

Five Myths about the Bush Tax Cut

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The tax cuts enacted in 2001 and 2003, known as the Bush tax cuts, are set to expire Dec. 31, and the fight over what to do is increasingly heated. Should the tax cuts expire, as some Democrats have said? Should they be extended, as most Republicans maintain? Or does the answer lie somewhere in between, as the Obama administration, led by Treasury Secretary Timothy Geithner, has argued in recent weeks?

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The cuts lowered tax rates across the board on income, dividends and capital gains; eventually eliminated the estate tax; further lowered burdens on married couples, parents and the working poor; and increased tax credits for education and retirement savings. Obama's proposal would extend most of these reductions, allowing only those for individuals making more than \$200,000 and families making more than \$250,000 to expire.

Complicating the debate is a gloomy economic and fiscal outlook, one that is decidedly different from the rosy scenario that prevailed at the beginning of the last decade. That outlook has given rise to a number of stubborn myths about what extending the Bush tax cuts would -- or wouldn't -- do.

1. Extending the tax cuts would be a good way to stimulate the economy.

As a stimulus measure, a one- or two-year extension has one thing going for it -- it would be a big intervention and would provide at least some boost to the economy. But a good stimulus policy can't just be big; it should also offer a lot of bang for the buck. That is, each dollar of government spending or tax cuts should have the largest possible effect on the economy. According to the Congressional Budget Office and other authorities, extending all of the Bush tax cuts would have a small bang for the buck, the equivalent of a 10- to 40-cent increase in GDP for every dollar spent.

Why? As the CBO notes, most Bush tax cut dollars go to higher-income households, and these top earners don't spend as much of their income as lower earners. In fact, of 11 potential stimulus policies the CBO recently examined, an extension of all of the Bush tax cuts ties for lowest bang for the buck. (The CBO did not examine the high-income tax cuts separately, but the logic it used suggests that extending those cuts alone would have even less value.) The government could more effectively stimulate the economy by letting the high-income tax cuts expire and using the money for aid to the states, extensions of unemployment insurance benefits and tax credits favoring job creation. Dollar for dollar, each of these measures would have about three times the impact on GDP as continuing the Bush tax cuts.

2. Allowing the high-income tax cuts to expire would hurt small businesses.

One of the most common objections to letting the cuts expire for those in the highest tax brackets is that it would hurt small businesses. As Sen. Orrin Hatch (R-Utah) recently put it, allowing the cuts to lapse would amount to "a job-killing tax hike on small business during tough economic times."

This claim is misleading. If, as proposed, the Bush tax cuts are allowed to expire for the highest earners, the vast majority of small businesses will be unaffected. Less than 2 percent of tax returns reporting small-business income are filed by taxpayers in the top two income brackets -- individuals earning more than about \$170,000 a year and families earning more than about \$210,000 a year.

And just as most small businesses aren't owned by people in the top income brackets, most people in the top income brackets don't rely mainly on small-business income: According to the Tax Policy Center, such proceeds make up a majority of income for about 40 percent of households in the top income bracket and a third of households in the second-highest bracket. If the objective is to help small businesses, continuing the Bush tax cuts on high-income taxpayers isn't the way to go -- it would miss more than 98 percent of small-business owners and would primarily help people who don't make most of their money off those businesses.

3. Making the tax cuts permanent will lead to long-term growth.

A main selling point for the cuts was that, by offering lower marginal tax rates on wages, dividends and capital gains, they would encourage investment and therefore boost economic growth. But when it comes to

fostering growth, this isn't the whole story. The tax cuts also raised government debt -- and higher government debt leads to higher interest rates. If estimates of this relationship -- by former Bush Council of Economic Advisers chair Glenn Hubbard and Federal Reserve economist Eric Engen, and by outgoing Office of Management and Budget Director Peter Orszag and myself -- are accurate, then the tax cuts have raised the cost of making new investments. As the economy recovers and private borrowing rises, the upward pressure on interest rates is likely to grow even stronger.

I have used standard growth and investment formulas to calculate that the overall effect of the Bush tax cuts on economic growth has therefore been negative -- and it will continue to be negative if the cuts are extended.

4. The Bush tax cuts are the main cause of the budget deficit.

Although the cuts were large and drove revenue down sharply, they are not the main cause of the sizable deficit that exists today. In 2007, well after the tax cuts took effect, the budget deficit stood at 1.2 percent of GDP. By 2009, it had increased to 9.9 percent of the economy. The Bush tax cuts didn't change between 2007 and 2009, so clearly something else is to blame.

The main culprit was the recession -- and the responses it inspired. As the economy shrank, tax revenue plummeted. The cost of the bank bailouts and stimulus packages further added to the deficit. In fact, an analysis by the Center on Budget and Policy Priorities indicates that the Bush tax cuts account for only about 25 percent of the deficit this year.

5. Continuing the tax cuts won't doom the long-term fiscal picture; entitlements are the real problem.

One theory holds that the country's long-term budget shortfall is "just" an entitlements problem, the result of rising costs associated with growing Social Security rolls and increased health-care spending (via Medicare and Medicaid). Republicans like this idea because it plays down tax increases as a potential solution. Democrats like it because it makes the recent health-care package seem like even more of a triumph.

But it just isn't true. The deficits we face over the next decade reflect a fundamental imbalance between spending and revenue, one that goes beyond entitlements. Based on projections by the CBO, Alan Auerbach of the University of California at Berkeley and myself, among others, even if the economy returns to full employment by 2014 and stays there for the rest of the decade, the continuation of current fiscal policies, including the Bush tax cuts, would lead to a national debt in the range of 90 percent of GDP by 2020. That's already the highest rate since just after World War II -- and Medicare, Medicaid and Social Security aren't expected to hit their steepest spending increases until after 2020. According to these same projections, the yearly deficit would rise to 6 to 7 percent of GDP by 2020. The Bush tax cuts would account for a significant chunk of this, considering that in each year they are in effect, the revenue lost because of them amounts to nearly 2 percent of GDP. Compounding the problem: By increasing the government's debt, the tax cuts have already led to higher interest payments on that debt. So even if all of the cuts expire on Dec. 31, we will still be paying for them for years to come.

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