

Congressional Testimony

How the Taxation of Labor and Transfer Payments Affect Growth and Employment

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A. Main Points

- 1) The United States faces a serious medium-term budget deficit problem—realistic forecasts show a rising trajectory for US government debt over the next two decades.
- 2) The primary drivers of the large increase in public debt over the past decade were: the George W. Bush-era tax cuts; wars in Iraq and Afghanistan; Medicare Part D; and the financial crisis that began in the fall of 2008. This is the sixth surge in national debt in US history; the previous five surges were all caused by war (see chapters 1 and 2 in *White House Burning* by Simon Johnson and James Kwak, on the history of US national debt).
- 3) The current nature of our financial sector generates system risk that has negative macroeconomic implications in the United States, including for our public finances.
 - a. To assess just the fiscal impact of the recent finance-induced recession, consider changes in the Congressional Budget Office’s (CBO) baseline projections over time. In [January 2008](#), the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to \$5.1 trillion by 2018 (23 percent of GDP). As of [January 2010](#), the CBO projected that over the next eight years debt will rise to \$13.7 trillion (over 65 percent of GDP)—a difference of \$8.6 trillion.
 - b. Most of this fiscal damage is not due to the Troubled Assets Relief Program—and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57 percent is due to decreased tax revenues resulting from the financial crisis and recession; 17 percent is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the “automatic stabilizers” in the United States are relatively weak); and another 14 percent is due to increased interest payments on the national debt—because we now have more debt.¹
 - c. In effect, a financial system with dangerously low capital levels—hence prone to major collapses—creates a nontransparent contingent liability for the federal budget

¹ See also the May 2010 edition of the International Monetary Fund’s (IMF) cross-country fiscal monitor for comparable data from other industrialized countries, <http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf>. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for one-tenth of the increase in debt in advanced G-20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the United States provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

in the United States. It also damages the nonfinancial sector both directly—when there is a credit crunch, followed by a deep recession—and indirectly through creating a future tax liability.

- d. Despite reform efforts since the crisis, including the Dodd-Frank legislation, big banks today still create major structural system risks.² Neil Barofsky, the Special Inspector General for the Troubled Assets Relief Program (TARP) summarized the situation well in his January 2011 [report](#), emphasizing: “perhaps TARP’s most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are ‘too big to fail.’”
- 4) The idea that the recent increase in public debt is due primarily to “runaway spending” since 2008 is completely at odds with the historical record—although it is true that spending was not under control in the period of 2000–08 (see chapter 3 in *White House Burning*.) The worsening deficits since 2008 have been primarily due to a big drop in tax revenue and the sharp fall in GDP due to the finance-induced recession.
- 5) Looking forward, as society ages we face increasing pressures on social security, Medicare, and other forms of basic social insurance. Healthcare spending—not just the government paid part of healthcare—needs to be brought under control. Efforts to reform the healthcare system more broadly met great resistance. Phasing out or otherwise limiting Medicare spending, while not addressing the increase in healthcare costs, is not an appealing approach—as the Congressional Budget Office has pointed out, this will likely just increase healthcare spending as a percent of GDP.³
- 6) In this context and over the coming decades, the United States needs to make a longer-term fiscal adjustment. Part of that should include additional tax revenues, phased in over the next two decades.⁴
- 7) The best way to strengthen revenues would be to introduce a value added tax—shifting taxation towards consumption and away from income. But this is unlikely to receive widespread political support in the near future.
- 8) A “tax reform” that reduces tax expenditures would be helpful—these tax expenditures are a form of disguised government spending and should be viewed on that basis (we make proposals along these lines in chapter 7 of *White House Burning*). But too many tax reform proposals today involve reducing or limiting government revenue. We need to strengthen the revenue base of the federal government—returning closer to the tax rates of the late 1990s.
- 9) The most feasible way to strengthen revenue is not to extend any part of the Bush-era tax cuts that expire at the end of this year.

² Andrew Haldane (Bank of England) and Anat Admati (Stanford University) both refer to system risk in this context as a form of pollution, i.e., a negative social spillover that should be discouraged by regulation and/or taxation.

³ For the details of the CBO’s assessment, see this column and the links it contains: <http://baselinescenario.com/2012/05/03/mitt-romney-and-paul-ryans-budget/>.

⁴ Scrapping the existing tax system would not make sense, for example under the so-called Fair Tax proposal—this would be a huge undertaking with big downside risks. The benefits of such a system have been greatly exaggerated by some of its proponents. See Bruce Bartlett, “Why the Fair Tax Won’t Work,” *Tax Notes*, December 24, 2007, pages 1241–1254, and chapter 9 in the President’s Advisory Panel on Tax Reform (http://govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_8-9.pdf), a report prepared during the administration of President George W. Bush.

- 10) There is no evidence that those tax cuts led to an economic boom, stimulated productivity, or otherwise boosted labor supply—the next section reviews in more detail exactly what happened. Similarly, we should expect that the removal of those tax cuts would not have any medium-term effect on the economy.
- 11) If there is concern for the short-run impact on the economy—depending on the precise situation at the end of this year—the Bush tax cuts could be replaced with a temporary payroll tax cut, linked to employment relative to total population (based on a rule set in law). This would ensure that revenue recovered as the economy picks up and as we return towards full employment.
- 12) Raising taxes is never easy or pleasant. But we need to put funding for the federal government on a more sustainable basis and the best way to do this is to strengthen revenue through not extending the Bush-era tax cuts.

B. Recent History of Tax Cuts

The election of George W. Bush gave the Republican Party control of the White House and both branches of Congress.⁵ Deficits were off the agenda. Instead, as the new president was inaugurated in January 2001, the CBO was projecting trillions of dollars in surpluses over the next decade, including a 2010 surplus of \$796 billion.⁶ The actual 2010 deficit was almost \$1.3 trillion—a difference of over two trillion dollars.

True to his campaign pledges and to the conservative base, the first major item on President Bush's agenda was large income tax cuts. Originally justified as a way of returning budget surpluses to the people, the tax cuts were repositioned as a way to stimulate a weakening economy—an example of touting tax cuts as the appropriate response to any situation.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was the third largest tax cut in modern history.⁷ It lowered tax rates for nearly everyone who paid income tax (with the top rate falling from 39.6 to 35 percent), increased deductions and exemptions for high-income households, made it easier to shield retirement savings from taxes, increased family tax credits, and eventually repealed the estate tax.⁸ The advertised impact of the tax cuts was \$1.3 trillion over ten years, but their true size was significantly higher. In order to avoid the

⁵ In May 2001, Senator Jim Jeffords left the Republican Party and began caucusing with the Democrats, giving them a 51-49 majority in the Senate. However, the Republicans were able to attract the few Democratic votes necessary to pass their budgetary proposals. From 2003 to 2007 the Republicans had majorities in both houses of Congress.

⁶ CBO, *The Budget and Economic Outlook: Fiscal Years 2002–2011*, January 2001, table 1-1, page 2. The projected 2010 surplus in the CBO's baseline would climb to \$806 billion by May 2001. CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2002*, May 2001, table 1, page 12. In retrospect, the CBO's economic forecast was too optimistic, but it was no more optimistic than forecasts by private sector economists. In January 2001, the CBO forecast average real GDP growth of 3.0 percent for the 2001–2010 period; the Blue Chip consensus forecast (and average of private sector economists' forecasts) was for average real GDP growth of 3.3 percent. CBO, *The Budget and Economic Outlook*, January 2001, table 2-2, page 30.

⁷ The largest as a share of GDP was the 1981 Reagan tax cut; the second largest was the 1964 Kennedy-Johnson tax cut. In 2010, when fully phased in, EGTRRA was projected to reduce tax revenues by \$176 billion, or 1.1 percent of GDP (as then projected by the CBO), making it larger than the Revenue Act of 1978. In real dollar terms, EGTRRA was the second-largest tax cut in modern history. We exclude the major tax cuts enacted as a result of the end of World War II. CBO, *Pay-As-You-Go Estimate, H.R. 1836: Economic Growth and Tax Relief Reconciliation Act of 2001*, June 4, 2001; Jerry Tempalski, *Revenue Effects of Major Tax Bills*, Treasury Department Office of Tax Analysis Working Paper 81, September 2006, table 2, pages 16–20.

⁸ For a summary, see CBO, *Pay-As-You-Go Estimate, H.R. 1836*, June 4, 2001. The estate tax repeal was phased in for 2010 only.

threat of a filibuster in the Senate, the tax cuts were passed through the budget reconciliation process,⁹ which meant that they could not permanently increase deficits, and so all of the tax cuts were scheduled to expire by the end of 2010.¹⁰ In order to reduce the total ten-year cost of the tax cuts—to make them easier to pass—several of them were deferred, with over 70 percent of the total tax reduction coming after 2006.¹¹ By 2010, when most of the tax cuts would be in effect, they were officially expected to cost \$176 billion (1.1 percent of GDP), not counting the additional interest payments they would require.¹² But the real impact of the 2001 tax cuts would be even bigger, because they increased the number of households exposed to the Alternative Minimum Tax (AMT); since Congress can be counted on to “patch” the AMT to shield middle-class households,¹³ this meant that future patches would have to be even bigger.¹⁴

The complicated phase-ins made the impact of the 2001 tax cuts much larger in 2010 than in 2001—and President Bush’s goal was to make them permanent at the 2010 level. The 2010 sunset provision made it possible to argue that allowing the tax cuts to expire would amount to a tax increase. As early as 2004, when Congress began extending provisions of the 2001 tax cuts, Representative Jim McCrery argued, “Anyone voting ‘no’ is voting for a tax increase for the American people, especially the middle class.”¹⁵ When 2010 rolled around, Republicans opposed, as a tax increase, any proposal to let any of the tax cuts expire; aided by a financial crisis and a major recession, which created an economic argument against “raising” taxes, the tax cuts were extended through 2012 with the support of a Democratic president and Democratic majorities in Congress. The 2001 tax cuts had become a Trojan horse that threatened to make a permanent, structural change in the tax system.¹⁶

⁹ By Senate rules, most measures require sixty votes in order to end debate and move to a vote; a filibuster allows forty-one Senators to prevent a vote. The budget reconciliation process, originally created by the Congressional Budget and Impoundment Control Act of 1974 to expedite budgetary legislation, provides an exception to this rule for bills that change revenue and mandatory spending laws. Allen Schick, *The Federal Budget: Politics, Policy, Process*, 3rd ed. (Brookings Institution Press, 2007), pages 142–47.

¹⁰ Under the “Byrd rule” in the Senate, a bill that goes through reconciliation cannot increase deficits in any year after the period specifically covered by the initial budget resolution.

¹¹ CBO, *An Analysis of the President’s Budgetary Proposals*, May 2001, page 6.

¹² CBO, *Pay-As-You-Go Estimate, H.R. 1836*, June 4, 2001. The GDP estimate is from CBO, *An Analysis of the President’s Budgetary Proposals for Fiscal Year 2002*, May 2001, table 5, page 16. Actually, it’s even more complicated because some tax cuts were phased out before 2010; if those were extended to 2010 (which some eventually were), the 2010 tax cut would become even bigger.

¹³ The AMT is an alternative tax system originally designed to ensure that the very wealthy paid at least some tax; it does this by disallowing many common tax deductions for high-income taxpayers. Because the AMT is not indexed for inflation, it would affect a growing number of middle-class households as time passes. Therefore, Congress regularly “patches” the AMT (raising the thresholds to account for inflation), but only for a few years at a time.

¹⁴ Taxpayers must calculate their tax liability under both the regular income tax and the AMT and pay whichever is greater. The 2001 tax cuts, by reducing ordinary income taxes, meant that more people would have to pay the AMT. Therefore, the official assumption (based on current law) was that AMT revenues would increase, partially offsetting the reductions in the ordinary income tax. In practice, this only meant that future actions to patch the AMT would cost even more in foregone revenue than they would have otherwise. See Leonard E. Burman, William G. Gale, and Jeffrey Rohaly, “The AMT: Projections and Problems,” *Tax Notes*, July 7, 2003: 105–117.

¹⁵ Iwan Morgan, *The Age of Deficits: Presidents and Unbalanced Budgets from Jimmy Carter to George W. Bush* (University Press of Kansas, 2009), page 229.

¹⁶ At the time, the Center on Budget and Policy Priorities estimated that the 2001 tax cut would cost \$4.1 trillion in its second decade (from 2012 through 2021), not counting additional interest on the larger national debt. Joel Friedman, Richard Kogan, and Robert Greenstein, “New Tax-Cut Law Ultimately Costs As Much As Bush Plan,” Center on Budget and Policy Priorities, revised June 27, 2001.

By 2003, the surplus was gone, the victim of the 2001 tax cut and an economic slowdown.¹⁷ But President Bush repeated the 2001 strategy: large tax cuts justified as an economic stimulus and passed through the reconciliation process, their total size masked by phase-outs, with intense pressure from conservative groups to keep Republican legislators in line. In addition to Americans for Tax Reform, the Club for Growth attacked moderate Republicans who wavered.¹⁸ This time, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) lowered the tax rate on capital gains (profits on the sale of investments) and dividends (payments made by corporations to their stockholders) to a maximum of 15 percent; it also accelerated several of the 2001 tax cuts so they kicked in sooner than originally scheduled. The official ten-year cost was \$350 billion, but again that figure relied on early phase-outs that few people expected to occur.¹⁹ (Not surprisingly, the major 2003 tax cuts were later extended through 2010 by the Tax Increase Prevention and Reconciliation Act of 2005.²⁰)

While most households that paid income taxes saw their taxes go down in 2001 and 2003, the biggest beneficiaries by any measure were the wealthy. When fully phased in, 67 percent of the tax cuts passed during the Bush administration went to the richest 20 percent of households; 15 percent of the benefits went to the richest 0.1 percent of households.²¹ Households making between \$40,000 and \$50,000 saw an average 2010 tax reduction of \$962, but households making more than \$1 million got an average of \$168,052.²² And this is not just because the rich pay more taxes to begin with. The richer you are, the larger the percentage increase in your after-tax income (8.2 percent for the wealthiest one-thousandth of all households, but only 2.6 percent for the median family) and the more percentage points were shaved off your effective federal tax rate.²³

One major reason for the unequal distribution of the tax cuts is that they focused on the income tax, while most people pay more in payroll taxes—the taxes on wages that are dedicated to Social Security and Medicare—which were unaffected by the tax cuts.²⁴ Another is that the 2003 tax cut primarily benefited people who earn taxable income from investments rather than

¹⁷ CBO, *The Budget and Economic Outlook: Fiscal Years 2004–2013*, January 2003, Summary table 1, page xvi. The CBO was projecting surpluses to return in 2007, but this was solely because of off-budget (Social Security trust fund) surpluses. On-budget surpluses would only return in 2012, but that assumed that the 2001 tax cut would expire.

¹⁸ Jacob C. Hacker and Paul Pierson, *Off Center: The Republican Revolution and the Erosion of American Democracy* (Yale University Press, 2005), page 53–54.

¹⁹ CBO, *Cost Estimate, H.R. 2: Jobs and Growth Tax Relief Reconciliation Act of 2003*, May 23, 2003.

²⁰ Morgan, note 16, above, page 230.

²¹ Tax Policy Center, Table T08-0157, Individual Income and Estate Tax Provisions in the 2001–08 Tax Cuts with AMT Patch Extended, Distribution of Federal Tax Change by Cash Income Percentile, 2010, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1866&DocTypeID=2>. We chose the 2010 impact because this was the last year before the tax cuts were scheduled to expire; we chose the version with the extended AMT patch because the AMT has been patched.

²² Tax Policy Center, Table T08-0156, Individual Income and Estate Tax Provisions in the 2001–08 Tax Cuts with AMT Patch Extended, Distribution of Federal Tax Change by Cash Income Level, 2010, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=1865&DocTypeID=1>.

²³ Tax Policy Center, Table T08-0157, note 21, above.

²⁴ 76.1 percent of all taxpaying households pay more in payroll taxes than in income taxes, including the employer share of payroll taxes. 50.6 percent of all taxpaying households pay more in payroll taxes than in income taxes when only counting the employee share of the payroll tax. These calculations are based on 2011, when the payroll tax was unusually low because of the December 2010 tax cut. Tax Policy Center, Table T11-0192, Distribution of Tax Units that Pay More in Payroll Taxes than Individual Income Taxes, by Cash Income Percentile, Current Law, 2011, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=3073&DocTypeID=2>.

income from labor—that is, the rich.²⁵ It is true that most taxpaying households did see their taxes go down, but those same households have to pay for the tax cuts in the form of reduced government services, lower future benefits, or higher future taxes; seen as a complete package, it's likely that most households were made worse off.²⁶ The sharp decrease in taxes for the very rich also contributed to increasing income inequality, as the top 1 percent of all households saw their share of the entire population's income rise steeply from 2002.²⁷

The Bush tax cuts certainly weakened the federal government's situation. Total government revenues fell from 20.6 of GDP in 2000 to 16.1 percent in 2004, the lowest level in more than half a century. That decline was due in part to the stock market collapse of 2000 and the brief recession of 2001. A better comparison is that during the 1991–2000 economic expansion (the period between two recessions), revenues averaged 18.9 percent of GDP; during the 2001–2007 expansion, they averaged only 17.3 percent—a difference worth about \$200 billion a year.²⁸ Supporters have argued that the tax cuts actually increased tax revenues by stimulating economic growth. In 2007, President Bush claimed, “It is also a fact that our tax cuts have fueled robust economic growth and record revenues.”²⁹ But there are two problems with this claim. One is that real economic growth was not particularly robust, averaging only 2.7 percent per year during the 2001–2007 expansion, as compared to 3.7 percent during the 1990s expansion (when tax rates were higher).³⁰ The other is that multiple economic analyses have shown that the economic growth caused by a tax cut can at best offset a portion of the revenues lost by that tax cut.³¹ In addition, while a tax cut may increase growth in the short term (because

²⁵ While many middle-class households have investments, a large proportion of those investments are in their houses—which are largely shielded from capital gains taxes—or in retirement savings accounts, which also enjoy tax preferences.

²⁶ Douglas W. Elmendorf, Jason Furman, William G. Gale, and Benjamin H. Harris, “Distributional Effects of the 2001 and 2003 Tax Cuts: How Do Financing and Behavioral Responses Matter?” Brookings Institution, June 2008. The authors model the financing of the tax cuts either as an equal-dollar loss for all households or as a loss that is proportional to income; on these assumptions, either 17 percent or 22 percent of households would benefit from the tax cuts. As they say, “To be sure, if one assumes that the financing occurs entirely through spending reductions and that the foregone spending is worthless to individuals, then the standard distributional analysis applies. However, despite decades of stump speeches about unnecessary government spending, the political process has been persistently unable to identify significant outlays that voters will blithely forego.” Their analysis also incorporates behavioral effects of the tax cuts, which increases the proportion of households made better off to 34 percent. *Ibid.*, table 5.

²⁷ Emmanuel Saez, “Striking It Richer: The Evolution of Top Incomes in the United States (Updated with 2008 Estimates),” July 17, 2010, available at <http://elsa.berkeley.edu/~saez/saez-UStopincomes-2008.pdf>, figure 2.

²⁸ We only include fiscal years that were entirely during periods of economic expansion; we excluded FY 1991 because the economy was in recession until March 1991; we excluded FY 2001 and 2002 because the economy was in recession until November 2001, which was during the 2002 fiscal year. In addition, after correcting for the effect of the economic cycle, tax revenues still fell from 20.1 percent of GDP in 2000 to 16.5 percent in 2004; cyclically adjusted revenues ranged from 19.5 percent to 20.1 percent of GDP from 1998 through 2000, but only from 15.4 percent to 18.9 percent from 2003 through 2009. (We omit 2001 from the comparison because the first Bush tax cut took place during the 2001 fiscal year.) CBO, *Measuring the Effects of the Business Cycle on the Federal Budget: An Update*, September 1, 2009. Finally, the Bush tax cuts were not fully phased in during part of the 2001–2007 expansion; had they been fully phased in at the beginning, average revenues would have been lower.

²⁹ George W. Bush, “What the Congress Can Do for America,” the *Wall Street Journal*, January 3, 2007.

³⁰ GDP data are from BEA, National Income and Product Accounts, table 1.1.6. Growth is measured from the first quarter following the end of a recession to the last quarter preceding the beginning of the next recession.

³¹ In 2005, the CBO (then headed by a Republican appointee, Douglas Holtz-Eakin) estimated that the economic effects of a 10 percent cut in income taxes would offset between 1 and 22 percent of the revenue loss in the first five years; in the following five years, the economic effects might offset up to 32 percent of the revenue loss, but might also *add* 5 percent to the revenue loss. CBO, “Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in

people will have more money to spend), a tax cut that increases deficits tends to reduce economic growth in the long term (because more government borrowing increases interest rates for everyone), according to a study by the congressional Joint Committee on Taxation (issued in 2006, when Republicans controlled both the House and the Senate).³²

Together, the Bush tax cuts (including the higher interest payments they caused) added about \$270 billion to the 2010 deficit.³³ Over the past decade, their cumulative effect has been to increase the national debt by close to \$3 trillion.³⁴ They are not the primary reason why the national debt is so much bigger today than expected in 2001: Tax cuts take second place to economic weakness, in particular the severe recession triggered by the financial crisis.³⁵ But of the conscious policy choices of the current century, the tax cuts (and their extension in December 2010) made the single largest contribution to today's budget deficits and to the recent growth in the national debt.³⁶

Income Tax Rates," Economic and Budget Issue Brief, December 1, 2005. A paper co-authored by Gregory Mankiw, a former chair of President Bush's Council of Economic Advisers, calculates that 32.4 percent of the static revenue loss of a capital gains tax cut and 14.7 percent of the static revenue loss of a labor tax cut could be offset in present value terms (ignoring short-term Keynesian effects). N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," *Journal of Public Economics* 90 (2006): 1415–33, page 1430. An offset of 32.4 percent is a lot, but far less than 100 percent. Even then, Mankiw and Weinzierl assume that government spending falls to keep the budget in balance. *Ibid.*, page 1417. If instead the tax cuts are financed by additional debt, their ultimate effect can be to lower economic growth in the long term, depending on the eventual consequences of the larger debt. Eric M. Leeper and Shu-Chun Susan Yang, "Dynamic Scoring: Alternative Financing Schemes," *Journal of Public Economics* 92 (2008): 159–82, page 166–69.

³² The Joint Committee on Taxation estimated that a 10 percent cut in individual income tax rates would reduce economic growth in the long run if the tax cut were financed by increased borrowing. Joint Committee on Taxation, *Exploring Issues in the Development of Macroeconomic Models for Use in Tax Policy Analysis*, JCX-19-06, June 16, 2006.

³³ In 2007, the CBO estimated the 2010 impact of the tax cuts, including interest payments, at \$269 billion. Peter R. Orszag, Letter to the Honorable John M. Spratt, Jr., July 20, 2007.

³⁴ Through 2008, the Bush tax cuts accounted for \$1.7 trillion in deficits and over \$200 billion in additional interest costs. Kathy Ruffing and James R. Horney, *Economic Downturn and Bush Policies Continue to Drive Large Projected Deficits*, Center on Budget and Policy Priorities, May 10, 2011, page 8. For 2009 through 2011, the CBO estimated a total impact of \$729 billion, but that was before the December 2010 tax cut extension. Orszag, note 33, above. The 2010 extension added almost \$200 billion to the 2011 impact of the tax cuts, not counting the new payroll tax cut and another AMT patch. CBO, *Estimate of Changes in Revenues and Direct Spending for S.A. 4753, an Amendment to H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, December 10, 2010.

³⁵ An analysis by the Pew Charitable Trusts broke down the components of the increase in the 2011 national debt since the CBO's projection in January 2001. The largest factor was lower revenues due to economic changes and technical reestimates (28 percent). The second largest was the 2001/2003 tax cuts (13 percent); the December 2010 tax cuts, which largely extended the 2001/2003 tax cuts, contributed 3 percent, while other tax cuts contributed 5 percent, for a total of 21 percent attributable to tax cuts. That does not include additional interest payments because of the larger debt created by those tax cuts. (The 2009 stimulus bill, by contrast, was responsible for only 6 percent of the increase in the debt.) Pew Fiscal Analysis Initiative, *The Great Debt Shift: Drivers of Federal Debt Since 2001*, April 2011, figure 3, page 5.

³⁶ *Ibid.*; Ruffing and Horney, note 34, above; Teresa Tritch, "How the Deficit Got This Big," the *New York Times*, July 23, 2011; Chad Stone, "What's Driving Projected Debt?" *Off the Charts*, Center for Budget and Policy Priorities, May 20, 2011. Brian Riedl of the Heritage Foundation has argued that focusing on the Bush tax cuts is arbitrary, since the projected deficit could also be blamed on Social Security, Medicare, or other programs. Brian Riedl, "The Bush Tax Cuts and the Deficit Myth," the *Wall Street Journal*, July 13, 2010. The Bush tax cuts, however, were a policy choice made after the long-term deficits in Social Security and Medicare were clearly visible, yet without making any effort to offset the tax cuts in any way. Riedl argues that deficits must be the fault of increasing spending because tax revenues remain roughly stable at around 18 percent of GDP. But this argument

In the conservative playbook, the reason to cut taxes is not just to put more money in people's pockets, but more importantly to force the government to shrink. If the Bush administration had cut spending to match the tax cuts, then the national debt would be far smaller today. But instead, the administration increased spending, which grew from 18.2 percent of GDP in 2001 to 20.7 percent of GDP in 2008.³⁷ Half of this increase was due to defense spending, largely because of the Afghanistan and Iraq Wars, which so far have cost well over \$1 trillion.³⁸ Democrats often blame the Iraq War on the Bush administration, which mounted a concerted campaign to build public support for the war. On the other hand, the Congressional resolution authorizing the invasion was backed by a majority of Democrats in the Senate and a near majority in the House.³⁹

In any case, what mattered for the federal budget was how we chose to pay for those wars: increased borrowing. President Lyndon Johnson resisted raising taxes to fight the Vietnam War because he was afraid higher taxes would undermine support for his domestic initiatives;⁴⁰ President Bush resisted raising taxes to fight the Iraq War because tax cuts *were* his major domestic initiatives. Instead, Bush introduced his 2003 tax cut in January,⁴¹ while he was building international support for the invasion, and it was passed in May, two months after the war began. The administration reconciled war with tax cuts in part by downplaying the costs of the war. When Lawrence Lindsey, director of the president's National Economic Council, estimated that the upper bound on the war's costs would be \$100 billion to \$200 billion (which, he added, was "nothing"), he was shot down by Mitch Daniels, director of the Office of Management and Budget, and Lindsey soon left the administration.⁴² Secretary of Defense Donald Rumsfeld claimed the cost would be no more than \$50 billion to \$60 billion.⁴³ Tom DeLay, by then House Majority Leader, said, "Nothing is more important in the face of a war than cutting taxes"—going even further than the original War Hawks of 1812, who merely declined to find a way to pay for the war they had just declared.⁴⁴

ignores the fact that tax cuts—including the Bush tax cuts—are the very mechanism that keeps tax revenues from growing much higher than 18 percent of GDP for very long.

³⁷ OMB, *Fiscal Year 2012 Budget of the U.S. Government: Historical Tables*, table 1.2.

³⁸ Defense spending grew from 3.0 to 4.3 percent of GDP—half of the total increase in GDP terms. *Ibid.*, table 8.4. As of January 2011, appropriations through 2010 were \$1,104 billion, with appropriations for 2011 running at an annual rate of \$159 billion. CBO, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, January 2011, Box 3-2, page 77. This does not include additional interest payments on the larger national debt, which came to \$64 billion through 2008. Ruffing and Horney, note 34, above, page 8. The appropriations include \$126 billion for war-related activities not specifically associated with Afghanistan and Iraq. Linda Bilmes and Joseph Stiglitz have estimated the true cost of the Iraq War at over \$3 trillion. Linda J. Bilmes and Joseph E. Stiglitz, *The Three Trillion Dollar War: The True Cost of the Iraq Conflict* (W.W. Norton, 2008). This figure, however, includes economic losses suffered by Americans that do not add to the government debt. See Peter Orszag, "Estimated Costs of US Operations in Iraq and Afghanistan and of Other Activities Related to the War on Terrorism," testimony before the House Budget Committee, October 24, 2007, page 10–14.

³⁹ Voting information for the Authorization for Use of Military Force Against Iraq Resolution of 2002 is available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:HJ00114:@@@R>.

⁴⁰ Dennis S. Ippolito, *Why Budgets Matter: Budget Policy and American Politics* (Pennsylvania State University Press, 2004), page 175.

⁴¹ Richard W. Stevenson, "Bush Unveils Plan to Cut Tax Rates and Spur Economy," the *New York Times*, January 8, 2003.

⁴² Elisabeth Bumiller, "White House Cuts Estimate of Cost of War with Iraq," the *New York Times*, December 31, 2002; Matthew Engel, "Cost of War Put at \$200bn, but That's Nothing, Says US Adviser," the *Guardian*, September 16, 2002.

⁴³ Morgan, note 16, above, page 235.

⁴⁴ Quoted in James Surowiecki, "A Cut Too Far," the *New Yorker*, April 21, 2003.

While many conservatives were happy to spend more on national defense, where they really wanted to cut spending was in the major entitlement programs: Social Security and Medicare. When asked what his ideal policies were, Grover Norquist said,

The first would be personalizing Social Security, privatizing Social Security, instead of having the state take 12 percent of your income and then promising to pay you something if you make it to 65 or 67. Instead, they should let you put that money into a 401(k), and then you would control it.⁴⁵

Structural Medicare reform had already been one of House Speaker Newt Gingrich's major goals in the 1995 budget fight.⁴⁶ By the Bush years, it was clear that current Social Security and Medicare policies would lead to large long-term deficits. But even here, President Bush's policies only increased long-term entitlement spending. In 2003, the president and his congressional allies *added* a new prescription drug program to Medicare—at the request of elderly people struggling with rising drug prices—without finding a way to pay for its benefits in full. The new program was officially estimated to cost \$395 billion over ten years;⁴⁷ Medicare's chief actuary estimated it would cost \$500 billion to \$600 billion, but was ordered by the program's administrator, a political appointee, not to provide his estimates in response to congressional requests.⁴⁸ In any case, the prescription drug benefit has made Medicare's future funding problems much larger: Today, almost one-third of Medicare's long-term deficit is due to the prescription drug program.⁴⁹ After the 2004 elections, President Bush also made reforming Social Security a top priority. He proposed allowing people to divert part of their payroll taxes into individual accounts that they would control and keep; but since those accounts would have reduced the amount of money available to pay current benefits, the government would have had to borrow up to one trillion dollars over the next ten years, adding to the national debt.⁵⁰ Because of widespread opposition, Social Security privatization never came close to a vote.

The tax policies of the Bush administration were a lopsided victory for the tax revolt—a victory that produced vast increases in government deficits and the national debt. The 2004 deficit reached \$413 billion (3.5 percent of GDP); modest economic growth reduced the deficit to \$161 billion in 2007 (1.2 percent), but it would have been significantly larger without a Social

⁴⁵ Nick Gillespie, "An Alliance for Freedom?" *Reason*, August/September 2008.

⁴⁶ See Jonathan Oberlander, *The Political Life of Medicare* (University of Chicago Press, 2003), page 175–76.

⁴⁷ CBO, *Estimate of Effect on Direct Spending and Revenues of Conference Agreement on H.R. 1*, November 20, 2003.

⁴⁸ Robert Pear, "Inquiry Confirms Top Medicare Official Threatened Actuary Over Cost of Drug Benefits," the *New York Times*, July 7, 2004. The administrator, Thomas Scully, resigned after the bill passed to become a lobbyist for health care companies.

⁴⁹ The seventy-five year deficits of the three major components of Medicare, in present value terms, are: Part A (Hospital Insurance), \$3.1 trillion; Part B (Medical Insurance), \$13.9 trillion; and Part D (Prescription Drug Coverage), \$7.5 trillion. (Part C refers to Medicare Advantage plans, which are provided by private insurers but subsidized by Medicare.) *2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, tables III.B9, III.C15, III.C23, pp. 83, 130, 146.

⁵⁰ CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2006*, March 2005, page 47–49. Participants diverting money into individual accounts would presumably receive lower guaranteed benefits when they retired. But money going into individual accounts would no longer be available to pay promised benefits to current retirees, requiring additional borrowing. The shortfall could have been reduced by lowering benefits for current retirees, but the president did not explicitly propose such a plan.

Security surplus that could not last once the Baby Boom generation began retiring.⁵¹ Even before the financial crisis, the outlook for 2010 had shifted from the \$796 billion surplus projected in 2001 to a \$241 billion deficit.⁵² And it was clear that demographic trends would soon turn against the federal government.⁵³

Focusing on the politics of taxes rather than the politics of spending may seem simply a matter of framing. Arguably, if increases in the national debt can be blamed on one side's insistence on tax cuts, they could as easily be blamed on the other side's insistence on spending increases. More concretely, Republicans may claim that the growth of the national debt is the fault of higher spending on Social Security and Medicare, not tax cuts. When considering the recent history of deficits and the debt, however, this is a false equivalence. In politics, there is a major difference between action that changes policy and inaction that simply preserves existing policy. The national debt was on a certain course in 2001, and it was the policies of the tax revolt that shifted it to a different course, with higher deficits. Republicans invested heavily and successfully in tax cuts that were meant to be permanent. Democrats, by contrast, made no significant efforts to expand spending on the major social insurance or welfare programs: Social Security has gone untouched, and while the Obama health care reform bill of 2010 increased certain types of health care spending, on balance it reduced future deficits rather than increasing them.⁵⁴ (The only recent entitlement expansion that significantly increased deficits was the Medicare prescription drug bill of 2003.) Insofar as Social Security and Medicare spending has increased since the days of surpluses, it is because of policy choices made decades before and simply left unchanged.

Even then, Social Security and Medicare have been relatively small contributors to the national debt. From 1984 (the year after the last major adjustment to Social Security) through 2007 (the last year before the recent financial crisis and recession), the two programs together ran a cumulative deficit of \$270 billion—a small fraction of the \$5 trillion national debt at the end of 2007.⁵⁵ More than one-quarter of that cumulative deficit was due to the Medicare prescription drug benefit added in 2003.⁵⁶ (Since the beginning of the recession, which triggered sharp declines in payroll taxes and increases in benefit payments, Social Security and Medicare have contributed another \$597 billion to the national debt—while the total national debt has grown by \$4 trillion.⁵⁷) In other words, the deterioration of the federal budget in recent years and

⁵¹ In 2007, Social Security ran a surplus of \$81 billion, not counting interest received from the rest of the federal government. Without that surplus, the 2007 government deficit would have been \$242 billion. The 2007 surplus was the sixth largest in history after 2000–2002 and 2005–2006. OMB, note 38, above, table 13.1.

⁵² CBO, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008, Summary table 1, page xii.

⁵³ CBO, *The Long-Term Budget Outlook*, December 2007, figure 1-2, page 4.

⁵⁴ Douglas W. Elmendorf, “CBO’s Analysis of the Major Health Care Legislation Enacted in March 2010,” testimony before the Health Subcommittee of the House Energy and Commerce Committee, March 30, 2011, table 1, page 2.

⁵⁵ OMB, note 38, above, tables 13.1 and 7.1. To calculate program deficits in any year, we take the actual trust fund surplus or deficit and subtract any interest received from the rest of the government and (for Medicare Parts B and D) any transfers from general government revenues; this yields the program’s true impact on the overall federal deficit in that year. Including interest payments from the rest of the government (but not transfers from general revenues), the programs together ran a surplus over the same period. The \$270 billion figure does not include additional interest payments, so the true impact on the 2007 national debt is slightly larger.

⁵⁶ *2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, table III.C19, page 139. To calculate the Medicare Part D deficit, we take all income except for transfers from general revenue and subtract all expenditures.

⁵⁷ Almost one-quarter of that \$597 billion is due to the Medicare prescription drug program. *Ibid.*

the resulting increase in the national debt are not the fault of Social Security and Medicare. Growing spending on these programs is a major factor in the future growth of the national debt (as we discuss in *White House Burning*) but not in the story of how we got to where we are today.

Despite the tax cuts of the Bush years, few people in 2007 thought that budget deficits amounted to a national emergency. Foreign investors' growing appetite for Treasury bonds ensured that significant budget deficits could be financed easily. The national debt was only 36 percent of GDP, right around the average for the previous fifty years.⁵⁸ As of January 2008, the CBO's baseline projection was for the national debt to fall to 23 percent of GDP by 2018 (assuming that all of the Bush tax cuts would expire on schedule).⁵⁹ The next president, it seemed, would inherit a significant long-term deficit problem, but not a crisis. The financial meltdown of fall 2008 changed this situation dramatically.

C. Background: Sources of Revenue for the Federal Government

In 2010, the federal government collected \$2.2 trillion in revenues, the vast majority of that from taxes. The **individual income tax** (for which returns are due on April 15) was the largest source of government revenues, accounting for \$899 billion, or 42 percent of the total. Each household has to pay a percentage of its income, ranging from 0 percent for the first few thousand dollars it earns to 35 percent for income that exceeds several hundred thousand dollars per year.⁶⁰ (Because of various exemptions, deductions, and tax credits—as well as basic poverty—almost half of all households pay no federal income tax at all.⁶¹) This structure means that the individual income tax is progressive: Rich people generally pay a higher percentage of their income than poor people.

Individual income taxes have fallen over the past thirty years, from 8.5 percent of GDP in the 1980s and 8.4 percent in the 1990s to 7.4 percent since the 2001 tax cut and 6.2 percent in 2010—the lowest level since 1950.⁶² Even if we ignore the recent recession (which lowered income taxes, since people have been making less money), individual income taxes were

⁵⁸ OMB, note 38, above, table 7.1. Government debt as a percentage of GDP averaged 36.7 percent from 1958 through 2007.

⁵⁹ CBO, *The Budget and Economic Outlook*, January 2008, Summary table 1, page xii. By law, the CBO baseline projection must follow certain rules that make it unrealistic. Most importantly, it must assume that current law remains unchanged; in 2007, this meant assuming that the Bush tax cuts would expire on schedule and that the AMT would be allowed to hit middle-class households. Despite this problem, because it is constrained to follow a consistent set of rules, the CBO baseline projection is often the best way to compare the government's fiscal position at different points in time.

⁶⁰ These are marginal tax rates, meaning that even if you are in the 35 percent tax bracket, you only pay 35 percent on income above a certain threshold, now around \$400,000. The current tax brackets were set by the 2001 tax cut; if it is allowed to expire, the top marginal rate will go back up to 39.6 percent. Technically speaking, there is no zero percent tax bracket, since taxes start at 10 percent on any taxable income. In practice, the personal exemptions and the standard deduction ensure that some of your income is not taxable.

⁶¹ Rachel Johnson, James Nunns, Jeffrey Rohaly, Eric Toder, and Robertson Williams, *Why Some Tax Units Pay No Income Tax*, Tax Policy Center, July 2011.

⁶² The 7.4 percent average is for fiscal years 2002—the first year for which large components of the 2001 tax cut were in effect—through 2010.

significantly lower as a share of the economy during the 2001–2007 economic expansion than during the 1991–2000 expansion, largely thanks to the Bush tax cuts.⁶³

As individual income taxes have been falling, the government has come to depend more on **social insurance contributions**, which brought in \$865 billion in 2010, or 40 percent of total revenues. The vast majority of this money comes from the dedicated payroll taxes for Social Security and Medicare, which are only levied on income from work, not income from investments.⁶⁴ Under current law, 12.4 percent of each person’s wages goes to the Social Security trust funds.⁶⁵ That money is used to pay benefits currently owed to retirees and disabled people; in previous years, when payroll taxes exceeded benefit payments, the surpluses were invested in Treasury bonds, meaning that they were lent to the rest of the federal government. Another 2.9 percent of wage income goes to another trust fund that pays for the Medicare Hospital Insurance program (Part A). Medicare’s Medical Insurance and Prescription Drug Coverage programs (Parts B and D), however, are *not* funded by the payroll tax; instead, they are paid for by beneficiaries’ premiums and copayments and by money from general government revenues (that is, other taxes). Together, the payroll tax, premiums, and copayments barely cover half of Medicare’s total expenses, which means that the program is heavily subsidized by the rest of the federal government.

The Social Security tax is only collected on each person’s wage income up to a cap, which was \$106,800 in 2011 (and is indexed to inflation), while the Medicare payroll tax is collected on all wage income.⁶⁶ This means that payroll taxes on the whole are regressive: Poor and middle-income people pay a higher percentage of their income than rich people.⁶⁷ As social insurance contributions have grown (due to rising tax rates), from 2 percent of GDP in the 1950s to over 6 percent in the first decade of the 2000s, an increasing share of government revenues has come from regressive rather than progressive taxes, shifting the overall tax burden onto lower-income people.⁶⁸

The third major source of federal revenues is the **corporate income tax**, which in 2010 brought in \$191 billion, or 9 percent of total revenues. Businesses routinely complain that the United States has one of the highest corporate tax rates in the world, with a federal tax rate of 35 percent; including state corporate taxes, we have the second-highest tax *rate* among all advanced economies.⁶⁹ But the effective tax rates that US corporations actually pay have been falling for

⁶³ Individual income taxes averaged 8.7 percent of GDP in fiscal years 1992–2000 and 7.6 percent of GDP in fiscal years 2003–2007. We exclude fiscal years 1991, 2001, and 2002 because the economy was in recession for part of each of those years.

⁶⁴ Self-employed people also pay the same payroll taxes.

⁶⁵ Technically speaking, the employee pays half of each payroll tax and the employer pays the other half. In addition, the December 2010 tax cut lowered the Social Security payroll tax by two percentage points for 2011 (since extended through February 2012).

⁶⁶ In addition, beginning in 2013, a higher Medicare payroll tax rate will be charged on earnings above certain thresholds designed to affect high-income taxpayers.

⁶⁷ Someone who makes \$50,000 a year ordinarily pays 15.3 percent of her salary, or \$7,650, in payroll taxes. Someone who makes \$200,000 a year, however, pays only \$19,043 in payroll taxes because of the cap on the Social Security tax; this works out to a tax rate of only 9.5 percent.

⁶⁸ The tax system as a whole remains modestly progressive, however. For example, in 2010, top-quintile households had 53.5 percent of pre-tax income and paid 68.6 percent of federal taxes, while middle-quintile households had 13.9 percent of pre-tax income and paid 9.8 percent of federal taxes. Tax Policy Center, table T11-0094, Distribution of Cash Income and Federal Taxes by Filing Status and Family Type, Under Current Law, by Cash Income Percentile, 2010, available at <http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2975&DocTypeID=7>.

⁶⁹ David Kocieniewski, “Where Pay for Chiefs Outstrips US Taxes,” the *New York Times*, August 31, 2011.

decades as powerful business interests successfully lobby for tax loopholes and companies become more aggressive at taking advantage of those loopholes.⁷⁰ Figuring out ways to book profits in overseas subsidiaries where corporate tax rates are lower has become a lucrative pastime for many companies from General Electric to Google, which have claimed billions of dollars in tax benefits.⁷¹ While the corporate tax amounted to 4.8 percent of GDP in the 1950s and 3.8 percent in the 1960s, it fell to 1.9 percent by the first decade of the 2000s and only 1.3 percent in 2010.⁷² Including state taxes, corporate taxes in the United States are among the lowest as a share of GDP in the industrialized world.⁷³

Tax loopholes not only reduce government revenues but also lead large companies to expend time and money on activities that serve no purpose other than reducing their taxes. It also puts smaller companies, unable to afford expensive lawyers and accountants, at a competitive disadvantage. Our low effective corporate tax rates have led to calls from liberals for corporations to pay higher taxes, but it is important to remember that companies are not real people. If they did pay higher taxes, it is hard to identify how that burden would be spread across employees (as lower wages), shareholders (as lower profits), or other capital owners (as lower rates of return).⁷⁴

In addition to individual income taxes, social insurance taxes, and corporate income taxes, the federal government brought in another \$208 billion in 2010 from sources such as alcohol, tobacco, and gasoline taxes, customs duties, and estate taxes. From any perspective, the total revenues of \$2.2 trillion (less than 15 percent of GDP) were remarkably low. Not since 1950 were total federal taxes such a small part of the economy as in 2009–2010. Leaving aside the recent recession, federal taxes averaged 17 percent of GDP during the 2001–2007 economic expansion; the last time taxes were so low during a period of growth was in 1958–1960.⁷⁵ Including federal, state, and local taxes, the total tax burden in the United States was 24 percent of GDP in 2009, the second-lowest level among the thirty-four industrialized countries in the Organization for Economic Cooperation and Development (OECD).⁷⁶ Compared to other rich countries, we are not an overtaxed country.

⁷⁰ See David Leonhardt, “The Paradox of Corporate Taxes,” the *New York Times*, February 1, 2011; David Kocieniewski, “US Business Has High Tax Rates but Pays Less,” the *New York Times*, May 2, 2011.

⁷¹ David Kocieniewski, “G.E.’s Strategies Let It Avoid Taxes Altogether,” the *New York Times*, March 24, 2011; Jesse Drucker, “The Tax Haven That’s Saving Google Billions,” *Bloomberg Businessweek*, October 21, 2010.

⁷² This may be due in part to the fact that pass-through entities, where tax is paid only on the individual level and not on the company level, are becoming increasingly popular in the United States. The high corporate tax rate in the United States may also be inducing companies to shift their income to other countries. See Tax Policy Center, “International Taxation,” in *The Tax Policy Briefing Book: A Citizens’ Guide to the 2008 Election and Beyond*, available at <http://www.taxpolicycenter.org/briefing-book/>.

⁷³ Over the past decade, the United States has had the eighth lowest corporate taxes among thirty-one OECD countries, measured as a percentage of GDP. Taxes averaged 2.5 percent of GDP over the 2000–2008 period, compared to an average of 3.5 percent for the OECD. Data are not yet available for 2009 for all countries; data are not available for the entire period for Chile and Mexico. OECD.StatExtracts, Revenue Statistics.

⁷⁴ For overviews of this debate, see Alan J. Auerbach, “Who Bears the Corporate Tax? A Review of What We Know,” chapter 1 in James M. Poterba, ed., *Tax Policy and the Economy*, vol. 20 (MIT Press, 2006); Rosanne Altshuler, Benjamin H. Harris, and Eric Toder, “Capital Income Taxation and Progressivity in a Global Economy,” *Virginia Tax Review* 30 (2010): 355–88.

⁷⁵ Again, we exclude fiscal years where the economy was in recession for part of the year. The average tax level in fiscal years 2003–2007 was 17.3 percent. The economy expanded from April 1958 to April 1960, leaving only one full fiscal year of expansion (1959), when taxes were 16.2 percent of GDP.

⁷⁶ OECD.StatExtracts, Revenue Statistics. Among all OECD countries, the only ones with lower total tax rates as a percentage of GDP in 2009 were Chile and Mexico. Arguably, we pay less in taxes because we have to pay more to

the private sector for health care (because the government pays for a smaller share of our health care than in comparable countries). On the other hand, however, our government pays more for health care in absolute terms than most other comparable governments. David A. Squires, "The US Health System in Perspective: A Comparison of Twelve Industrialized Nations," The Commonwealth Fund, Issues in International Health Policy, July 2011, exhibit 3, page 4.