

# **Snake-Oil Tax Cuts**

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Paper written for the Economic Policy Institute, Sept. 1, 2008.

Background for Panel on

Corporate and High Income Tax Cuts and The Economy:

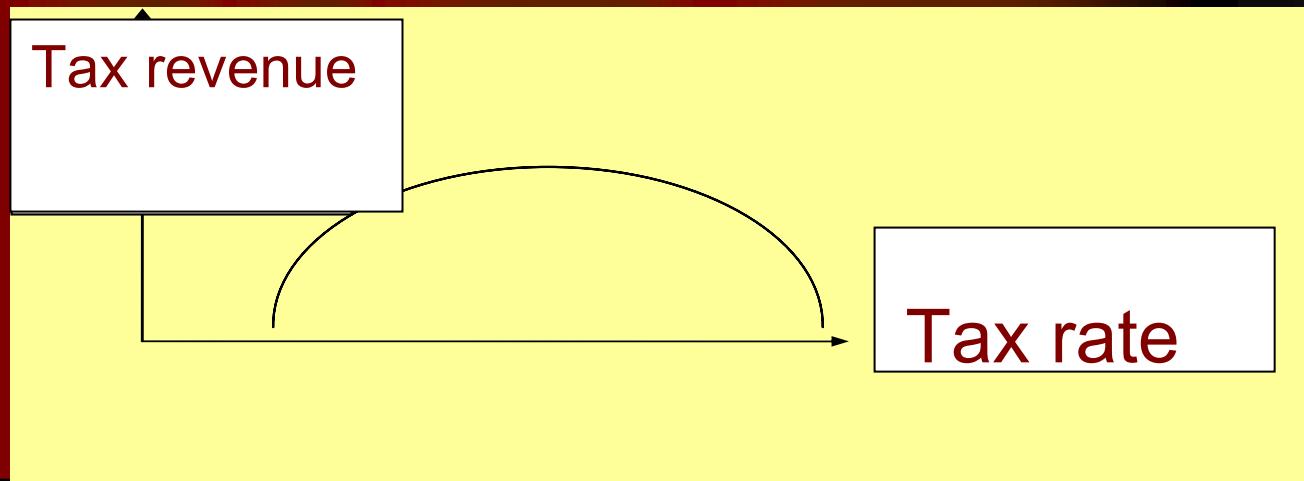
*The Economics, History, and Public Debate of Supply-Side Policies*  
at Center for American Progress, Washington, DC, Sept. 12, 2008.

# Tax cuts

- are always tempting for politicians. But
- In recent decades “conservative” presidents
  - have enacted huge tax cuts that are anything but conservative fiscally; and
  - have justified them by appeals to theory.

In particular, they have appealed to two theories:

- the Laffer Proposition, which says that cuts in tax rates will pay for themselves via higher economic activity,

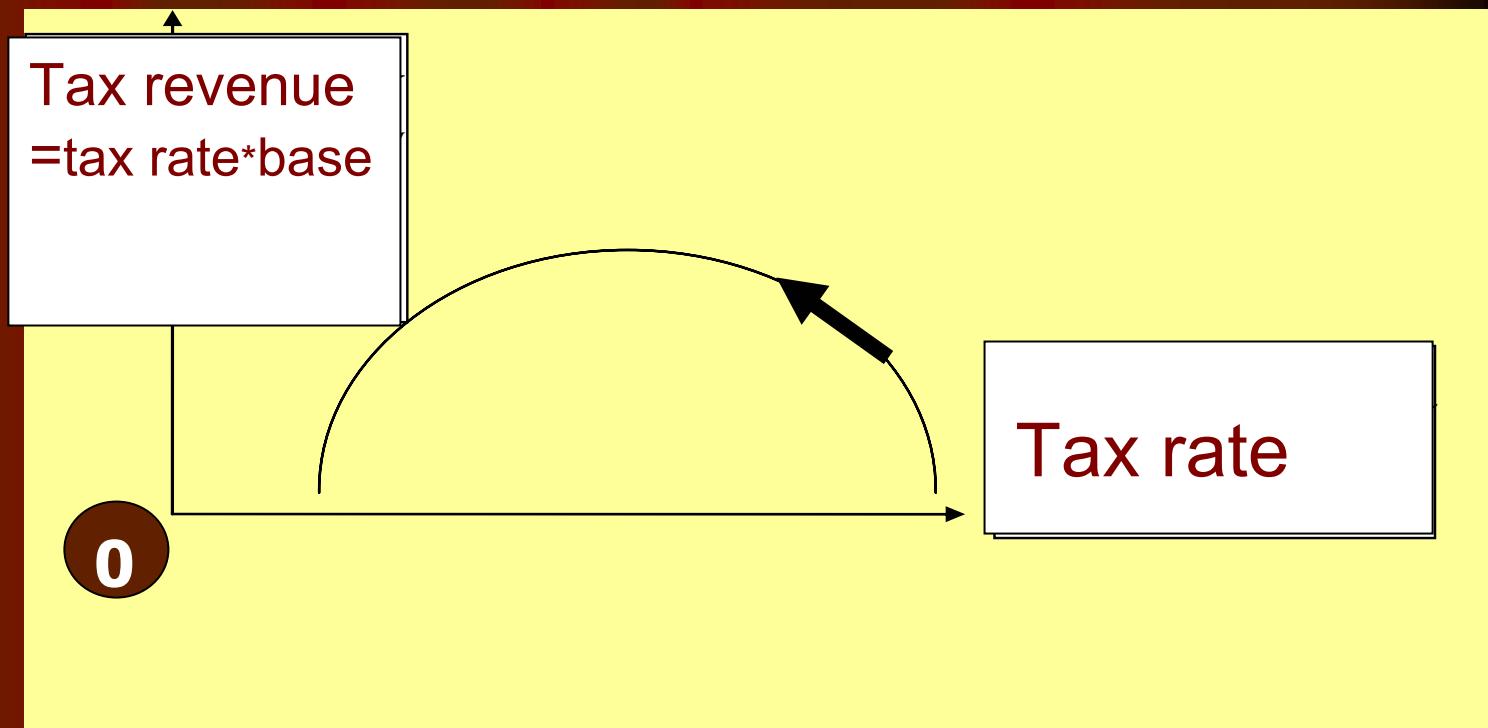


and

- the Starve the Beast Hypothesis, which says tax cuts will increase the budget deficit & so put downward pressure on federal spending.



The Laffer Proposition is theoretically possible under certain conditions,



# but it does not in fact apply to US income tax rates:

- a cut in those rates reduces revenue, precisely as common sense would indicate.
- This was the outcome of the two big experiments of recent decades:
  - the Reagan tax cuts of 1981-83 &
  - the Bush tax cuts of 2001-03,
  - both of which led to record US budget deficits.

# The Laffer Hypothesis is widely rejected:

- Evidence from the 1990s
  - Austan Goolsbee, 2000 "What Happens When You Tax the Rich? Evidence from Executive Compensation," *Journal of Political Economy*, 108, no. 2.
  - Austan Goolsbee, 1998, "Give Me Shelter: What Happens When You Tax the Rich?" *Capital Ideas*, 1, No. 3, Summer, Grad. School of Bus., Univ. of Chicago.
  - R. Kasten, D., Weiner,& T. Woodward, 1999, "What Made Receipts Boom and When Will They Go Bust?" *National Tax Journal*.
- The experience of the Bush tax cuts
  - William Gale & Samara Potter, "An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," LV, no. 1, March, 133-186, *National Tax Journal*, 2002;
  - Gale & Laurence Kotlikoff, 2004, "Effects of Recent Fiscal Policies on Today's Children and Future Generations," Boston University;
  - Alice Rivlin & Isabel Sawhill, eds., 2004, Restoring Fiscal Sanity: How to Balance the Budget, Brookings Institution Press, esp. the forecasts in their Chapter 1.
  - Rubin's "Comment," in Frankel & Peter Orszag, eds., *American Economic Policy in the 1990s* (MIT Press) 2002, p. 133.

# Scholarly rejections of the Laffer Hypothesis, continued

- Austan Goolsbee, 1999, "Evidence on the High-Income Laffer Curve from Six Decades of Tax Reform," *Brookings Papers on Economic Activity*, no. 2 analyzes six different U.S. tax changes since 1922 for evidence in support of the high-income Laffer curve. The historical record suggests that it is unlikely that governments can raise more money by cutting rates at anything like today's marginal tax rates.
- H.Uhlig & M.Trabandt, 2006, "How Far Are We from the Slippery Slope? The Laffer Curve Revisited," CEPR DP No. 5657 use international evidence to examine the shape of the Laffer curve. They find that the US & EU-15 area are located on the left side of their Laffer curves – i.e., in the range where cuts in tax rates lose revenue -- but the EU-15 economy is much closer to the top of the curve than the US.
- W.J.M. Heijman and J.A.C. van Ophem, 2005, "Willingness to pay tax: The curve revisited for 12 OECD countries," *J. of Socio-Economics* 34, no. 5 try also to account for rising tax rates driving economic activities "underground" and hence depriving governments of revenue. They conclude that raising the marginal tax rate in major OECD countries would increase, not decrease, revenue.

- The rejection applies even to capital gains taxes, where any apparent revenue gains from tax cuts are attributable to reallocation over time or away from earned income.
  - Leonard Burman & William Randolph, 1994, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Rev.*. 84, no. 4 (Sept.): 794-809
  - Alan Auerbach & Jonathan Siegel , 2000, "Capital-Gains Realizations of the Rich and Sophisticated," *American Economic Review*, 90, No. 2, (May), pp. 276-282

# Finally, this rejection is the view of almost all professional economists

including the economic advisers to Presidents Reagan & Bush:

- **Martin Feldstein** (1985): “The experience since 1981 has not been kind to the claims of the Supply Side extremists ... Each of those predictions has proven to be wrong.”
- **Feldstein** (1994): “I objected therefore to those Supply-Siders like Arthur Laffer who argued that a 30 percent across-the-board tax cut would also be self-financing because of the resulting increase in incentives to work.”
- **Glenn Hubbard** (2003): “Although the economy grows in response to tax reductions... it is unlikely to grow so much that lost tax revenue is completely recovered by the higher level of economic activity.”
- **Greg Mankiw** (1998): “Subsequent history failed to confirm Laffer’s conjecture that lower tax rates would raise tax revenue. When Reagan cut taxes after he was elected, the result was less tax revenue, not more.”

So thoroughly discredited is the Laffer Hypothesis, that many deny that Reagan or Bush or their top officials could have ever believed such a thing.

But quotes suggest that they did.

- The Reagan Administration:
  - **Reagan** himself: "...our kind of tax cut will so stimulate the economy that we will actually increase government revenues..." July 7, 1981 speech.
  - His Treasury Secretary, **Donald Regan**, wrote of his "very strong opinion that a tax cut would produce more revenue than a tax increase."
  - **Regan** (1988) further opined: "The increase in revenues should be financed not by new and higher taxes, but by *lower* tax rates that would produce more money for the government by stimulating higher earnings by corporations and workers..."

# The George W. Bush Administration is abundantly on record as believing the Laffer Hypothesis.

## Bush himself:

- **11/13/02** "Well, we have a deficit because tax revenues are down. Make no mistake about it, the tax relief package that we passed -- that should be permanent, by the way -- has helped the economy, and that the deficit would have been bigger without the tax relief package."
- **7/24/03** "The best way to get more revenues in the Treasury is not raise taxes, slowing down the economy, it's cut taxes to create more economic growth. That's how you get more money into the U.S. Treasury."
- **8/6/05** "The tax relief stimulated economic vitality and growth and it has helped increase revenues to the Treasury. The increased revenues and our spending restraint have led to good progress in reducing the federal deficit.."
- **8/22/06** "One of the interesting things that I hope you realize when it comes to cutting taxes is this tax relief not only has helped our economy, but it's helped the federal budget. In 2004, tax revenues to the Treasury grew about 5.5 percent. That's kind of counter-intuitive, isn't it? At least it is for some in Washington. You cut taxes and the tax revenues increase. See, some people are going to say, well, you cut taxes, you're going to have less revenue. No, that's not what happened. What happened was we cut taxes and in 2004, revenues increased 5.5 percent. And last year those revenues increased 14.5 percent, or \$274 billion. And the reason why is cutting taxes caused the economy to grow, and as the economy grows there is more revenue generated in the private sector, which yields more tax revenues."
- **7/11/06** "Some in Washington say we had to choose between cutting taxes and cutting the deficit. You might remember those debates. You endured that rhetoric hour after hour on the floor of the Senate and the House. Today's numbers show that that was a false choice. The economic growth fueled by tax relief has helped send our tax revenues soaring. That's what's happened."

# And Bush's officials

- Vice President Cheney: 1/30/03,  
2/9/06.
- Treasury Secretary John Snow: 2/7/06
- Press Secretary Ari Fleischer: 1/8/03
- OMB Director Joshua Bolten: 7/03,  
12/10/03,  
7/05

When tax cuts result in larger, not smaller deficits, their defenders sometimes switch to Starve the Beast Hypothesis as their rationale



The Starve the Beast Hypothesis claims that politicians can't spend money that they don't have.

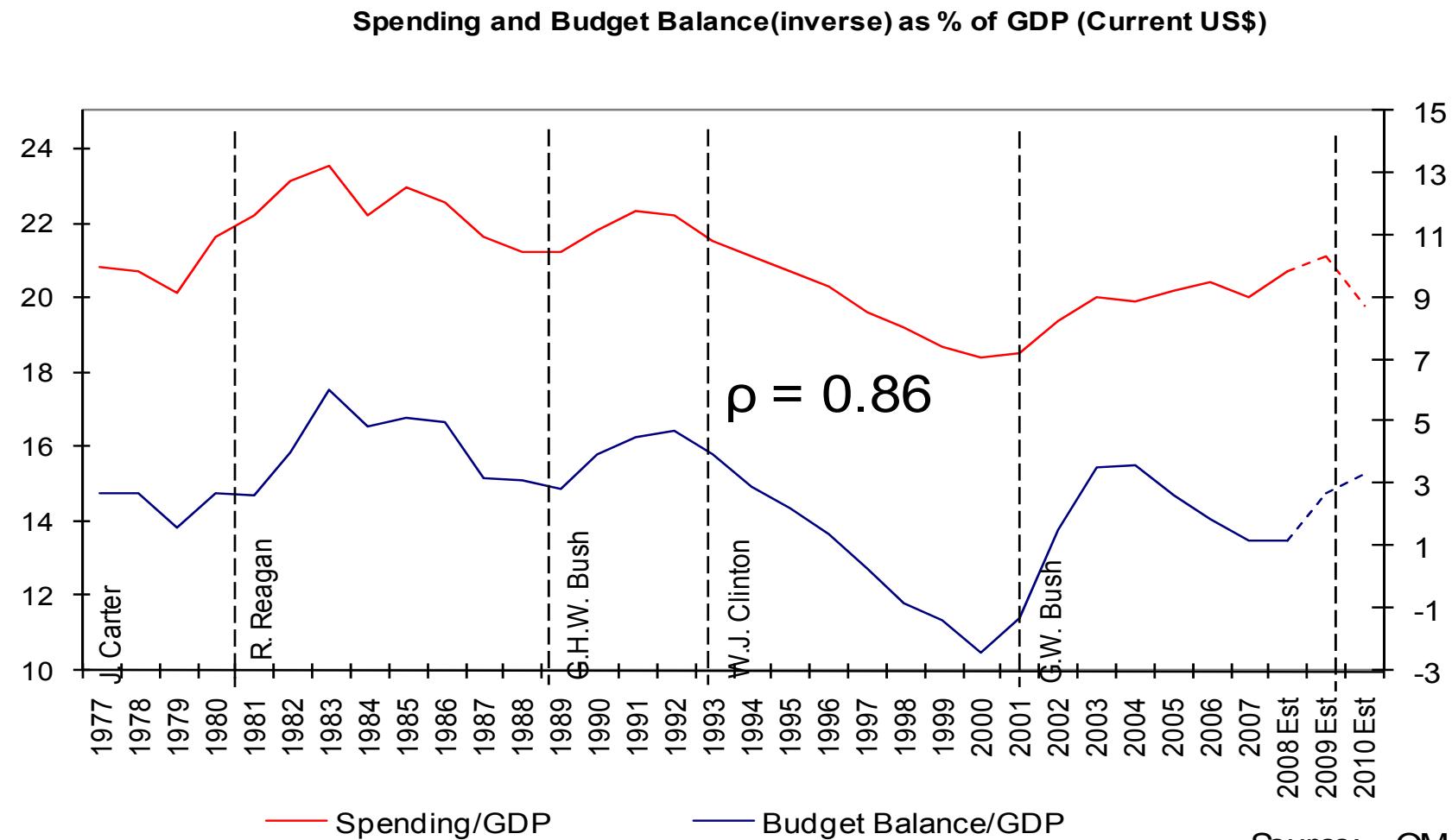
- In theory, Congressmen are supposedly inhibited from spending, by constituents' fears that the resulting deficits will mean higher taxes for their grandchildren.
- The theory fails on both conceptual grounds and empirical grounds.

Conceptually, begin by asking:  
what it the alternative fiscal regime to which  
Starve the Beast is being compared?

- The natural alternative is the regime that was in place during the 1990s, which I call Shared Sacrifice.
- Then, any Congressman wishing to increase spending had to show how they would raise taxes to pay for it.
- Logically, a Congressman contemplating a new spending program to benefit some favored supporters will be more inhibited by fears of constituents complaining about an immediate tax increase (under the regime of Shared Sacrifice) than by fears of constituents complaining that budget deficits might mean higher taxes many years into the future.

The 1990s' Shared Sacrifice approach succeeded in eliminating budget deficits, to a substantial degree by slowing spending.

Compare this to the sharp rises in spending when Presidents Reagan, Bush I, and Bush II took office.



# Again, more systematic econometric analysis confirms rejection of Starve the Beast.

- William Niskanen,
  - 2002, "Comment" in *American Economic Policy in the 1990s*, edited by Jeffrey Frankel & Peter Orszag, MIT Press, pp.184-187.
  - 2004, "Starve the Beast Does Not Work, *Cato Policy Report* 26, no.2, March-April: 2. And
  - 2006, "Limiting Government: The Failure of 'Starve the Beast'" *Cato Journal*, Fall.
- William Gale & Peter Orszag, 2004, "Bush Administration Tax Policy: Revenue and Budget Effects," *Tax Analysts*
- Christina & David Romer, 2007, "Do Tax Cuts Starve the Beast: The Effect of Tax Changes on Government Spending," NBER WP no. 13548.

# Senator John McCain?

- The candidate says: “Tax cuts, starting with Kennedy, as we all know, increase revenues.” (“The Full McCain: An Interview in *Natl. Rev.*, March 5, 2007.)
- His policy director, Douglas Holtz-Eakin, disavows the Laffer Proposition, just as the economists who advised Presidents Reagan & Bush did.

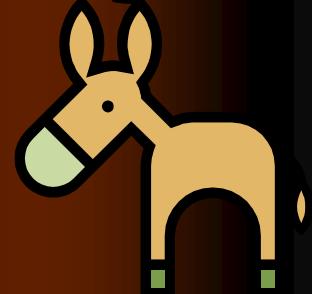
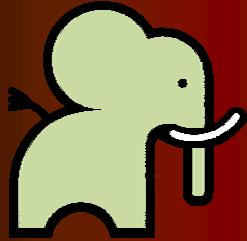
# Laffer Proposition vs. Starve the Beast

- It is insufficiently remarked that the two propositions are inconsistent with each other: reductions in tax rates can't increase tax revenues and reduce tax revenues at the same time.
- But being mutually exclusive does not prevent them both from being wrong.

The Queen in *Alice in Wonderland* said that, with practice, she was able to believe as many as six impossible things before breakfast.

- Most of us are more limited in our capacity for credulity.
- Any good conservative who believes both the Laffer Proposition (tax cuts raise revenues) and Starve the Beast (higher revenues lead to higher spending, anathema to conservatives) should run on a truly novel platform: higher tax rates!
- Why?
  - Higher tax rates would reduce revenues (this is what Laffer says would happen) and
  - thereby reduce spending (this is what Starve the Beast says would happen).

# Bottom line for election campaigns



- All candidates should be obliged to make clear their economic philosophies.
- Any candidate who proposes extending tax cuts, should be forced to choose between the Lafferite defense and the “Starve the Beast” defense.
- Only then can the rest of us know which of the two mutually inconsistent propositions to refute.

Tax revenue

Tax rate

