The Bush Tax Cuts

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Article:

Tax season is behind us for another year, so we now have a little time to reflect on tax policy. President Bush's tax policy has been simple: cut taxes. In fact, his economic agenda has been little else than a series of tax cuts, so it's not surprising that he's calling for Congress to make them permanent. Without such action, some of the tax cuts will expire in 2008.

The Bush tax cuts came in three major installments from 2001 to 2003. The first two addressed wage income and some forms of investment income, while the third installment, the Jobs and Growth Act of 2003, focused on investment income. Its most notable features were reductions in taxes on stock dividends and capital gains.

When the president was promoting the cuts, he made many optimistic claims on their behalf. They would pull the economy out of recession. They would help middle-income Americans as well as the richest among us. And they would create jobs.

Let's look at how many of these claims came true. Of course, for some people tax cuts are their own justification, and for them a discussion like this doesn't matter. But for the rest of us, it makes sense to hold the tax cuts up to a reasonable policy standard, and the president's own claims seem like a good place to start.

Did the tax cuts pull us out of recession?

Strictly speaking, the 2002 and 2003 cuts couldn't pull us out of recession because we were already out. Contrary to those who believe that 9/11 caused or at least deepened the recession, it actually ended in November 2001. By late 2003, the economy had been expanding for nearly two years, if one measures expansion in terms of national income. But it can make sense also to gauge a recovery in terms of employment, and as I'll note below, the jobs recovery after the 2001 recession has been weak.

Who benefited?

During the 2004 election campaign, the president said that "most of the tax cuts went to low- and middle-income Americans." As it turns out, this is far from the truth. A new analysis of Internal Revenue Service data by the New York Times, in conjunction with Citizens for Tax Justice, confirms that the benefits of the 2003 tax cuts were highly tilted toward the rich.

Americans with incomes of $1 million or more, which is to say the top one-tenth of one percent of all earners, saw their taxes fall by an average of over $40,000 in 2003 (the last year for which detailed tax data are available). That tiny sliver at the top end of the income distribution received 43 percent of the tax cut. The top 2 percent of all earners, those earning $200,000 or more, claimed over 70 percent.

If all the tax cuts from 2001 to 2003 are taken into account, the Times analysis shows that those earning $ 10 million or more saw their taxes lowered by an average of $1 million in 2003. As a result, those very rich people paid roughly the same proportion of their earnings in income tax as people earning between $200,000 and $500,000.

Traditionally, our system of income taxes has been structured to be "progressive," i.e. to tax richer people at higher tax rates. The Bush tax cuts are changing this. The 2003 tax cuts lowered the tax rate on dividends and capital gains by so much that the tax code now clearly favors income from investments over income from wages and salaries. And that favors the rich, who are the primary holders of investments.

Other than their homes, the financial assets of most middle-income people are 401Ks and other retirement accounts that were unaffected by the tax cuts. When income from those accounts is withdrawn after retirement, it'll be taxed as wage income rather than investment income. Consistent with this, the Times analysis showed that a family earning $50,000 saved only $ 10 in investment taxes in 2003.

Some argue that progressivity is unfair, and that everyone should pay the same tax rate. But then it's hard to justify taxing dividends and capital gains at a *lower* rate than for wage income. Moreover, if one takes *all* taxes into account, including state and local taxes, it was already the case that the average tax rate was roughly the same for all income groups. Prior to the Bush cuts, the tax system may not have been simple, but it was nearly flat. If made permanent, the Bush tax cuts could lead to a tax system in which rich people pay a *lower* share of their income in taxes.

What's with the AMT?

The irony of the Bush tax cuts is that they're benefiting the extremely rich but aren't doing much for the merely well-off. A symptom of this is the alternative minimum tax, which was not part of the Bush tax cuts. The AMT was enacted in 1969 to limit the tax write-offs of the very rich. A taxpayer who qualifies for the AMT has to make two calculations, a regular one and one for the AMT. If the AMT calculation is higher, the AMT is the amount due to the government.

But bizarrely, the AMT has never been fully adjusted for inflation. It was originally intended to affect only those earning $1 million or more in today's dollars, but more and more middle-income taxpayers are subject to it. The obvious solution is to index the tax to inflation. But instead Congress is arguing over whether to eliminate the tax altogether, and in the meantime it applies "patches" each year to mitigate the impact on middle-income families. If not for this year's patch, the AMT would have hit 18.9 million taxpayers.

Given the pro-rich slant of the president's tax cuts, one has to wonder if failing to index the AMT is actually his goal. After all, even with this year's patch, less than one percent of all AMT revenues are projected to come from taxpayers earning over $1 million.

Did cuts create jobs?

The sharp tilt in favor of the richest taxpayers could be justified, in principle, if reducing taxes to the rich enriched the rest of the economy. Tax-cut supporters more honest than the president acknowledge that the tax cuts are benefiting the rich but claim that this is good because it's the rich who create jobs. (In an earlier Republican presidency, the operative phrase here would have been "trickle-down.") So have rich folk been creating jobs for the rest of us? According to the data, probably yes. But when viewed in context, job creation in the wake of the tax cuts has been weak.

In the four years after the 2001 recession, the U.S. economy created about 1.6 million net jobs, an increase of only 1.2 percent over those four years. (I say "net" because the economy *lost* over 1.8 million jobs in 2002 and 2003.) Of course, not all of these new jobs can be attributed to the tax cuts, because the economy would have recovered from the recession with or without them. But for the sake of comparison, in the four years after the 1991 recession, the U.S. economy created nearly 9 million jobs, an increase of 8.2 percent.

Now, perhaps this comparison is unfair because the jobs recovery after the 2001 recession has been the slowest on record. For myriad reasons, including the possibility that the economy has needed time to digest the impressive technological gains of the 1990s, employment has only recently reached its pre-recession levels. So let's ignore the first two post-recession years for a moment.

In 2004 and 2005, the economy created nearly 3.5 million jobs, an increase of 2.7 percent over that two-year period. That's not bad, but since World War II the average two-year job gain has been 4 percent. In the comparable two-year period after the 1991 recession, employment rose by 5.8 percent. So even after giving the post-2001 recovery the benefit of the doubt, its employment performance is still sub-par.

None of this is to suggest that the 2001 recession was President Bush's fault. Nor was it the fault of President Clinton or anyone else. That's not how recessions work—for the most part they just happen. But employment data make it hard to argue that the Bush tax cuts were successful job creators. We had more vibrant job growth back in the higher-tax Clinton years.

The argument that investors will create jobs rests on a belief that "supply creates its own demand." It holds that if businesses are better funded, then consumers will flock to them. But it doesn't always work this way, particularly after a recession, when income has fallen. The more appropriate outlook then is that "demand creates its own supply." If enough people have the means to make purchases, businesses will ramp up to meet the increased demand. If job creation were the primary goal, we should have put more money in the hands of people who weren't rich. But maybe that wasn't the primary goal.

Don't get me wrong: Of course the Bush tax cuts stimulated the economy. But they probably weren't the most stimulative policy we could have used. If we're going to have a policy that generates large government deficits and widens the gap between rich and poor, it would have been nice to get more in return.

So as short-run economic policy, the Bush tax cuts were inequitable and inefficient. And that's the good news. The long-run implications of making the tax cuts permanent should make anyone nervous. The government's borrowing is warping our position in inter-national financial markets and crowding out savings by Americans.

The way we service our debt makes it harder for American manufacturers to compete with China. The federal government can't afford to start new initiatives or invest in new infrastructure. And it's hard to see how it can afford to make the necessary adjustments to Social Security and other entitlement programs to ensure their future viability.

On the other hand, if you want your tax cut and don't care about policy implications or the future of your country, then by all means lobby Congress to make the cuts permanent. You have the right to be wrong.