

Keeping the Bush Tax Cut in Proportion Commentary

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Just how big is the tax cut under debate in the US? How big in relation to the economy and current tax collections? And how big compared with past cuts?

We know that President George W. Bush and the House of Representatives want \$1,600 billion of tax cuts over 10 years, that the Senate has counter-proposed a cut of \$1,200 billion, and that a compromise will be somewhere in between. But what does this mean?

Given Congress's tendency to phase in changes over many years, the best long-term measure of size counts all provisions when fully in place.

A rough but fairly accurate measure of a fully implemented bill is its annual cost after about a decade. By this rule, the president's proposal would reduce taxes by about 1.5 per cent of gross domestic product. Congress would then compromise at perhaps 1.3 per cent, although it could keep the same long-run costs just by phasing in provisions more slowly.

Either way, this is less than one-tenth of the 22 per cent of GDP the government currently collects in taxes and less than one-fifteenth of total federal, state and local tax collections.

Is this a lot? That depends on how much money you think government needs for today's expenditures or to put aside for tomorrow. Simply compared with past tax changes, however, this year's proposals seem neither small nor large, but moderate.

Since 1940, the most significant changes have come with the build-up and decline in taxes around the second world war and the Korean conflict, although the fall in taxes in no way followed the cut in defence spending also taking place.

What is remarkable about the post-Korean period, which includes the Vietnam war, the Great Society and the Reagan Revolution, is the relative constancy of federal revenues as a percentage of GDP.

Viewed by themselves, President Ronald Reagan's tax cuts in 1981 would have eventually risen to a cost of about 4 per cent of GDP, certainly a lot larger than anything proposed this year. But some of the Reagan cuts were offset immediately by inflation-driven tax increases. (Not until 1984 were provisions made effective so that people would not have to pay higher rates simply because their incomes rose with inflation.)

Another tax increase soon followed in 1982, negating some of the provisions of the 1981 cut before they became effective. Other increases were then enacted, most notably in 1983, 1984 and 1987 under President Reagan, in 1990 under the current president's father, and in 1993 under President Bill Clinton.

Today, federal taxes as a percentage of GDP are higher than they were right before the Reagan cuts.

By some measures, they are at an all-time high, although no year since the Korean conflict really stands out from any other.

Like the 1981 tax cuts, the current round follows on the heels of tax increases. The 1981 round was in part a reaction against the big tax increases during years of high inflation, when a family with about twice the average income found itself moving from a tax rate of 22 per cent on their next dollar of income to above 40 per cent.

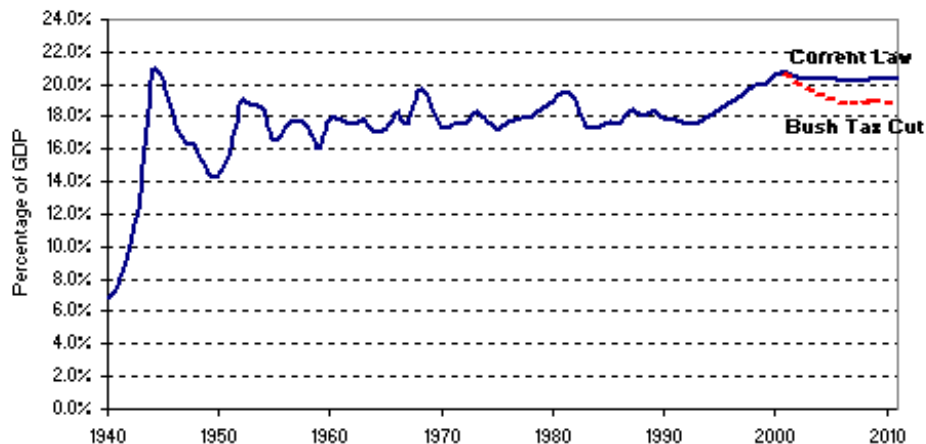
In fact, the Reagan cuts and the "inflationary" tax increases in the late 1970s were about the same size as a percentage of GDP.

The cuts now under discussion also follow a period of tax increases, due only partly to the 1993 tax laws that

hit mainly higher-income individuals. Some increase in average tax rates in the 1990s also came as growing real incomes pushed people into higher brackets, more families had two full-time workers and more capital gains were realised.

The current tax bill is important, but don't forget that it is a moderate move, not a foray into the dangerous unknown.

Federal Revenues as a Percentage of GDP: Current Law versus Proposed Bush Tax Cut



Source: Eugene Steuerle and Adam Carasso, The Urban Institute, 2001. Based on the Budget of the U.S. Government, FY 2002.

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