



Why Tax Cuts Still Matter

By William Beach

Once again, presidential politics has turned to tax policy.

The candidates are debating not only whether the sluggish economy justifies another round of tax cuts, but whether the tax cuts enacted by President Bush in 2001 and 2003 should be allowed to expire or be made permanent.

Our country's economic future may well turn on how voters resolve these questions. Right now, voters may be somewhat confused. After all, much of what is being said about the state of tax policy in the United States seems to make a lot of sense. Take the issue of extending the Bush tax cuts.

Most Democrats argue that these cuts have primarily benefited upper-income taxpayers, who now enjoy a smaller tax burden than before the reductions were put into place. They also argue that the Bush tax cuts have starved the federal government of needed revenue. Letting the cuts expire, they claim, would help fund other national priorities, such as building new schools and repairing roads and bridges.

These are all compelling claims. But as with everything else in politics, the question must be asked: Are they true?

THE TRUTH ABOUT TAX CUTS

Let's look at the first claim. Central to the argument for letting the Bush tax cuts expire is the claim that high-income taxpayers do not pay

as great a share of all income taxes today as they did prior to 2001. This claim is plainly false.

The Internal Revenue Service provides data on its Web site (www.irs.gov) on the percentage of income taxes paid by high-income taxpayers out of all income taxes. Anyone can obtain this information. Many who do will be surprised to learn that the top 1 percent of income earners paid 39.4 percent of all income taxes in 2005, the latest year for which such data are available. That is the highest percentage of all income taxes that this group has paid since 1986, when their share stood at 25.7 percent.

The top 5 percent of income earners paid 59.7 percent of all income taxes in 2005, which was the highest percentage in the past 20 years. Tax share records were also set by the top 10, top 25, and top 50 percent of income earners. In other words, every category of high-income taxpayer as defined by the IRS paid a higher share of taxes in 2005 than they have since 1986, the earliest date for which the IRS provides data.

Of course, a taxpayer's share of all income taxes could go up while the percentage of his or her own income paid in taxes goes down. Has that happened? If the Bush tax cuts did for all taxpayers what they were intended to do, then the answer would be yes, and it is. The Congressional Budget Office (CBO) analyzed

the effects of the Bush tax cuts by estimating the percentage of household income that typical households all across the income distribution paid in all federal taxes, including income taxes. By this measure, the percentage paid in income taxes (the so-called effective tax rate) was lower in 2005 for every group than it was in 2000. For example, the middle fifth of households had an effective tax rate of 5 percent in 2000 and a rate of 3 percent in 2005. The top 20 percent had an effective rate of 17.5 percent in 2000 and 14.1 percent in 2005.

That's a lot of numbers. Suffice it to say that most taxpayers paid lower taxes in 2005 than in 2000. So, high-income taxpayers are shouldering a greater share of income taxes paid, but they—like all other taxpayers—are paying at a lower rate on their own income.

If that's the case, then don't the advocates of letting the Bush tax cuts expire prevail on their second claim—mainly, that the tax cuts starve the government of revenue and more tax cuts would just make the revenue picture worse?

Actually, that claim also is false.

The CBO provides data on revenues as a percentage of GDP from 1962 through 2007 and forecasts of the revenue percentage for 2008 (see www.cbo.gov). Since 1962, the long-term percentage has been at or near 18 percent of GDP. In 2000, this percentage stood at a whopping 21.4 percent, its record since 1962.

Then the recession set in and revenues dropped steadily through 2002. By 2003, the slow economy and the tax cuts of 2001 had reduced the percentage to 16.1 percent. Congress cut taxes again that year. Interestingly, revenues began to respond to the stronger economy that the 2003 tax changes encouraged.

By 2005, the percentage had climbed to 17.4 percent. By 2007, it had risen again—to 18.6 percent. For 2008, the CBO expects the revenues as a percent of GDP to stand at

19 percent, significantly above the long-term trend of about 18 percent of GDP.

If the Bush tax cuts starved Washington of revenues, why did revenues start growing again after the second large tax cut in 2003? The reason is clear: The tax cuts had their intended effect of lowering the burden of Washington on working families and entrepreneurs. These folks responded by working harder and making more investments, all of which lifted the economy out of its doldrums following the collapse of the dot-com bubble. If there was anything that starved Washington of revenues, it was a sluggish economy, not the tax cuts.

What of the claim that more tax cuts are not needed now to boost the economy out of its doldrums?

What strikes economists who study U.S. economic growth is the trend of this economy, not the occasional slowdown. This is an economy that appears always able to absorb increases in labor and capital by growing steadily and more strongly. Indeed, tax policymakers should always set their sites on encouraging more work, entrepreneurship, and investment, since the U.S. economy seems to have an insatiable appetite for all three. What this means is that tax cuts on labor, capital, and enterprise still matter, and probably will always matter. That is a particularly telling truth when Washington's overall revenue take rises significantly above its long-term trend of 18 percent.

Given that the claims against the Bush tax cuts are false, that revenue growth is strong at the lower levels of tax rates instituted in 2001 and 2003, and that federal revenues have risen significantly above their long-term trend, now is the time to consider more tax reductions, not tax increases.

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