Policy Note 2001/5

THE BACKWARD ART OF TAX CUTTING

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This policy note examines the case for large tax cuts, focusing on the issues surrounding the purpose and overall size of the needed cut. Although Congress has passed a significant package of tax relief, many have worried that the budget surplus on which it was based will never appear. Thus, some have advocated “triggers” to reduce the size of the tax cuts should tax revenues begin to decline. This note argues that such a proposal represents “backward thinking.”

IT’S OVER. The abundantly proportioned lady is singing. Federal Reserve chairman Greenspan has lost his luster and, as reported in the April 2 New York Times, fallen from “maestro” to “dot-com sucker” in the blink of an eye. Those bubble-com stocks are now cheaper than the air that filled the irrationally exuberant mania of the last millennium. Every day brings another round of profit disappointments, bankruptcy, and mass layoffs. State budgets are already feeling the effects of the downturn, as legislators are forced to cut spending in the face of projected exploding budget deficits. There will be no “V” recovery, nor even a “U” recovery; we’ve barely started down the vertical portion of the “L.”

In an open letter to Congress, many prominent economists (including Nobel laureates Arrow, Klein, and Sharpe) warned that this downturn may be more severe than in the recent past. While they called hopefully for interest rate reductions, in a classic understatement (to which the Japanese can attest) they recognized that rate reductions alone may not suffice. Accordingly, they advocated a one-time tax cut, or “dividend,” that would provide each American taxpayer with a check, thus helping to boost the sagging economy. This measure contrasted with President Bush’s plan, which they criticized as “too large, too skewed to the wealthy,” “too late to head off a recession,” and more fundamentally, “predicated on a 10-year forecast of the U.S. economy, which no one can make with certainty.” As such, they said, the Bush plan risks a return to chronic budget deficits and a weakened capacity for the government to meet future spending requirements.

Congress has now passed the Economic Growth and Tax Relief Reconciliation Act, which will provide some $1.3 trillion in tax relief over the next decade, but the doubts raised by the economists in their April 20 letter remain widespread. Indeed, there is still some talk of introducing “triggers” that would reduce or eliminate tax relief if the budget surplus disappears. It is argued here, however, that the bill actually provides little more than a quarter of the fiscal relaxation required for the near term. The real danger is that the “backward thinking” evident in the economists’ statement (and some of the Congressional debates) will limit further fiscal adjustments that will be required should the recession deepen.

The Case for a Tax Cut

While candidate Bush’s call for a tax cut during the 2000 presidential campaign was justified mainly on the basis of long-run, supply-side factors, much of the recent debate has centered on the near-term prospects for a downturn. Evidence that the United States is sliding toward recession is apparent to everyone willing to confront it. Economic growth fell from a 6 percent to a 1 percent rate by the fourth quarter of 2000 (and stood at 1.2 percent for the first quarter of 2001). After piling up over the course of last year, inventories are being cut in anticipation of sluggish sales. Earnings reports are continually downgraded. Large-scale layoffs are a daily event. (See Table 1.) Total nonfarm payroll employment fell by 182,000 in April 2001, by 19,000 in May, and by another 114,000 in June. Since last July, manufacturing has lost well over 800,000 jobs. The unemployment rate rose to 4.5 percent in April and June as the ranks of the unemployed swelled by almost 900,000 since October. (The slight decline in this rate to 4.4 percent in May was due to labor force exit.) Even the service sector is now losing jobs-in part due to the collapse of dot-coms. The slowdown of the American economy has already started to slow growth in other nations. Mexico has lost 200,000 jobs so far this year; some project that this number will rise to 700,000 as the United States sinks into recession (Kraul 2001).

The aggregate value of equities has dropped from $17 trillion a year ago to about $12 trillion today. Nasdaq has fallen by two-thirds, with no bottom in sight (Bogle 2001). Overall price-earnings ratios are still at 24, and earnings will be falling: to achieve a PE ratio of, say, 18, over a period of declining profits means that stocks must fall much lower. Another way of looking at it is to calculate relative values in private portfolios. From 1960 to 1980, equities typically averaged about 18 percent of wealth. This rose to 24 percent in 1991, and now stands at 41 percent. Equities may have to lose another $5 trillion just to return relative weightings to 25 percent. Of course, many have credited the wealth effect for the strength of the Clinton expansion. If true, then even if the Dow manages to stay in the 10,000-point range, the expansion is doomed because only capital gains can fuel the borrowing that finances consumption spending. By the same logic, the past year’s $5 trillion losses must eventually cool the consumption boom-if they haven’t already.

Let us be clear. Gross domestic product (GDP) may rebound over the next couple of quarters. The extremely sharp downturn of the last three quarters does not necessarily signal that only bad news is in the offing. The boom is almost certainly finished, but the recession could still be some distance into the future. Many of us at the Levy Institute believe that the depth of the coming recession will in part be functionally related to the length and height of the preceding expansion. This is because the nature of the expansion was unprecedented. As Wynne Godley (2001) demonstrated, the expansion was fueled by previously unseen (in the United States) deficit spending by the private sector. The longer this proceeded, the bigger the mountain of accumulated private indebtedness. If the economy continues to grow, albeit more slowly, this mountain will continue to reach new heights due to the country’s fiscal policy stance and trade account. Given an overall budget surplus (equal to nearly 3 percent of GDP and projected to increase over time even if economic growth remains below 3 percent) as well as a trade deficit (4 percent of GDP), the private sector’s deficit reached almost 7 percent of GDP last year. Thus, even as GDP growth slowed in the fourth quarter of 2000, the net flow of credit actually rose to more than 14 percent of private disposable income.
According to estimates by Godley and Izurieta (2001), household debt alone had reached 124 percent of household disposable income by the end of last year. There is no precise rule to determine how much debt the private sector can handle; psychology and rules of thumb play a huge role, as do interest rates, which together with total debt determine debt service ratios. It is true that falling interest rates have slowed the growth of debt service burdens, which now stand above 14 percent of income, a level approximately equal to the peak reached during the 1980s. If the Fed continues to reduce interest rates, the private sector can accumulate larger debt burdens if it wants to. This is why it is entirely possible for moderate growth to continue for a few more quarters, but also why such growth necessarily entails a more precarious financial position—what Hyman Minsky called "stretching liquidity"—leading to financial fragility. (See, for example, Minsky 1992.) Households and firms will become increasingly vulnerable to any curtailment of income flows or increases in interest rates. Minsky argued that such processes eventually push the status of many firms and households from hedge (income flows are sufficient to pay interest and principal) to speculative (income flows are sufficient to cover only interest payments) and, finally, to Ponzi (insufficient income flows force the debtor to borrow simply to pay interest). Note that the position becomes increasingly precarious if interest rate reductions encourage more borrowing and thereby extend the expansion.

Let us sort out two separate issues: first, the size and scope of the necessary tax cut, and second, the precarious nature of the projected surplus. At best, a temporary tax cut—no matter how large—can only postpone the inevitable. To be sure, it is preferable to reliance solely on monetary policy because it can postpone the hard landing without requiring additional debt accumulation by the private sector. However, any reasonable assumptions about the relationships among economic growth, the federal budget, and the U.S. trade account suggest that a private sector deficit must reemerge if growth is to continue after the temporary tax cut "dividend" has evaporated. The reason is simple. Given globalization and our import propensities together with those of our trading partners, the United States will run trade deficits as long as its economic growth rate is close to those of the rest of the world. Only if the U.S. growth rate were several orders of magnitude lower than the rest of the world’s could balanced trade be achieved. While it is true that dollar depreciation could help to reduce our trade deficit, it is difficult to foresee a situation in which a fall of the dollar sufficient to do so (probably 25 percent or more) could be maneuvered or tolerated.

The other imbalance we face is in the federal budget. At even small rates of growth, the budget will remain in surplus. According to the May 2001 Congressional Budget Office (CBO) baseline projections, the federal budget surplus will grow from 2.4 percent of GDP, achieved last year, to 5.2 percent of GDP by 2011 (CBO 2001b). This means that even if we achieved

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### Table 1 Recent Job Cuts Announced by Major Companies

<table>
<thead>
<tr>
<th>Company</th>
<th>Job Cuts 1</th>
<th>Job Cuts 2</th>
<th>Job Cuts 3</th>
</tr>
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<tbody>
<tr>
<td>Motorola</td>
<td>30,000</td>
<td>Texton</td>
<td>3,600</td>
</tr>
<tr>
<td>DaimlerChrysler</td>
<td>26,000</td>
<td>Schwab</td>
<td>3,400</td>
</tr>
<tr>
<td>Nortel Networks</td>
<td>20,000</td>
<td>Texton</td>
<td>3,600</td>
</tr>
<tr>
<td>Lucent Technologies</td>
<td>20,000</td>
<td>Schwab</td>
<td>3,400</td>
</tr>
<tr>
<td>JDS Uniphase</td>
<td>16,000; 64%*</td>
<td>Ericsson LM</td>
<td>3,300</td>
</tr>
<tr>
<td>Delphi Automotive System</td>
<td>11,500 (7,600 in U.S.)</td>
<td>Gateway</td>
<td>3,000</td>
</tr>
<tr>
<td>Verizon</td>
<td>10,000</td>
<td>Amtrak</td>
<td>2,500</td>
</tr>
<tr>
<td>Procter &amp; Gamble</td>
<td>9,600</td>
<td>ShopKo Stores</td>
<td>2,500</td>
</tr>
<tr>
<td>Cisco</td>
<td>8,500; 19%**</td>
<td>AOL Time Warner</td>
<td>2,400</td>
</tr>
<tr>
<td>Solecron</td>
<td>8,200; 10%**</td>
<td>Sears</td>
<td>2,400</td>
</tr>
<tr>
<td>Compaq</td>
<td>7,000; 10%**</td>
<td>Standard Register</td>
<td>2,400</td>
</tr>
<tr>
<td>Sara Lee</td>
<td>7,000</td>
<td>Agere</td>
<td>2,000; 11%**</td>
</tr>
<tr>
<td>Hewlett-Packard</td>
<td>6,000</td>
<td>Coca Cola</td>
<td>2,000</td>
</tr>
<tr>
<td>Whirlpool</td>
<td>6,000</td>
<td>Electrolux</td>
<td>2,000</td>
</tr>
<tr>
<td>JCPenney</td>
<td>5,300</td>
<td>Service Merchandise</td>
<td>1,750</td>
</tr>
<tr>
<td>Walt Disney Co.</td>
<td>4,000</td>
<td>American Greetings Corp.</td>
<td>1,500</td>
</tr>
<tr>
<td>Xerox</td>
<td>4,000</td>
<td>Northwest Airlines</td>
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<tr>
<td>Dell</td>
<td>3,000-4,400***, 10%**</td>
<td>Amazon.com</td>
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<tr>
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<td>3,655</td>
<td>3Com</td>
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</tr>
</tbody>
</table>

** Estimated percentage reduction of company's total labor force due to recent job cuts.
*** In addition to 1,700 job cuts during February and March 2001.
balanced trade, and even if state and local governments exactly balanced their budgets (rather than running surpluses, as is normal), the private sector would still have to run an overall deficit equal to 5.2 percent of GDP by 2011 in order to maintain moderate economic growth. No iron law of deficits would proclaim this to be impossible; based on postwar U.S. experience, however, it could be dismissed as being outside the realm of probability. As Godley (2001) showed, private sector deficits had never, before the late 1990s, achieved such levels and never lasted for much more than a year and a half. Rather, the normal case in the United States is short-lived private sector deficits during robust expansions, followed by a return to the more normal condition, surpluses. Note also that even if we balanced our trade beginning next year, the private sector deficit would remain at 2.8 percent of GDP—the projected federal budget surplus, plus an amount equal to whatever overall balance state and local governments achieved—and rise steadily every year thereafter. Another way of stating this is to say that given the projected federal budget imbalance, personal saving will have to remain negative, and indeed grow increasingly negative, over the next decade in order to keep aggregate demand high enough for the economy to grow. It is highly irresponsible to formulate budget policy on the assumption that Americans will continue to spend in excess of their incomes for the foreseeable future.

This means that a very large and permanent adjustment must be made to the fiscal stance. Simply to eliminate fiscal drag, that adjustment must be equal to 2.7 percent of GDP this year and rise to 5.2 percent by 2011. All of this presumes, of course, that the trade deficit could be eliminated immediately. Once we add to the mix the likelihood of continuing trade deficits, the size of the required fiscal adjustment becomes very much larger. An immediate adjustment of at least 4.5 percent of GDP (an amount equal to $450 billion annually) is required. This may be a conservative figure. It may turn out that as households and firms adjust their spending to falling incomes, the resulting demand gap could easily equal 8 percent of GDP, or $800 billion annually. In other words, even the president's plan provides at most one-third and perhaps as little as 20 percent of the fiscal adjustment that will eventually be needed. Obviously, it is not necessary for the entire adjustment to come in the form of a tax cut, nor are all tax cuts created equally in terms of their capacity to stimulate demand. The tax relief package passed by Congress in May 2001 should be supplemented by another $200 billion in payroll tax cuts targeted to the bottom three-fourths of the population, which got little benefit from the bill that was passed. An additional minimum annual stimulus of $100 billion would still be required today, and the amount would rise over time. Based on CBO baseline projections, GDP will exceed about $16 trillion in 2010, with a budget surplus of $806 billion. The CBO (2001a) estimates that when the Economic Growth and Reconciliation Act's provisions are fully phased in, the surplus for 2010 will be reduced by $261 billion. This amounts to a little over 30 percent of the adjustment that will be required simply to eliminate fiscal drag. If that to add we roughly $300 billion of tax relief targeted to middle- and lower-income workers and their employers (through a permanent reduction of the payroll tax, for example), that still leaves "room" for $230 billion of additional enhancements, to come in the form of spending increases. Note that this will not lead to an expansionary budget, but to a balanced budget that will not drag down the economy. If the United States still has a trade deficit in 2011, and if our private sector wants to have positive savings, then additional fiscal adjustment will be required even beyond that.

**If We Can't Trust the Projections, Should We Cut Taxes Anyway?**

Many observers have cited the tenous nature of long-term projections, arguing that it would be foolhardy to formulate fiscal policy today on the basis of surpluses that may never materialize. Ironically, many of those who recognize that at least some tax cut is needed today because of the likelihood of a recession want to tie future tax cuts to the size of the surplus. In other words, if the surpluses never appear, the tax cuts would be eliminated. This is perhaps the finest example that one could find of the backward art of economic thinking.

The CBO projections of surpluses are based on currently anticipated budget policy and on assumptions of economic growth rates and unemployment rates (which are projected to be substantially worse than those of the past five years). If the economy performs better, the surpluses will be larger. If the economy founders—as many of us expect—the surplus will be correspondingly lower (and, indeed, will almost certainly be reversed as the budget moves to deficit). The purpose of fiscal adjustment, including tax cutting, is to eliminate the fiscal drag incorporated in current budget policy. If successful, this will not only eliminate future surpluses, but will do so without requiring a recession that would destroy private sector income and wealth and thereby destroy tax revenues. In other words, the surpluses will not come to pass under any likely scenario, with or without tax cuts. But we can "choose" today whether to eliminate the surpluses, with or without a recession.

To get some idea of the course of events that is likely to ensue without a substantial and immediate fiscal adjustment (that is, a combination of tax cuts and spending increases), we need look no further than the case of Japan. Figure 1 (see page 8) superimposes Japan's fiscal stance over that of the United States, shifting Japan's numbers 10 years forward. (Just for fun, I've also included Canada, as its current situation looks eerily similar to that of the United States.) Thus, Japan's fiscal surpluses at the end of the 1980s are laid over the fiscal surpluses of the United States at the end of the 1990s. Looking forward from 1990, Japan might have faced a future very similar to the one faced by the United States today—surpluses as far as the eye could see. However, after the Japanese economy collapsed, the surpluses continued for only a few more years, with the fiscal restriction pulling the economy ever further downward. Eventually, the surpluses disappeared and the budget changed course sharply to huge deficits—8 percent of GDP—not simply because fiscal policy was relaxed, but because the sluggish economy reduced tax revenues in a cyclical manner.

The United States today is not the Japan of 1990. In some ways, the U.S. position does not look quite so perilous; U.S. consumers are far less "thrifty." Once Japanese consumers lost faith in their economy, practically nothing could get them to renew consumption. A deep recession will certainly dampen consumers' spirits in the United States, but it is unlikely that they will remain depressed for a whole decade. Eventually, consumers may be willing to borrow again, which will renew growth and reduce the size of the government's deficit. Further, the Japanese "miracle" of the 1970s and 1980s was characterized by much higher investment rates—nearly twice as high, as a percent of GDP, compared to what has been typical in the United States—which led to a massive overcapacity in Japan that would take many years to work off. In the United States, as many have noticed, much of our investment boom since 1995 could be attributed to the high-tech information sector. This boom, too, led to massive overcapacity, even though the high-tech sector is a relatively small part of our economy. A true "new economy" may yet emerge in our future that will utilize this capacity, but in the meantime, writing off the excess capacity should not be as painful here as it has been in Japan. Finally, one could argue that the United States has a more "dynamic" economy—with a younger population, greater immigration, lower labor costs, and fewer trade barriers—that will enable it to recover more quickly due to complex and perhaps unidentifiable, but fortuitous synergies.

**Figure 1** Japan's 1981-2000 Budget Balance as a Percent of GDP Supimposed over Budget Balances in Canada and the U.S. for 1991-2000

**Note:** Budget surpluses are given a negative sign to reflect their presumed negative effect on the private sector.  

**Source:** Internation Monetary Fund (data for 2000 are IMF projections).
surplus, which added to the financial balance of its private sector, while the United States runs a trade deficit that contributes to the deterioration of the private sector's financial balance. Indeed, Japan's household saving rate is very high. Even during the period of government sector surpluses, the household saving rate fell from a peak of about 19.5 percent in 1990 to about 18 percent in the early 1990s; by the end of the 1990s it had grown to 24 percent. As noted above, a high household saving rate depresses aggregate demand and may constrain economic recovery. Thus, Japanese household balance sheets were strong at the beginning of the recession and remained so throughout. By contrast, the U.S. consumer enters the recession heavily indebted. Further, Japan is historically a low-unemployment society-corporations are most reluctant to lay off workers while the U.S. economy experiences much wider swings of unemployment. Our unemployment rate may well climb to double digits, which will generate widespread defaults on debt (albeit, perhaps, without bankruptcies, as a result of anticipated changes of bankruptcy law). Still, one can hope that U.S. policy will be wiser than Japan's has been—one need only recall Japan's consumption tax hike in 1998, which killed a weak recovery. A quick and large fiscal adjustment today could soften the coming landing.

Conclusion

There is mounting evidence that a severe contraction has already begun. As the economy has slowed, many have begun to worry that projections of budget surpluses running "as far as the eye can see" were overly optimistic—as New York Times columnist Paul Krugman recently opined, "from now on the prospect is for chronic budget shortfalls" (Krugman 2001b). The projected disappearance of surpluses has led many to second-guess the wisdom of tax cuts. According to Krugman, "If the Senate had known six weeks ago what it knows now, it wouldn't have approved that huge, irresponsible tax cut." As argued here, however, the tax cut should not be predicated on budget surpluses, but rather on a fiscal stance that is appropriate to economic performance.

Also of concern to some is the "accuracy" of today's projections of tomorrow's surpluses. This is a red herring. Over any period of time, the desired relationship between a government's revenues and its total expenditures will depend on the performance of the economy. At very high rates of growth, such as those achieved recently in the United States, a budget surplus may well be desirable. A surplus is, of course, "normal" in a boom as tax revenues rise as a percent of income (due to the progressivity of the tax system) and as some kinds of spending (such as "safety net" expenditures) fall. When an economy falters, however, it is desirable for the budget to move toward deficit. The problem in the cases of both Japan and the United States, however, is that budgets do not move quickly enough; at least in the case of the United States, the problem is compounded by a weakening of automatic stabilizers in recent years. The slowness of the budget's response is partly due to a lag (taxes paid April 15 were somewhat influenced by equity market performance), partly due to long-term reduction of the U.S. safety net as a result of welfare reform, partly due to reduced progressivity of the tax system, and partly due to the increased role played by the United States as the "importer of last resort" (meaning that as our economy slows, there is little improvement in our trade account). Further, there is the strong likelihood that consumption will fall more sharply than incomes as the economy slows and as households voluntarily (and, perhaps, involuntarily) reduce credit-financed purchases. Thus, while we only slowly increased the gap between income and spending as households became ever more accustomed to making purchases on credit, this trend can be sharply and quickly reversed as uncertainty rises. This means that the fiscal adjustment required on the downside may be much larger than what is required on the upside.

In view of all this, the idea behind "triggers" that would tie tax relief to realized budget surpluses appears seriously flawed. As the surplus disappears due to slower growth, we need to increase—not reduce—the fiscal stimulus. Indeed, to get it right, the triggers should operate in a reverse manner, generating larger tax cuts as the slowing economy destroys fiscal revenues.

The notion that budget surpluses are needed to pay for tax relief represents a serious misunderstanding of government financing and of the countercyclical nature of tax revenues.

Notes

1. These figures are based on Flow of Funds data and calculations supplied by Rob Parenteau of Dresdner RCM Global Investors. The estimates are necessarily rough. I have used lower-end values for financial wealth and privately held equities. The losses required to restore normal weightings could be larger than $5 trillion if higher-end assumptions are used.

2. As Godley shows, the private sector deficit is identically equal to the government sector's surplus plus the balance of payments deficit.

3. Note that Krugman (2001a) has argued that we won't be able to "afford" future spending if we cut taxes. This represents a misunderstanding of the nature of government spending, and also ignores the imbalances built into the budget.

4. In a fine example of the art of backward thinking, Bergsten (2001) opposes tax cuts on the grounds that they will reduce national saving and force the United States to borrow from foreigners to "pay for" the cuts. The relationships among the three sectors (private domestic, government, foreign) dictates that a reduction of the government surplus must increase private domestic saving or increase the trade deficit, all else equal. Maintenance of a budget surplus in the presence of a trade deficit must, by accounting identity, result in a private sector deficit—hence, it cannot "add to" national saving.

5. According to the CBO, its "baseline projections are intended to show the expected level of the budget deficit or surplus assuming that current tax and spending policies continue." Congressional Budget Office. "Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods," February 2001; http://www.cbo.gov/showdoc.cfm?index=2732&from=4&sequence=0


7. More correctly, the tax cut I am advocating for the long run mostly reduces fiscal drag—the long-term goal is to return the federal budget to deficit at a moderate rate of economic growth. The short-term adjustment should be larger, in order to provide some stimulus.

References


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