Myths about Tax Cuts
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Greensboro *News and Record*, June 29, 2003

"The trouble with most folks isn't so much their ignorance, as knowing so many things that ain't so." I was reminded of that quotation by 19th-century humorist Josh Billings as I watched President Bush sign his tax-cut-heavy Jobs and Growth Plan into law. Supporters of the plan claim no ignorance at all about the wonderful effects of tax cuts. But there are some things they believe that just ain't so.

Myth #1: Tax cuts inject money "into the economy"
I recently heard a person-on-the-street interview on the radio, and the interviewee said that the Bush tax cuts make sense because of all the money that will be injected into the economy. I wondered to myself, what does this guy think? That the government takes our money and throws it into the ocean?

Oddly, the idea that tax cuts represent a flow of money from somewhere utterly external to the economy isn't uncommon. Certainly the Bush administration has used the metaphor of money entering the economy, but it doesn't have a monopoly on the notion. Congressional Democrats have also talked about getting money into the hands of Americans who will "spend it back into the economy." The difference is that Democrats have in mind a different group of Americans than Republicans do.

The fact is that the government takes our tax money and spends it *in the economy*, more or less just like we do. It doesn't throw it in the ocean or store it in a vault under a mountain. The federal government hires people, contracts for services, and buys products such as computers and Bradley Fighting Vehicles. State governments do pretty much the same thing, except that they hire more teachers and buy fewer Bradley Fighting Vehicles.

To be sure, consumer spending accounts for two-thirds of gross domestic product (which is essentially the country's income). But government spending is also a component of GDP. A dollar of government spending and a dollar of consumer spending both increase GDP by a dollar. What a tax cut does is take spending from one place (the public sector) and put it in another place (the private sector).

In some respects, government spending may be preferable to consumer spending as a way to spur the economy. Imagine the government is deciding whether to embark on a $100 billion spending program or give out a $100 billion tax cut. Both have the same short-run effect on the government's budget balance (or lack thereof).

If spent by the government, the $100 billion will go directly "into the economy," with a ripple effect as it gets passed on by consumers and merchants. The same ripple effect takes place if the $100 billion is given to consumers as a tax cut, but not all of that $100 billion will make it to the first ripple. That's because not all of that $100 billion will be spent. A fraction will be saved. The U.S. saving rate is well under 10 percent, but the rate rises as income increases. Hence the greater the share of the tax cut that goes to upper-income people, the smaller the spending effect of the tax cut.

Now, one might argue that the kind of spending done by the government is inferior to the kind of spending done by consumers, and that it's so inferior as to outweigh the savings leakage. At least reasonable people could disagree about that, and we wouldn't have to pretend that tax cuts cause money to appear magically "in the economy."

Myth #2: Double taxation of dividends is unique in the tax code

President Bush's Jobs and Growth Plan cuts the tax rate on stock dividends by more than half, to just 15 percent. The president wanted the tax eliminated altogether, because he characterizes the tax on dividends as "double taxation." First a corporation pays a corporate income tax, and then the dividend paid to its owners, the stockholders, is taxed again. The president said in a speech in January, "Double taxation is bad for our economy. Double taxation is wrong."

But it's interesting that the White House website talks more specifically about the inequity of double taxation of *corporate* income. The distinction is important, because double taxation is all around us. If it were truly bad for our economy and wrong as a general principle, we would have to eliminate a whole lot of taxes that the president appears to think are just fine.

For example, if I pay income tax on what I earn and then pay sales tax on stuff I buy with that after-tax income, isn't that double taxation? And on some items I buy with my already-taxed income, such as my car, I have to continue paying a property tax year after year. For many wage-earners, double taxation hits hardest in the combination of income tax and Social Security. And it's worth noting that the income profile of those subject to this particular variety of double taxation is different than that of most dividend earners.

Finally, this myth is aggravated by the fact that supporters of a dividend-tax reduction tend to look only at tax rates, not the actual taxes paid. Over the years, corporations have become adept at avoiding corporate income taxes. Among other loopholes, dividends are exempt from Social Security. All in all, the actual burden on income earned through owning stock is usually less than on wage income.

Myth #3: The tax cuts will pull the economy out of recession

The problem with anti-recession policies is that they tend to go to work after the recession is over. According to the National Bureau of Economic Research, the recession started in March 2001. At some point, the NBER will announce that the recession ended some time ago. Many economists feel it ended last summer, though the lack of movement since then has made it tough to discern a trend.

The best kind of anti-recession policy is one that prepares the economy for the next recession, instead of chasing after remedies once the recession has started. Jobs programs get started late, public spending projects take time to get off the ground, and tax cuts have a mixed track record.

In February of this year, more than 400 economists, including 10 Nobel prize winners, signed a petition that appeared in a full-page ad in the New York Times and criticized tax cuts as a means of reviving the economy. The petition stated, "Regardless of how one views the specifics of the Bush plan, there is wide agreement that its purpose is a permanent change in the tax structure and not the creation of jobs and growth in the near term."

Even if the Bush administration's projection of 1.4 million jobs created over the next year and a half is borne out, that's a below-average rate of job creation. Of course, it would be better than the 1.7 million jobs that have been lost since the first Bush tax cut in 2001. Over the long haul, the economy has added nearly two million jobs every 18 months. And in the year and a half after President Clinton's 1993 budget bill that *raised* income tax rates, the economy added nearly five million jobs! I'm not suggesting that we raise taxes now, but the evidence is far from clear regarding the effectiveness of tax cuts.

The president's tax cuts may or may not be good policy in the long run. They may or may not be "fair" (a word tossed around by both supporters and opponents). They may lead to spending reductions in the future, which is the stated purpose of the curious reversal of Congressional Republicans who now think that budget deficits are good.

However, the president's tax-cut package isn't a free lunch or a source of found money. It won't eliminate double taxation. It will eventually require either new taxes or reductions of government services. And it will do little to boost the economy out of the current (or already past?) recession.

But other than that, I have no problem with it.