percent in real per-capita terms) as in the 1980s (1.5 percent).⁵

Capital gains rate cuts, like other tax cuts, lower revenue in the long run. Especially when a capital gains cut is temporary, like the 2003 cut, investors have a strong incentive to realize their capital gains before the old, higher rate returns. This can cause a *short-term* increase in revenues, as happened after 2003. (Capital gains realizations also went up after 2003 because of the increase in the U.S. stock market. The capital gains tax cut cannot take credit for the stock market recovery, though, since

¹ For a more detailed discussion, see: Richard Kogan and Aviva Aron-Dine, “Claims that Tax Cuts ‘Pay For Themselves’ Too Good To Be True: Data Show No ‘Free Lunch’ Here,” Center on Budget and Policy Priorities, revised July 27, 2006.

² See also: Aviva Aron-Dine, Chad Stone, and Richard Kogan, “How Robust Was the 2001-2007 Economic Expansion?” Center on Budget and Policy Priorities, revised April 22, 2008, <http://www.cbpp.org/8-9-05bud.htm>.

³ Office of Management and Budget and U.S. Census Bureau data.

⁴ U.S. Commerce Department data.

⁵ Office of Management and Budget and U.S. Census Bureau data.

European stocks performed just as well as U.S. stocks during this period.⁶⁾

Over the long run, however, there is virtually no evidence that cutting capital gains taxes spurs nearly enough economic growth to pay for itself. As the Congressional Budget Office recently stated, the “best estimates of taxpayers’ response to changes in the capital gains tax rates do not suggest a large revenue increase from additional realizations of capital gains — and certainly not an increase large enough to offset the losses from lower rates.”⁷

Deficit-financed tax cuts carry significant costs that are likely to outweigh any short-term boost in economic growth. Deficit-financed tax cuts can stimulate an economy in recession and temporarily improve growth. In the long run, however, the resulting deficits lower national savings and are a drag on the economy. Thus, such tax cuts would lose revenues both by cutting tax rates and by harming the economy. Brookings Institution economist William Gale and now-CBO director Peter Orszag concluded that the 2001 and 2003 tax cuts are “likely to reduce, not increase, national income in the long term” because of their effect in swelling the deficit.⁸ CBO’s recent study of a deficit-financed extension of the 2001 and 2003 income-tax cuts found that “real [Gross National Product] per person would decline by 13 percent in 2050” relative to a extension that was financed through a balanced mix of revenue and spending changes effective immediately.⁹

Given the evidence, economists across the political spectrum reject the notion that tax cuts pay for themselves. They include Edward Lazear, current chairman of President Bush’s Council of Economic Advisers (who told Congress, “I certainly would not claim that tax cuts pay for themselves”) and N. Gregory Mankiw, the CEA chair earlier in President Bush’s administration (who once compared an economist who says that tax cuts pay for themselves to a “snake oil salesman trying to sell a miracle cure”).¹⁰

In addition, the Bush Treasury Department’s own “dynamic” analysis of the cost of the 2001 and 2003 tax cuts estimated that they would generate only enough economic growth to cover *less than 10 percent* of their long-term cost.¹¹ Furthermore, that estimate was based on a best-case scenario; it depended on the assumption that the cost of the tax cuts would be fully offset by spending cuts.

In sum, the idea that tax cuts pay for themselves sounds too good to be true because it *is* too good to be true. Tax cuts lose revenue, and when they are deficit financed, they can also contribute to poorer economic performance over the long term.

⁶ Gene Amromin, Paul Harrison, and Steve Sharpe, “How Did the Dividend Tax Cut Affect Stock Prices?” Federal Reserve Board Discussion Paper, December 2005, <http://www.federalreserve.gov/PUBS/FEDS/2005/200561/200561pap.pdf>.

⁷ Congressional Budget Office, “Sources of Growth and Decline in Individual Income Tax Revenues Since 1994,” May 2008, p. 11. For more on this issue, see the following CBPP reports: “Experts Agree that Capital Gains Tax Cuts Lose Revenue,” revised May 7, 2008; Aviva Aron-Dine and Joel Friedman, “The Capital Gains and Dividend Tax Cuts and the Economy,” revised March 27, 2006; “Tax Cuts: Myths and Realities,” revised May 9 2008.

⁸ William Gale and Peter Orszag, “Bush Administration Tax Policy: Effects on Long-Term Growth,” *Tax Notes*, October 18, 2004.

⁹ Extension of all of the 2001 and 2003 tax cuts includes provisions other than the personal income tax provisions covered by CBO’s study; thus the economic effects of extending all of the tax cuts would be larger than stated above. Congressional Budget Office, “Long-Term Effects of Indexing the Alternative Minimum Tax and Extending the Tax Reductions of 2001 and 2003,” Letter to Senator Kent Conrad, July 17, 2008.

¹⁰ Edward Lazear, testimony before the Joint Economic Committee, June 27, 2006; N. Gregory Mankiw, *Principles of Economics* (Fort Worth: Dryden Press, 1998), pp. 29-30.

¹¹ U.S. Department of the Treasury, “A Dynamic Analysis of Permanent Extension of the President’s Tax Relief,” July 25, 2006, <http://www.treasury.gov/press/releases/reports/treasurydynamicanalysisreporjuly252006.pdf>.