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## UNCERTAINTY AND TAXES: A Fatal Policy Mix

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## **Introduction**

The much-discussed Bush-era tax rates expire on December 31, 2010. Republicans have pushed for a permanent extension of all the current tax rates, while Democrats have pushed to make rates on the middle class—defined as individuals earning under \$200,000 and married couples earning under \$250,000—permanent and to let the existing rates on higher earners expire and return to a high of 39.6 percent. It now appears that the most likely compromise will be a temporary extension of all the tax rates, possibly for two years.<sup>1</sup>

Kicking the tax reform can down the road introduces a new element into ongoing political discussions. At a time of growing concerns about issues including mounting federal deficits and entitlement reform, the consensus seems to be to extend the current tax code only until these problems can be fully addressed and then tackle tax reform.<sup>2</sup> However, the environment of uncertainty that a temporary extension of the current tax rates imposes in the meantime will have disastrous consequences.

People do not like uncertainty,<sup>3</sup> especially when it comes to their taxes. Uncertainty in the tax code leads to economic paralysis because, in such an environment, it does not make good business sense to hire and invest. Moreover, under uncertainty, individuals are fearful of spending and/or taking additional investment risk. Without that spending and investment, the economy will not return to full employment growth.

As this paper will show, tax reform is necessary. However, given our current tax structure, any increase in marginal income-tax rates will actually retard economic growth and stall recovery further. It is important for Congress to focus on implementing stable low marginal tax rates that do not discourage working, saving, or investing and provide taxpayers with some degree of certainty to make growth-promoting economic decisions.

## **The 2001–2003 Tax Cuts**

The two major tax bills passed in 2001 and 2003<sup>4</sup> lowered taxes for all taxpayers. However, since these pieces of legislation were passed using budget reconciliation, both are set to sunset (expire) on December 31, 2010. If Congress takes no action, the tax code will revert to its pre-2001 structure.

If 2000 rates return, key changes include the return of the “marriage penalty” and the estate tax (the “death tax”), the end of expanded tax credits such as the child tax credit, which went from \$500 to \$1,000, and the loss of some deductions by high-income households. Capital-gains tax rates, dividend-tax rates, and income-tax rates will also increase at every income level.<sup>5</sup>

The most discussed change, however, has been the return to the pre-2001 income-tax rates. Table 1 outlines marginal tax rates, defined as the rate paid on the “last dollar” of taxable income,<sup>6</sup> for different policy proposals. Notably, the lowest 10-percent percent bracket would be replaced by a 15-percent bracket. Remaining tax brackets would increase to 28 percent, 31 percent, 36 percent, and the highest to 39.6 percent.

**Table 1: Marginal Tax Rates**

Current Policy (Bush-Era Tax Rates)	Obama Proposal	New Rates (Bush-Era Tax Rates Expire)	Taxable Income: Single Filer	% of Filers
10%	10%	15%	\$0–\$8,575	18.4%
15%	15%	15%	\$8,575–\$34,850	35.2%
25%	25%	28%	\$34,850–\$84,350	16.5%
28%	28%	31%	\$84,350–\$175,950	3.0%
33%	28%	36%	\$175,950–\$195,550	1.2%
33%	36%	36%	\$195,550–\$382,550	“ ”
35%	39.6%	39.6%	\$382,550 and above	0.7%

Sources: Columns 1-4: Tax Policy Center, 2011 Tax Parameters, [http://www.taxpolicycenter.org/taxtopics/TCE\\_CompareRates\\_2011.cfm](http://www.taxpolicycenter.org/taxtopics/TCE_CompareRates_2011.cfm); Column 5: 2008 tax year; an additional 20 percent of filers are in the 0-percent rate category, Wall Street Journal, November 10, 2010, <http://online.wsj.com/article/SB10001424052748703585004575604890565234512.html>.

### Taxes and the Economy

Proposals to reduce marginal income-tax rates are common during periods of weak economic growth. According to Barro and Redlick (2010), these tax reductions are designed to stimulate work effort and, by extension, “to boost disposable income and consumption,” thereby increasing economic growth.<sup>7</sup> The theory is that tax cuts stimulate the economy by increasing the return on work and saving relative to leisure. Barro and Sahasakul (1986) describe how this encourages work, saving, and investment, which adds to the economy’s long-term capacity for growth, wealth accumulation, and job creation.<sup>8</sup>

One source of evidence of the effects of income-rate deductions comes from Austen and Carroll (1999).<sup>9</sup> Using taxpayer data before and after the Tax Reform Act of 1986 (TRA86),<sup>10</sup> they find several behavioral responses to tax changes in the 1980s.<sup>11</sup> For example, a broadening of the tax base coupled with a decrease in marginal tax rates spurred economic activity and led to an increase in reported earnings. Conversely, they found that every \$1.00 increase in taxes is associated with a decrease in reported income of approximately \$0.60. Overall, these findings suggest that marginal income-tax rate changes have significant effects on incomes and therefore should not be ignored in the evaluation of tax policies.

In another line of research, Prescott (2004) attributes lower labor-force participation in some European countries almost entirely to higher marginal tax rates.<sup>12</sup> Lower marginal income-tax rates, he suggests, would increase the labor

supply and therefore total output in the process. Similarly, Koskela et al. (1994) illustrate the effects of taxes by showing that low personal-saving rates in certain Nordic countries from 1962–90 can be attributed in part to higher income-tax rates.<sup>13</sup> Further, from a sample of 21 developed countries for the period 1972–1981, Fardmanesh (1989) finds that income taxes, along with domestic taxes on goods and services, are actually as bad for economic growth as are deficits.<sup>14</sup>

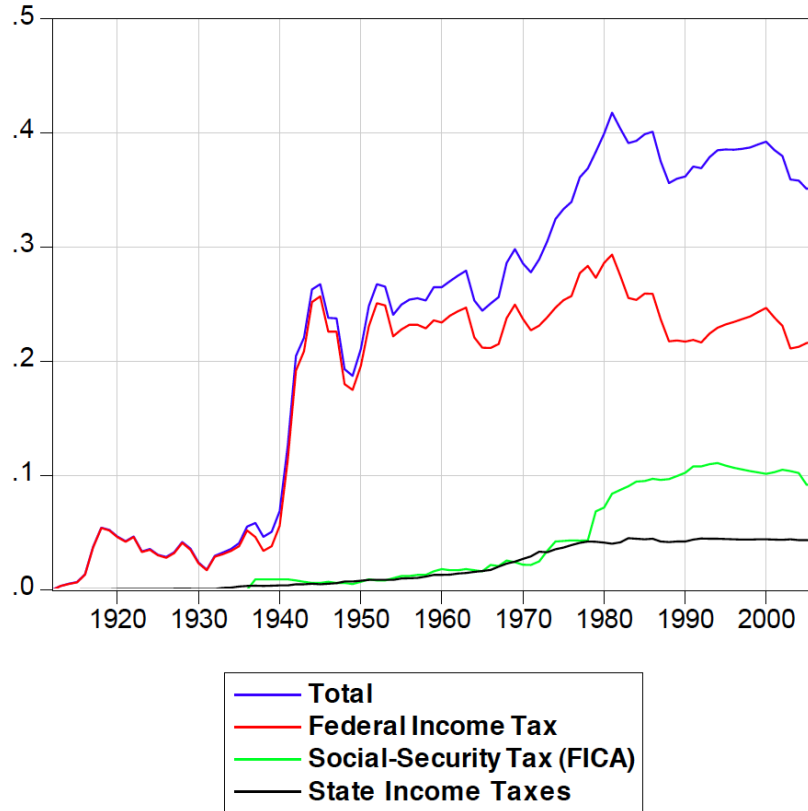
More recently, the 2003 Bush-era tax reforms helped to bring about strong economic growth in the short run.<sup>15</sup> Major criticism of Bush-era tax cuts comes from the tax policies of the previous decade—the so-called “booming ’90s.” President Clinton pushed a major tax increase bill through Congress in 1993<sup>16</sup> and critics often cite the subsequent period of economic growth as evidence that tax hikes are pro-growth policies.<sup>17</sup> The truth is, however, that the real economic boom occurred in the latter half of the 1990s, when the Republican-led Congress passed a tax-relief bill that was signed into law in 1997.<sup>18</sup> From 1997–2000 the economy averaged 4.2 percent real growth, employment increased by another 11.5 million jobs, and the S&P 500 rose an astounding 95 percent.

### **Average Marginal Tax Rates and Economic Growth**

Marginal tax rates differ from average tax rates, or the total tax amount paid as a percentage of total income earned.<sup>19</sup> The government does not take an average percentage of total income, but rather a percentage of the additional, or marginal, dollar made. As Barro and Redlick (2010) note, “[t]he economic effects of taxation depend on the configuration of marginal tax rates.”<sup>20</sup> Their work, among others, shows that marginal tax rates influence macroeconomic aggregates such as GDP.

Since there is surprisingly little existing empirical evidence on the response of economic aggregates (indicators) to changes in taxes, Barro and Redlick (2010) construct a time series on average marginal income-tax rates, or AMTRs, from federal and state income taxes and the Social Security payroll tax from 1912–2006. They then use this data to gauge the effects at the aggregate level.<sup>21</sup> Figure 1 illustrates the AMTR trend over this time period. Overall, movements in the average marginal federal individual income-tax rate usually dominate the variations in the overall marginal rate.

**Figure 1: Average Marginal Income-Tax Rates, 1912–2006**



*Source: Robert J. Barro and Charles J. Redlick, Mercatus Center Working Paper No. 10-22, July 2010.*

The post-1950 sample reveals significantly negative effects on GDP from increases in the average marginal income-tax rate, or AMTR. Theory suggests that an increase in the marginal income-tax rate makes leisure relatively less expensive. This tends to increase leisure and reduce consumption. As this happens, GDP falls. Barro and Redlick (2010) find that these effects usually show up with a one-year lag.

The same is true in reverse. A decrease in marginal income-tax rates on labor income makes leisure relatively more expensive. As such, leisure decreases and consumption increases, which increases labor input and GDP. Barro and Redlick (2010) estimate that a cut in the AMTR by 1 percentage point raises the following year's per capita GDP by around 0.5 percent.

They also conclude that increasing government tax revenue, which historically rises with increases in the AMTR, by \$1.00 is associated with a decrease in GDP by \$1.10.

### **Conclusion: Focus on Certainty**

The 111th Congress, which ends this year, will ultimately have to make a decision to extend or repeal the tax reforms of 2001 and 2003 either in part or in full. If no action is taken, then by law the tax code will revert to its pre-2001 form in January 2011. Any solution Congress reaches should address the underlying policy issue that uncertainty in the tax code impedes economic growth.

Ali (2001)<sup>22</sup> finds a strong negative relationship between economic growth and several policy instability variables. New research by Bachmann et al. (2010)<sup>23</sup> relies on confidential business survey data and finds increases in business uncertainty are associated with prolonged declines in economic activity.”<sup>24</sup> Even though they do not see a significant rebound in economic activity when uncertainty is resolved, a theme emerges: without information on what income tax rates will be in the near future, the work and investment incentives of economic actors will be negatively affected.

It is therefore not a path to compromise that Congress should seek, but rather a path to stable, lasting economic growth through a predictable tax code with low marginal tax rates. Though fundamental tax reform is necessary, raising taxes during a fragile economic recovery is a path to disaster. The 2001 and 2003 tax reforms should therefore be made permanent.

#### ENDNOTES

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<sup>1</sup>Damian Paletta and Janet Hook, “Geithner Expects a Deal on Tax Cuts,” *Wall Street Journal*, November 17, 2010, <http://online.wsj.com/article/SB10001424052748704312504575618373456592444.html>.

<sup>2</sup> John D. McKinnon. “Extending Tax Cuts, but With a Catch.” *The Wall Street Journal*, November 10, 2010, <http://online.wsj.com/article/SB10001424052748703585004575604890565234512.html>.

<sup>3</sup> For a review of literature see Matt Mitchell, “What are the Costs of Political Uncertainty,” November 2, 2010, <http://neighborhoodeffects.mercatus.org/2010/11/02/what-are-the-costs-of-political-uncertainty/>

<sup>4</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) & The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)

<sup>5</sup> Eric Fox, “How Will The Expiring Bush Tax Cuts Affect You?” *Forbes*, July 22, 2010, <http://www.forbes.com/2010/07/22/expiring-bush-cuts-affect-personal-finance-taxes.html>.

<sup>6</sup> For further explanation, see Alan Reynolds, “Marginal Tax Rates,” *The Concise Encyclopedia of Economics*, *Library of Economics and Liberty*, 2008, <http://www.econlib.org/library/Enc/MarginalTaxRates.html>.

<sup>7</sup> Robert J. Barro and Charles J. Redlick, “Macroeconomic Effects From Government Purchases and Taxes,” Mercatus Center Working Paper No. 10-22, July 2010, <http://mercatus.org/publication/macroeconomic-effects-government-purchases-and-taxes>.

<sup>8</sup> Robert J. Barro and Chaipat Sahasakul, “Average Marginal Tax Rates from Social Security and the Individual Income Tax,” *The Journal of Business*, Vol. 59, No. 4, Part 1, October 1986.

<sup>9</sup> Gerald Auten and Robert Carroll, “The Effect of Income Taxes on Household Income,” *The Review of Economics and Statistics*, Vol. 81, No. 4, November 1999, pp. 681-693, <http://www.jstor.org/stable/2646717>.

<sup>10</sup> TRA86 lowered tax rates for most taxpayers, while broadening the tax base by eliminating many deductions and exclusions. High-income taxpayers experienced the largest-percentage reduction in tax rates, and also the greatest expansion of their tax base.

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<sup>11</sup> Tax-induced responses could include increased labor supply and participation, increased savings, altering the timing of income, changes in the form of compensation, reduced tax evasion and avoidance and changes in taxpayer decisions about deductions.

<sup>12</sup> Edward C. Prescott, "Why Do Americans Work More than Europeans?" *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 28, No. 1., July 2004, pp. 2-13, [www.minneapolisfed.org/research/QR/QR2811.pdf](http://www.minneapolisfed.org/research/QR/QR2811.pdf).

<sup>13</sup> Erkki Koskela and Matti Viren, "Taxation and Household Saving in Open Economies: Evidence from the Nordic Countries," *The Scandinavian Journal of Economics*, Nol. 96, No. 3, September 1994.

<sup>14</sup> Moshen Fardmanesh, "Economic Growth and Alternative Deficit-Reducing Tax Increases and Expenditure Cuts: A Cross-Sectional Study," *Public Choice*, Vol. 69, No. 2, 1991.

<sup>15</sup> The 2003 Bush tax cuts were mainly cuts in marginal income tax rates and tax cuts on capital gains and dividends, all of which typically increase economic growth. The 2001 Bush tax cuts were based more on demand-side tax rebates though, which do not significantly increase economic growth.

<sup>16</sup> The Omnibus Budget Reconciliation Act of 1993 (OBRA-93)

<sup>17</sup> From 1993- 1996, the economy grew at an average annual rate of 3.2%, employment rose by 11.6 million jobs and the S&P 500 rose 78%, page 2 in J.D. Foster, "Tax Cuts, Not the Clinton Tax Hike, Produced the 1990s Boom," Heritage Web Memo #1835, March 4, 2008, <http://www.heritage.org/Research/Reports/2008/03/Tax-Cuts-Not-the-Clinton-Tax-Hike-Produced-the-1990s-Boom>.

<sup>18</sup> The Taxpayer Relief Act of 1997 (Public Law 105-34)

<sup>19</sup> *supra* note 5

<sup>20</sup> Robert J. Barro and Chaipat Sahasakul, "Measuring the Average Marginal Tax Rate from the Individual Income Tax," *The Journal of Business*, Vol. 56, No. 4, October 1983, pp. 419- 452, <http://www.jstor.org/stable/2352842>.

<sup>21</sup> "Marginal rates" for the AMTR correspond to the effect of an additional dollar of income on the amounts paid of the three types of taxes. For the earlier version of this time series see Robert J. Barro and Chaipat Sahasakul, "Measuring the Average Marginal Tax Rate from the Individual Income Tax," *The Journal of Business*, Vol. 56, No. 4, October 1983, <http://www.jstor.org/stable/2352842>.

<sup>22</sup> Adbiweli M. Ali, "Political Instability, Policy Uncertainty and Economic Growth: An Empirical Investigation," *Atlantic Economic Journal*, March 2001, <http://www.entrepreneur.com/tradejournals/article/77151097.html>.

<sup>23</sup> Ruediger Bachmann, Steffen Elstner, Eric R. Sims, "Uncertainty and Economic Activity: Evidence from Business Survey Data," NBER Working Paper No. 16143, June 2010, <http://papers.nber.org/papers/w16143>.

<sup>24</sup> Matt Nesvisky, "Uncertainty and Economic Activity," NBER Digest, November 23, 2010, <http://www.nber.org/digest/nov10/w16143.html>.