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LETTING HIGH-INCOME TAX CUTS EXPIRE IS PROPER RESPONSE TO NATION'S SHORT- AND LONG-TERM CHALLENGES

By Chuck Marr

Letting President Bush's tax cuts for families making over $250,000 expire as scheduled at the end of 2010, while temporarily redirecting this money to more efficient ways of boosting the economy while it is weak, would help the nation address two key challenges: short-term economic weakness (with nearly one in ten Americans out of work) and unsustainable long-term deficits.

Over the next year or two, policymakers could channel the savings from letting the tax cuts expire — about $40 billion in 2011 — to uses that have more "bang for the buck" in creating jobs and promoting growth. For example, Congressional Budget Office (CBO) analysis suggests that using those savings for a combination of a job-creation tax credit and continued state fiscal assistance would generate three times as much additional economic activity as using them to extend the high-income tax cuts.

Over the longer term, allowing these high-end tax cuts to expire on schedule would produce substantial deficit-reduction savings. (Policymakers could dedicate the short-term as well as the long-term savings to deficit reduction if they cannot agree on other short-term uses of the funds to boost the economy.)

A short-term extension of the tax cuts for high-income households, which some have suggested, also would be ill-advised. It would have only a small effect on the current, weak economy, while posing a substantial risk that Congress would continue extending the tax cuts and even make them permanent, creating much larger deficits for years to come. This risk is especially high given that the next Congress is likely to include considerably more proponents of making these tax cuts permanent. This is a matter of no small consequence: deficits and debt will be about $1 trillion higher over the next ten years if the high-income tax cuts remain in place.

Extending High-Income Tax Cuts the *Least* Effective Stimulus Option

Given the economy's present weakness, some argue that now is not the time to allow the 2001 and 2003 tax cuts for high-income households to expire. But analysis in a recent CBO report decisively refutes this argument.[1] CBO examined 11 options to stimulate growth and job creation and found

[1] Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011,* January 2010, http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf.

that extending the 2001 and 2003 tax cuts in general came in *last* in effectiveness.[2] CBO concluded that a job-creation tax credit, funds to help states balance their budgets with fewer cuts in services and tax increases, and extended unemployment insurance benefits would all generate more jobs and growth on a dollar-for-dollar basis.

Furthermore, CBO indicated that extending the tax cuts for *high-income households in particular* would rate even *lower* in effectiveness than extending all of the tax cuts. This is because, as CBO explained, "higher-income households … would probably save [rather than spend] a larger fraction of their increase in after-tax income."[3] An economy in a recession or the early stages of a recovery needs more spending, not more saving.

In short, CBO found extending the tax cuts for high-income households to be the worst of all options under discussion for preserving or creating jobs and boosting economic growth while the economy is weak.

Alan Blinder, a former Federal Reserve Vice Chair and one of the nation's most eminent economists, recently made this point as well. Writing in the *Wall Street Journal,* Blinder observed:[4]

> Consider three different ways to add a dollar to the budget deficit: increase unemployment benefits by $1, give a $1 tax cut to someone earning $50,000 a year, or give a $1 tax cut to someone earning $5 million a year.
>
> While the immediate impacts on the budget are identical, the near-term spending impacts are not. The unemployed worker struggling to make ends meet will likely spend the entire dollar right away. The $50,000 earner probably will spend the lion's share of it, saving just a bit — that's what most Americans do. But the $5,000,000 earner probably will save most of the new-found dollar.
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> The impacts on economy-wide demand will therefore be quite different. Paying more in unemployment benefits offers the most spending "bang" for the budgetary "buck." Extending the Bush tax cuts for the wealthy offers the least.

As a result, Blinder explained, it would be more economically efficient to let the high-income tax cuts expire to and use the proceeds to advance policies that create more jobs and growth in the short term, while devoting the savings to deficit reduction after that.

More Effective Uses of the Proceeds While the Economy is Weak

A number of policies would represent more effective uses of these resources in the period immediately ahead. Examples include:

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[2] One other option — extending relief from the Alternative Minimum Tax — came in only marginally better than extending the 2001 and 2003 tax cuts.

[3] CBO, p. 25.

[4] Alan S. Blinder, "Obama's Fiscal Priorities Are Right," *The Wall Street Journal*, July 19, 2010, http://online.wsj.com/article/SB10001424052748703394204575367490020828732.html?mod=WSJ_Opinion_LEADTop.

- **A jobs tax credit:** CBO estimates that a temporary jobs tax credit — one that reduced a firm's payroll taxes on new hires — would generate *three times* as much economic growth as extending the Bush tax cuts, per dollar of cost. CBO's analysis also shows that each dollar spent on a jobs tax credit would create *four to six times* as many jobs as a dollar spent on extending the Bush tax cuts.

  Moreover, these comparisons refer to extending the Bush tax cuts *as a whole.* The disparity in the effectiveness of these various policies is even greater when only the tax cuts for high-income households are considered.

- **State fiscal assistance:** The tax increases and budget cuts that states are imposing in response to their weak revenues are weighing heavily on the economy. CBO estimates that providing fiscal assistance to states would generate three to four times as much economic growth as extending the tax cuts and would create two to three times as many jobs. Moreover, Goldman Sachs' economic analysis unit reported on July 20 that, primarily because it no longer expects Congress to extend state fiscal relief or provide other further stimulus (beyond the just-approved extension of unemployment benefits), it is now significantly lowering its growth forecast for 2011.[5]

- **Unemployment benefits:** As noted above, unemployed workers quickly inject unemployment benefits back into the economy to help pay for their living costs. CBO concludes that dollar for dollar, this policy generates the largest bang-for-the-buck — for both economic growth and creation — of any of the policy options it examined.

Allowing the high-income tax cuts to expire on schedule would free up almost $40 billion in revenue next year (almost $90 billion over two years), based on estimates from the Treasury Department and the Joint Committee on Taxation.[6] As the CBO analysis shows, this money could be put to other uses that would generate substantially more economic activity and jobs. Just $13 billion in state fiscal relief would stimulate the economy as much as the approximately $40 billion it would cost to extend all of the high-income tax cuts.

Using the economic multipliers in the CBO analysis,[7] one can examine how the impact of extending the tax cuts for high-income households would compare to two hypothetical packages, one channeling $20 billion into state fiscal relief and $20 billion to a job creation tax credit, and the other channeling the full $40 billion into a further extension of unemployment benefits. (The just-enacted extension of unemployment benefits runs out in November, but the unemployment rate is expected still to be between 9 and 10 percent at that time.)

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[5] Goldman Sachs Global ECS US Research, "The End of the Road for Fiscal Stimulus?," July 20, 1010.

[6] Based on Treasury estimates in President Obama's 2011 budget, table S-8, and JCT estimates of dividend tax cut-related costs not included in the Treasury estimates (see footnote 9 for specifics).

[7] For simplicity, these estimates use the midpoint of CBO's multiplier range for each policy option. They also apply CBO's multiplier for extending the entire 2001 and 2003 tax-cut package to an extension of the high-income tax cuts. In actuality, the multiplier for high-income tax cuts would be somewhat lower, and the advantages of using the resources for the hypothetical packages instead even greater than the figures cited here.

A) Extending the $40 billion in high-income tax cuts would generate about $10 billion in GDP.

B) Allowing these tax cuts to expire and instead providing $20 billion in state fiscal relief and $20 billion toward a job creation tax credit would generate about $32 billion in GDP: $15 billion from the state fiscal relief and $17 billion from the jobs tax credit. The result would be a net gain of $22 billion in economic activity — or a tripling of the impact.

C) Allowing the high-income tax cuts to expire and providing $40 billion in continued unemployment benefits instead would generate about $52 billion in GDP. Compared to extending the high-income tax cuts, this would result in a net gain of $42 billion in economic activity — *five times* the economic stimulus that would come from extending the high-income tax cuts.

Letting Tax Cuts Expire on Schedule Would Lock in Long-Term Budget Savings

The country is on an unsustainable fiscal path. CBO estimates that, even in the highly unlikely event that Congress enacts *all* of the deficit-reduction proposals in the President's fiscal year 2011 budget, the debt will climb to 90 percent of the gross domestic product by 2020, and annual deficits will be above 5 percent of GDP (and rising) at that time.[8]

If Congress extends the tax cuts for married filers with incomes above $250,000 and single filers with incomes above $200,000 — the top 2 percent of U.S. households — then deficits and debt will be about *$1 trillion higher* over the next ten years than if it lets them largely expire, as President Obama has proposed.[9] In subsequent decades, extending the high-income tax cuts would increase deficits by even larger amounts.

Even a temporary extension of these tax cuts would be quite ill-advised. Not only would it be a highly inefficient way to stimulate the economy now, but it would pose serious long-term fiscal risks. A one- or two-year extension would hand to the next Congress the critical decisions on the ultimate disposition of the high-income tax cuts. Proponents of making those tax cuts permanent are expected to make major gains in the November election and thus to have more votes for such a move. A one-year or two-year extension now would likely lead to a second extension, and to either more extensions after that or action by a future Congress to make all of the Bush 2001 and 2003 tax cuts permanent. That, of course, would produce higher deficits as far as the eye can see. The much more fiscally responsible course is to allow the high-income tax cuts to expire on schedule at the end of this year.

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[8] Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011*, March 2010, http://www.cbo.gov/ftpdocs/112xx/doc11280/03-24-apb.pdf. "Debt" as used here refers to debt held by the public.

[9] Based on President Obama's 2011 budget, table S-8 (produced using Treasury Department estimates). This includes the costs (relative to President Obama's proposals) of extending the top two marginal income tax breaks, the repeal of the Pease and PEP provisions, and the 15 percent tax rate on income from capital gains and dividends for households with income above the $250,000 and $200,000 thresholds. The figure also includes the cost of reducing the tax rate on dividends for households above the $250,000/$200,000 thresholds, from ordinary tax rates to President Obama's proposed rate of 20 percent for these households, as estimated by JCT. Some $838 billion of the $1 trillion increase in the deficit would come from revenue losses. The other $180 billion would come from increased interest payments on the national debt.