



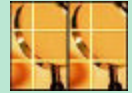
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Opposition to the Bush Tax Cuts  
Special Report 2003/01

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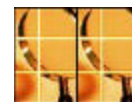
# Special Report 03/01



## OPPOSITION TO THE BUSH TAX CUTS

BY  
L. RANDALL WRAY

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## OPPOSITION TO THE BUSH TAX CUTS

BY L. RANDALL WRAY, SENIOR RESEARCH ASSOCIATE

Recently, a group of economists (including at least 10 Nobel laureates) have been circulating a statement opposing the tax cuts proposed by President Bush. Their critique boils down to three related points. First, they argue, the tax cuts have been advanced as part of a stimulus package, but the design of the proposal is flawed. It will not stimulate jobs and growth in the near-term. Second, the tax cut plan is not “revenue neutral”, hence, will add “to the nation’s projected chronic deficits.” Further, this will reduce the government’s long-term capacity “to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research”. Finally, the President’s plan would impose a “permanent change in the tax structure”, when what is needed, according to these economists, is an “immediate but temporary” package to expand demand. In summary, a proper stimulus plan would provide only “temporary incentives for investment”, spurring “growth and jobs in the short term without exacerbating the long-term budget outlook.”

While we share some skepticism about the likelihood that the President’s plan will provide sufficient stimulus to prevent continued deterioration of economic growth, we think the economists’ statement represents a flawed and even dangerous misunderstanding of the headwinds faced by our economy. The US is not merely facing a “temporary” shortfall of demand (attributed by the economists to “overcapacity, corporate scandals, and uncertainty). Nor will a “revenue neutral tax reform effort” do any good. Rather, the problem we face is a prospective long-term insufficiency of demand that results from four constraints.

First, and most important, our federal government’s budget has become imbalanced to a degree last seen in the 1920s. Partially due to budget-balancing agreements, partially due to large increases of Social Security taxes in the 1980s, and partially due to a long-term trend to devolve spending responsibility to the states, the federal budget has become excessively biased to run surpluses at moderate rates of economic growth. These surpluses, in turn, require that the nongovernment sector taken as a whole (including households, firms, and the foreign sector) must run deficits. Indeed, the budget surpluses achieved during the Clinton years were matched by unprecedented domestic private sector deficits—that reached above 6% of GDP.

This leads to the second headwind. The US private sector has been spending more than its income every year since 1996. The long-term legacy is record indebtedness that burdens households and firms. As is widely recognized, firms have already cut back

spending as they try to work off some of this debt; short-term tax incentives will not induce firms to undertake new projects given excess capacity and heavy indebtedness. American households are widely given credit for the recovery (albeit, an anemic one) as they have continued to borrow and spend. However, no one doubts that consumption is running out of steam. No “revenue neutral” tax cut plan is going to reduce the burden on households sufficiently to encourage continued growth of consumption.

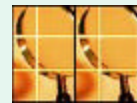
Third, devolution has placed more responsibilities on state budgets. This is undesirable for two reasons. First, state taxes are regressive (highly so in some cases), placing the heaviest burden on those least able to pay. More importantly, states must act procyclically, increasing spending in a boom (fueling the boom) while slashing spending and raising taxes in a slump (there is little doubt that states helped to turn the early 1990s recession into a “double dip”). It is time for the federal government to increase grants to states, especially on a counter-cyclical basis. Only the federal government can lean against the wind, cutting taxes and increasing spending in a recession.

Finally, the US trade deficit has trended upward over the past two decades. Unlike many economists, we do not view this with alarm. In our view, the trade deficit results mostly from insufficient demand in the exporting nations, and a trade deficit allows American consumers to enjoy real benefits (after all, exports are a cost and imports are a benefit). At the same time, however, we recognize that all else equal, a trade deficit reduces American demand for domestic output. Given a balance of payments deficit equal to about 4% of GDP, the US government sector must run a deficit of 4% of GDP simply to allow our private sector to balance its own budget (with spending equal to after-tax income). Hence, all else equal, the federal budget should be biased toward a deficit—not a surplus—at moderate rates of economic growth.

In conclusion, the notion that any stimulus package should provide only a temporary boost, that investment incentives should be temporary, and that tax cuts must be revenue-neutral seriously misunderstands our present situation. While we have some doubts about the President’s plan, we do share his apparent belief that tax cuts should be permanent, that spending incentives should be geared to the long-term, and that a bias toward fiscal deficits is nothing to fear.

## CFEPS

*Center for Full Employment and Price Stability*



The Center for Full Employment and Price Stability is a non-partisan, non-profit policy institute at the University of Missouri - Kansas City dedicated to promoting research on and public discussion of issues related to macroeconomic and monetary policy, especially employment and budgetary policy. The Center is interested in your feedback on the ideas put forward in its publications. You can contact us at:

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