What Went Wrong With the Bush Tax Cuts?

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Some pundits have argued that the weak economic growth that followed the passage of the Bush tax cuts proves that free-market economics—specifically the belief that lower taxes fuel faster and stronger economic growth—doesn't work. The reality of the Bush tax cuts is that they were deeply flawed in their design and implementation and far from the "failed experiment in free-market economics," as they are often portrayed.

A new study from the Mercatus Center at George Mason University by Matthew Mitchell and Andrea Castillo identifies several faults of the Bush tax cuts and reviews the fundamental lessons to be learned from their failures.

A summary of the study's key findings is below. To read "What Went Wrong with the Bush Tax Cuts" in its entirety, or to learn more about the study's authors, please click here http://mercatus.org/publication/what-went-wrong-bush-tax-cuts.

SUMMARY

Tax cuts alone do not equal free-market economics, nor do they equal fiscal reform. Cutting taxes allows policymakers to give voters something they want, while appearing to rein in the size of government. But this is a temporary illusion *unless the tax cuts are combined with necessary reductions in spending*—a far more difficult but also the more important task.

Lesson 1: Tax cuts without spending cuts are not tax cuts; they are tax deferrals.

The Bush tax cuts were fundamentally flawed in that they were undertaken without any effort to reduce unsustainable government spending. In fact, spending exploded in the decade following their implementation:

- Tax revenues fell from 19.5 percent of GDP in 2001 to 15.1 percent of GDP in 2009.
- Spending rose from 18.2 percent of GDP in 2001 to 25.2 percent of GDP in 2009.
  Note: Spending increased steadily throughout the Bush administration and increased dramatically at the end of 2008 and through 2009 with the stimulus bill and other "one-time spending." Since that time, however, spending has only fallen slightly, to 24.3 percent of GDP.

Deficits and debt discourage spending and investing in lieu of saving for the inevitable tax crunch.

- To the extent that taxpayers are forward-looking and can see that deficits require future tax hikes, they will forego current consumption in order to save for the inevitable tax increase.
- To the extent that taxpayers are not forward-looking they will fall under the fiscal illusion that government spending is less expensive than it really is and will demand more government.

Lesson 2: Good tax systems are stable and predictable.

The initial slow phase-in and temporary nature of the Bush tax cuts made the policies less predictable—and also less potent.

- The paper illustrates that when the tax code picks winners and losers through credits, rebates, and exemptions, marginal incentives to work and invest are not improved.
- Today there are more than 140 temporary provisions in the tax code. There were fewer than a dozen in the 1990s.

Lesson 3: Low marginal rates tend to increase the incentive to work and save.

The 2001 and 2003 Bush tax cuts and the 2008 Bush stimulus plan included exemptions, deductions, rebates, and credits with the Keynesian goal of putting money back in the hands of consumers in hope that they would, in turn, purchase more goods and services.

- Research by Matthew Shapiro and Joel Slemrod found that a majority of households did not use the extra money on consumer spending. Instead, they used it to pay off existing household debt, thus replacing private debt with government debt.
- Instead of focusing on ways to get money into the hands of particular consumers (e.g., targeting parents with children via the child tax credit), real reform should reduce marginal tax rates and simplify the tax code by closing loopholes. This allows for larger rate reductions, thus improving incentives to work and invest for *all* taxpayers.

Lesson 4: Real marginal tax cuts lead to economic growth.

Christina Romer and David Romer examined 60 years of U.S. data and found that "tax cuts have large and persistent positive output effects."

- Specifically, they found that a tax cut of 1 percent of GDP increases real GDP by about 3 percent over the short term and by about 1.8 percent over the medium term.

Nobel laureate Edward Prescott attributed differences of work habits across countries to differences in labor taxation.

- In the 1970s, U.S. marginal tax rates were *higher* than European rates, and Americans worked *less* than Europeans.
- In the 1990s, the situation was reversed: U.S. rates were *lower* than European rates, and Americans worked *more* than Europeans.

Lesson 5: You can't starve the beast through tax cuts if you're feeding it with borrowed funds.

Fiscal conservatism requires constraint both in taxation—and in spending and borrowing.

- Empirical research analyzing U.S. quarterly data from 1959 to 2007 suggests that the "fiscal illusion" effect is real: when voters are not presented with the invoice for big government, they demand bigger government.

It would be a mistake to use the disappointing performance of the Bush tax cuts to dismiss decades of economic evidence that demonstrate that lower taxation is better for economic growth. Instead, the experience should prompt policymakers to utilize its lessons when crafting and implementing fundamental spending and tax reform.

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