



# What Effects Would the Expiration of the 2001 and 2003 Tax Cuts Have on the Economy?

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## Summary

In 2001 and 2003, Congress enacted major tax cuts (popularly referred to as the “Bush tax cuts”), the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27), that are scheduled to expire at the end of 2010. (Subsequent legislation extended or increased certain provisions of those acts.) Congress is currently debating whether to extend some or all of those expiring tax cuts on a temporary or permanent basis in the context of large budget deficits. Two main economic arguments are made against allowing the tax cuts to expire. First, it is maintained that the long-term economic performance of the economy would suffer if the tax cuts were allowed to expire. Second, it is asserted that extending the tax cuts would be beneficial to the economy in the short run as it emerges from the recession.

Opponents of allowing the tax cuts to expire argue that doing so would reduce long-run incentives to work, save, and invest in the long run. According to economic theory, it is ambiguous whether tax cuts lead to more or less work, saving, and investment. The expiration of the tax cuts would nevertheless reduce the budget deficit, absent other policy changes, which economic theory predicts would have a positive effect on the economy in the long run.

To gauge whether the long-term effects of the tax cuts’ expiration on the economy would be significant, this report compares the performance of economic indicators in the period before (1993-2000) and after (2003-2007) the tax cuts were enacted. GDP growth, median real household income growth, weekly hours worked, the employment-population ratio, personal saving, and business investment growth were all lower in the period after the tax cuts were enacted. Average unemployment was the same over the two periods, and productivity growth was slightly higher after the tax cuts were enacted. One interpretation of these data is that the tax cuts contributed to the deterioration in economic performance, perhaps because of the negative economic effects of the higher budget deficits. An alternative interpretation is that the tax cuts did not have significant enough effects to show up in the data at a time when other factors were causing the economy to perform relatively poorly. In this interpretation, the tax cuts could have small positive, small negative, or no effects on the economy.

Opponents of allowing the tax cuts to expire argue that doing so at this time risks pushing the economy back into recession. The economy has already recorded several consecutive quarters of positive economic growth, and double dip recessions are rare. The size of the tax cuts is large, however, compared to projected GDP growth, assuming alternative minimum tax (AMT) relief were also allowed to expire. If one assumes that AMT relief is extended regardless, then the expiration of tax cuts would be expected to have a more modest effect. Another argument in favor of extending the tax cuts is a concern that the economy may continue to grow, but at a sluggish pace for the foreseeable future, as occurred in Japan. An argument in favor of allowing the tax cuts to expire is the potential danger of a fiscal crisis if investors become unwilling to continue financing the government’s large budget deficit. Related to this argument is the fear that as the economy continues to recover, a large deficit could push rates of borrowing from abroad back up to unsustainable heights.

A comparison of economic growth and changes in fiscal policy since 1990 indicates that deficit reduction need not lead to subpar growth in the short run if other sectors of the economy are growing strongly. Even during the 1990-1991 recession, deficit reduction did not stop the economy from growing in 1992 and growing solidly in 1993.

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Two main economic arguments are made against allowing the tax cuts to expire as scheduled. First, the long-term economic performance of the economy would suffer if the tax cuts were allowed to expire. Second, extending the tax cuts would be beneficial to the economy in the short run as it emerges from the recession. This report analyzes these arguments using historical evidence and by examining the current economic environment.

## **A Brief Description of the Tax Cuts**

The 2001 tax cuts, EGTRRA, included phased-in reductions to all marginal income tax rates, the estate and gift tax, the so-called “marriage penalty,” and increases in the child tax credit. The 2003 tax cuts, JGTRRA, accelerated many provisions of EGTRRA, temporarily increased favorable tax treatment of business investment,<sup>2</sup> and introduced new provisions, including reductions in tax rates on capital gains and dividends. Major provisions of both acts were fully phased in by 2003, with the exception of reductions in the estate and gift tax. The estate and gift tax was gradually reduced, until the estate tax was fully repealed in 2010. The Working Families Tax Relief Act of 2004 (WFTRA; P.L. 108-311) and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA; P.L. 109-222), extended or increased certain provisions in EGTRRA and JGTRRA. All of these acts and subsequent legislation provided temporary adjustments to the alternative minimum tax (AMT) to prevent an expansion in the number of taxpayers subject to it due to inflation and income growth.<sup>3</sup>

The tax cuts were financed through an increase in the budget deficit, meaning that the legislation enacting them contained no significant provisions to offset the revenue loss by raising other revenues or reducing spending. Likewise, if the tax cuts were allowed to expire as scheduled and no other actions were taken, the increase in revenue would reduce the budget deficit. Not including additional debt service costs, the increase in the deficit resulting from the tax cuts equaled about 2¼% of gross domestic product (GDP) in 2004.<sup>4</sup> Assuming expiring AMT provisions are also extended, the budgetary cost of permanently extending the expiring tax cuts is estimated to be about 2½% of GDP in 2011 and 3½% of GDP in 2012, not including additional

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<sup>1</sup> For more information, a legislative history, and the current legislative status, see CRS Report R41393, *The Bush Tax Cuts and the Economy*, by Thomas L. Hungerford.

<sup>2</sup> These provisions were first introduced in the Job Creation and Worker Assistance Act, P.L. 107-147.

<sup>3</sup> For a detailed description of the provisions in these acts, see CRS Report R41111, *Expiration and Extension of the Individual Income Tax Cuts First Enacted in 2001 and 2003: Background and Analysis*, by James M. Bickley. For more information on the AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

<sup>4</sup> CRS calculations based on Joint Tax Committee data.

debt service costs.<sup>5</sup> If AMT provisions are allowed to expire, the cost of permanently extending the expiring tax cuts is estimated to be about ¾% of GDP in 2011 and 1½% of GDP in 2012.

## **The Relationship Between Tax Cuts and the Economy in the Long Run**

Opponents of allowing the tax cuts to expire argue that the tax cuts boosted the long-term performance of the economy. These are often referred to as “supply-side” effects. Proponents assert that in response to a higher after-tax rate of return caused by marginal rate reductions, workers will work more, savers will save more, and businesses will invest more. If labor and capital inputs are higher, then economic growth and income would be higher.

Theoretically, the response of working and saving to lower taxes could be positive or negative. In the case of saving, a lower tax rate could cause a household to save more to take advantage of the higher rate of return the tax rate offers. (In technical terms, this is referred to as a substitution effect.) But it could also lead to the household saving less, since it now takes less saving to reach a target, such as a down payment for a home or a retirement fund. (In technical terms, this is referred to as an income effect.) The same countervailing effects are present when marginal rates are lowered on labor—workers can work more to take advantage of the greater reward, or work less and enjoy the same after-tax income. Since the income and substitution effects work against each other, theory cannot predict whether tax cuts will have a positive or negative effect on work and saving overall.

In the case of many tax expenditures (deductions, credits, and exemptions), which do not involve marginal rate reductions, there would only be an income effect and thus no potential for a positive effect on labor or saving. The largest provisions in the Bush tax cuts are devoted to marginal rate reductions, but tax expenditures are included as well.

Furthermore, when tax cuts are deficit financed, as was the case in 2001 and 2003, the federal borrowing to finance the tax cuts is expected to have a negative effect on the economy in the long run. Borrowing to finance tax cuts must be financed out of domestic or foreign saving. If it is financed out of domestic saving, it “crowds out” private investment by raising interest rates in response to the greater demand on that saving. If it is financed out of foreign saving (i.e., borrowing from abroad), the effect on interest rates and crowding out can be avoided. Instead, the foreign saving enters the United States in the form of a higher trade deficit (the shortfall between exports and imports), because the only way that our nation can borrow from another is by buying more of its goods and services than it buys of ours.<sup>6</sup> For debt held by foreigners, returns to capital will flow to foreigners instead of Americans. In reality, some combination of crowding out and higher trade deficits is likely to result from a higher budget deficit. Thus, even if the tax cuts were to have positive “supply-side” effects on the economy, those effects could potentially be negated in part or full by the negative effects of the larger budget deficit on economic growth through higher interest rates and a higher trade deficit.

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<sup>5</sup> CRS calculations based on Congressional Budget Office data.

<sup>6</sup> For more information, see CRS Report RL31032, *The U.S. Trade Deficit: Causes, Consequences, and Policy Options*, by Craig K. Elwell.

Any effects that the tax cuts (and resulting higher budget deficits) had on the economy would be expected to eventually be reversed if allowed to expire. The next section looks at macroeconomic indicators before and after the tax cuts to see what effect they may have had.

## **The Performance of the Economy Before and After the 2001-2003 Tax Cuts**

Because there are theoretical reasons to believe that deficit-financed tax cuts could have either a positive or negative effect on the economy, it is useful to turn to empirical evidence to see which effects appear to dominate. Unfortunately, there is no way to directly observe the effects of tax cuts on the economy. To estimate their effects, it is necessary to compare how the economy actually performed in response to the tax cuts to a counterfactual case of how the economy would have performed if there had been no tax cuts, holding all other conditions constant. Because many other factors are simultaneously altering economic conditions over time, estimates vary considerably.<sup>7</sup> Most importantly, the business cycle naturally leads to a boom and bust pattern over time that strongly influences any macroeconomic indicator. Nevertheless, if tax cuts had an important effect on the supply side of the economy as proponents maintain, one would expect to see some evidence of their effects on major macroeconomic indicators over long periods of time.

Prior to 2001, the tax code had not changed significantly since 1993, when income, payroll, and corporate tax rates had been increased by the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).<sup>8</sup> **Table 1** presents major supply-side indicators of economic growth, labor, saving, and investment that might be influenced by tax cuts in the period before and after the 2001-2003 tax cuts. To reduce the influence of the business cycle on the results, **Table 1** omits the recession years of 2001, 2002, 2008, and 2009. Data for 2001 and 2002 are also excluded because the tax cuts were not fully phased in at that point; 2008 and 2009 are also excluded because there were additional tax cuts made in those years.<sup>9</sup> All of the major economic indicators except labor productivity growth were better during the period before the tax cuts. These results are not driven by outliers. For example, GDP growth in six of the eight years between 1993 to 2000 was higher than the highest year of growth in the 2003 to 2007 period. If the recession and partial implementation years had been included in the comparison, then the pre-tax cut period would outperform the post-tax cut period by a larger margin except for personal saving and productivity growth.<sup>10</sup> For example, total employment and inflation-adjusted median household income were lower in absolute terms in 2009 than before the 2001 tax cuts.

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<sup>7</sup> For a review of the literature on supply side effects and the 2001 and 2003 tax cuts, see CRS Report RL33672, *Revenue Feedback from the 2001-2004 Tax Cuts*, by Jane G. Gravelle.

<sup>8</sup> The most significant tax legislation enacted between 1993 and 2001 was the Tax Relief Act of 1997, which created new tax expenditures including the child tax credit, education tax credit and the Roth IRA. Its only major change to marginal tax rates was a reduction in the capital gain rate from 30% to 28%. This legislation was estimated to reduce taxes by an average of 0.1% of GDP. For a history of tax legislation, see Jerry Tempalski, "Revenue Effects of Major Tax Bills," Office of Tax Analysis, Department of U.S. Treasury, OTA Working paper 81, September 2006.

<sup>9</sup> Taxes were temporarily cut as part of stimulus packages in 2008 (P.L. 110-185) and 2009 (P.L. 111-5).

<sup>10</sup> The 1993-2000 period still had a higher average saving rate than 2001-2009, but 2001-2009 had a higher saving rate than 2003-2007. Average productivity growth was higher from 2001 to 2009 than 2003 to 2007.

**Table 1. Economic Indicators Before and After the Tax Cuts for Expansion Years**  
Annual Average

	1993-2000	2003-2007
GDP Growth	3.9%	2.7%
Median Real Household Income Growth	1.7%	0.6%
Private Employment Growth	2.7%	1.2%
Weekly Hours Worked	34.4	33.8
Employment-Population Ratio	63.4%	62.7%
Unemployment Rate	5.2%	5.2%
Personal Saving as % of Disposable Income	4.6%	2.6%
Business Investment Growth	10.3%	5.6%
Labor Productivity Growth	2.0%	2.2%

**Source:** CRS calculations based on data from Bureau of Economic Analysis and the Bureau of Labor Statistics

Supply-side proponents assert that tax cuts give workers an incentive to work harder and businesses an incentive to hire more workers, which would appear in the data as more hours worked by existing workers or more workers drawn into employment. By either measure, the labor market performed better before the tax cuts. Before the tax cuts, private employment grew at more than twice the annual rate it did after the tax cuts, a higher percentage of the total population was employed, and private sector employees worked 0.6 more hours each week. The average unemployment rate was the same in both periods; however, from 1993 to 2000 it fell from 6.9% to 4.0%, while from 2003 to 2007 it fell from 6.0% to 4.6%. Labor productivity growth (the increase in output per hour worked) was 0.2 percentage points higher in the tax cut years, however.<sup>11</sup>

Supply-side proponents also argue that tax cuts cause households to save more and businesses to invest more. The rates of personal saving and business investment growth were almost twice as high before the tax cuts, however.

Output (GDP) grows when the economy employs more labor, more capital, or uses those resources more efficiently (i.e., productivity increases). Because labor and capital performed better before the tax cuts, both GDP and median income grew significantly faster before the tax cuts, despite the slightly lower rate of productivity growth. GDP grew 1.2 percentage points faster each year, and household median income grew more than twice as fast before the tax cuts. As a measure of the experience of the “average” household, median household income is the most cited measure because it is unaffected by income growth skewed toward one end of the income distribution. As a measure of overall economic performance, some would prefer mean income growth. The decline in the growth rate of mean income after the tax cuts (not shown in **Table 1**) was even larger than the decline in median income growth, however.

How should the findings that the economy performed better before than after the tax cuts by almost any supply-side indicator be interpreted? One interpretation is that the tax cuts contributed

<sup>11</sup> Productivity growth was fastest from 1998 to 2005. It was very low in 1993 and 1994.

to the deterioration in economic performance, because income effects on work and saving dominated or because of the negative economic effects of the higher budget deficits. An alternative interpretation is that the tax cuts did not have significant enough effects to show up in the data at a time when other factors were causing the economy to perform relatively poorly. In this interpretation, the tax cuts could have small positive, small negative, or no effects on the economy.

## **The Relationship Between Tax Cuts and the Economy in the Short Run**

An analysis of the tax cuts' long-run effects does not include the interaction of tax cuts and the business cycle, since business cycle fluctuations cancel each other out over time. But in the short run, tax cuts that are deficit-financed can boost ("stimulate") overall spending in the economy if recipients choose to boost their spending in response. These are often referred to as "demand-side" effects. In the case of the expiring tax cuts, their extension would keep demand at a relatively constant level compared to the previous year. (For purposes of this discussion, the extension could be temporary or permanent, since the economic effects being discussed are short-term.) If the tax cuts are allowed to expire, spending would be lower, all else equal, than a baseline of the economy prior to their expiration.<sup>12</sup> Demand-side effects are likely to be stronger if there is significant excess capacity in the economy, meaning there are unused labor and capital resources that can be brought back into production if spending is boosted. In the long run, excess capacity is brought back into use and the economy returns to full employment automatically through gradual market adjustment, so tax cuts do not permanently stimulate spending.

Extending the tax cuts is not the only policy option for maintaining the current level of demand in the short run. Alternatively, the government could allow the tax cuts to expire and maintain the current level of demand in the economy by offsetting it with higher government spending or a different set of tax cuts.<sup>13</sup> The key to influencing overall spending in the economy is changes in the budget deficit, although different channels for increasing the deficit are believed to have different "multiplier effects" on total spending or "bang for the buck" that could make some policy options somewhat more stimulative or contractionary than others.<sup>14</sup> To the extent that a tax cut is saved or used to reduce debt by recipients, the spending multiplier would be smaller.

Whether extending the tax cuts would have a desirable effect on overall spending depends on the state of the economy at the time of expiration. The next section discusses different views on the projected near-term economic outlook.<sup>15</sup>

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<sup>12</sup> Estimating the effects of the tax cuts' expiration on the economy depends on what baseline is used for comparison. For a current law baseline, in which the tax cuts expire as scheduled, allowing the tax cuts to expire does not change the baseline projection of economic activity.

<sup>13</sup> The government can also boost demand through expansionary monetary policy, although some economists doubt the effectiveness of further monetary stimulus when the Fed's main policy instrument, overnight interest rates, are already near zero. Further monetary stimulus could be pursued through the use of unconventional policy instruments, such as balance sheet operations or "quantitative easing."

<sup>14</sup> If a policy change increases total spending by more than it increases the deficit, it is said to have a multiplier effect greater than 1. For more information, see Congressional Budget Office, *Policies for Increasing Economic Growth and Employment in 2010 and 2011*, January 2010.

<sup>15</sup> For more information, see CRS Report R41332, *Economic Recovery: Sustaining U.S. Economic Growth in a Post-* (continued...)

## The Near-Term Economic Outlook

The last four quarters of economic growth convinced the National Bureau of Economic Research (NBER) to announce in September 2010 that the recession had ended and a new expansion had begun in June 2009. The current consensus among professional forecasters is that the economy will continue its expansion through at least 2011, albeit at a rate that is not rapid enough to make a significant reduction in the high unemployment rate.<sup>16</sup> Based on this forecast, a case could be made to allow the tax cuts to expire (because the expansion is already underway) or extend them (because the projected reduction in unemployment over the next year is too low).<sup>17</sup>

Dissenters to the consensus view on the economic outlook point to some alternative scenarios which can be considered unlikely but not implausible. Some economists are concerned the economy will experience “double dip” recessions, meaning a return to economic contraction in the near term. By historical standards double dips are rare—in the 20<sup>th</sup> century, there were only two cases where the economy emerged from a recession, only to be quickly followed by another recession (beginning in 1920 and 1981).<sup>18</sup> In 1981, a large tightening of monetary policy is seen as playing a key role in the economy’s return to recession, whereas the Federal Reserve has indicated at present that it expects to maintain an expansionary stance in the foreseeable future. The usual pattern is that once the expansion takes root (as the NBER has determined has happened), it continues for some time. For the expansion to be knocked off course and the economy to return to recession, some new “shock” to the economy would likely be needed, such as economic crisis throughout Europe, perhaps following a sovereign default. By their nature, shocks are hard to foresee, but large shocks are relatively infrequent.

Another possible scenario is that the economy does not re-enter recession, but nor does it experience its usual steady return to full employment and normal growth rates. Instead, it experiences long-term stagnation, sometimes referred to as a deflationary or liquidity trap, where overall spending does not grow quickly enough to significantly reduce the slack in the economy. Evidence in favor of this scenario is the weakness of the expansion to date and the fact that the economy may still be suffering from a debt overhang, where business and consumers are “deleveraging” (increasing saving to reduce debt). While the United States has not experienced such stagnation in the post-World War II period, Japan’s experience since its equity and real estate bubbles burst in the early 1990s illustrates that this scenario is possible in a modern economy. From 1980 to 1991, GDP growth in Japan averaged 3.8%. Since 1991, GDP growth has never exceeded 2.9% in a year, and from 1992 to 2003, GDP growth was below 2% in all but two years. From a low starting point, Japan’s unemployment rate rose each year from 1991 to 2002. From 1995 to 2009, Japan experienced 10 years of deflation (falling prices) and low inflation in the other years, which indicates that Japan’s low growth was in part due to inadequate demand. Although the central bank lowered overnight interest rates to low nominal levels and budget

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(...continued)

*Crisis Economy*, by Craig K. Elwell.

<sup>16</sup> Blue Chip, *Economic Indicators*, vol. 35, no. 9, September 2010. Blue Chip is the average forecast for a group of more than 50 business economists.

<sup>17</sup> For a detailed discussion, see CRS Report R41006, *Unemployment: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte.

<sup>18</sup> The economy experienced two recessions during the Great Depression. The first ended in 1933 and the second began in 1937. The Great Depression experience is not comparable to current fears of a double dip recession because the two recessions were over four years apart, and output grew very rapidly during the expansion between the two recessions.

deficits were large (5.6% of GDP on average from 1993 to 2009), Japan's use of fiscal and monetary stimulus over this period was not enough to break out of its deflationary trap. Further, some economists believe that Japan's deflationary trap was prolonged by sporadic attempts by the government to withdraw fiscal and monetary stimulus prematurely. Other economists believe it was prolonged by Japan's failure to adequately clean up problems in its financial system caused by its financial crash.

Another potential economic problem that has been identified is the large federal budget deficit, which is on an unsustainable path for the long run under current policy because the federal debt cannot rise continually relative to GDP.<sup>19</sup> Eventually, the deficit will have to be reduced through tax increases or lower spending, but to date, the size of the deficit has had no demonstrable negative effect on the economy and there is no sign that investors doubt the government's continued solvency—macroeconomic theory predicts that the negative effects would be manifested in higher interest rates or trade deficits, both of which have fallen significantly since the recession began. Nonetheless, the moment at which the deficit becomes unsustainable is the moment that bondholders become convinced that the government cannot honor its obligations. The moment that occurs, if it were to occur, is unpredictable and could occur suddenly at any time. However small the possibility of a run on the federal debt by creditors may be, it cannot be ruled out entirely as long as the deficit remains on an unsustainable path, and would be expected to have large negative effects on the economy were it to occur. More prosaically, there is also the possibility, without a run on the debt, that the deficit begins to have deleterious effects on interest rates and the trade deficit as the economy returns to normal. Putting a dent in the deficit has been a major argument forwarded in favor of allowing the tax cuts to expire as scheduled. On the other hand, because the deficit reduction required to place the budget on a sustainable path is larger than the savings from full expiration of the tax cuts and AMT relief, expiration does not guarantee that a future fiscal crisis could be avoided. A case could be made for a temporary extension until the economy strengthened on economic grounds since the deficit has not been harmful to the economy to date, but eventual deficit reduction is needed. Political considerations might make expiration harder to accomplish in the future if a temporary extension was enacted at present, however.

Related to fears about the unsustainability of the budget deficit are fears that the United States borrows from abroad at an unsustainable pace. In 2006, U.S. borrowing from abroad reached a historic high of 6% of GDP. Borrowing from abroad fell by half to 3% of GDP in 2009, which is still high by historic standards. The question among economists is whether this improvement is structural or cyclical in nature. If it is the latter, then borrowing from abroad would be expected to rise again as the recovery gathers strength. Since the budget deficit must be financed out of domestic or foreign saving and domestic saving is relatively low, some economists fear that if a large budget deficit persists much longer, it could cause borrowing from abroad to grow rapidly to very high levels as the economy improves. If domestic private saving fell back to its 2000 to 2008 range of 14% to 18% of GDP, there would be little domestic saving available to finance private investment in the presence of a budget deficit of the size recorded in 2010 (9% of GDP).<sup>20</sup> Allowing the tax cuts to expire as scheduled would reduce the budget deficit and take some pressure off U.S. borrowing needs going forward.

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<sup>19</sup> For more information, see CRS Report R40770, *Economic Effects of a Budget Deficit Exceeding \$1 Trillion*, by Marc Labonte.

<sup>20</sup> The trade deficit fell in 2010 despite the large budget deficit because private saving was unusually high and private investment was unusually low. Private saving consists of household saving and business saving.

## **The Short-Term Performance of the Economy Following Changes in the Budget Deficit**

In the short run, there is concern that allowing the tax cuts to expire could push the economy back into recession by reducing overall spending. Estimates of how much the expiration of the tax cuts would reduce overall spending are subject to the same counterfactual problem as estimates of how much the tax cuts originally boosted spending in the short run—because the effects cannot be observed directly, estimates are only as good as the economic models that produce them.

Would the expiration of the tax cuts be enough of a “shock” to total spending to push the economy back into recession? As discussed above, when coupled with extensions to the expiring AMT provisions, the tax cuts are fairly large relative to projected GDP growth. The tax cuts would reduce revenue by 2.5% in 2011, reducing total spending by more or less than that amount depending on the size of the multiplier effect, compared with a growth rate of 2.7% for FY2011 projected by Blue Chip.<sup>21</sup> Alternatively, if one’s baseline is that the AMT provisions will be extended regardless of what happens to the tax cuts, then the contractionary effect on total spending would be significantly smaller, because the tax cuts alone would reduce revenue by an estimated 0.75% of GDP in 2011.

Has the economy been able to withstand tax increases in the past? As discussed above, this question cannot be answered in isolation of the overall budget picture because all policy changes that increase or decrease the deficit have a stimulative or contractionary effect on spending, respectively. For that reason, **Figure 1** compares GDP growth to the annual change in the cyclically adjusted federal budget deficit from 1990 to 2009. The cyclically adjusted budget deficit is used as a proxy for the size of annual policy changes to the budget deficit.<sup>22</sup> A look at the historical record shows that when spending in other parts of the economy—whether it be consumption, investment, or net exports—is robust, deficit reduction need not result in subpar rates of overall economic growth. The period from 1993 to 2000 featured small reductions in the cyclically adjusted budget deficit each year except 1999 and robust economic growth. In those cases, monetary policy could be used to offset any contractionary effects of deficit reduction, however. Doing so could prove more difficult at present because the Fed has already exhausted conventional policy tools by reducing overnight rates to zero and used unorthodox tools on a large scale to stimulate spending.

Although the last two recessions featured increases in the deficit in response to the decline in GDP growth, it is interesting to note that in 1991 the deficit was reduced during the recession, and growth nevertheless bounced back the next year and reached a solid rate the following year.<sup>23</sup> Notably, the Omnibus Budget Reconciliation Act of 1990 cut spending and raised marginal

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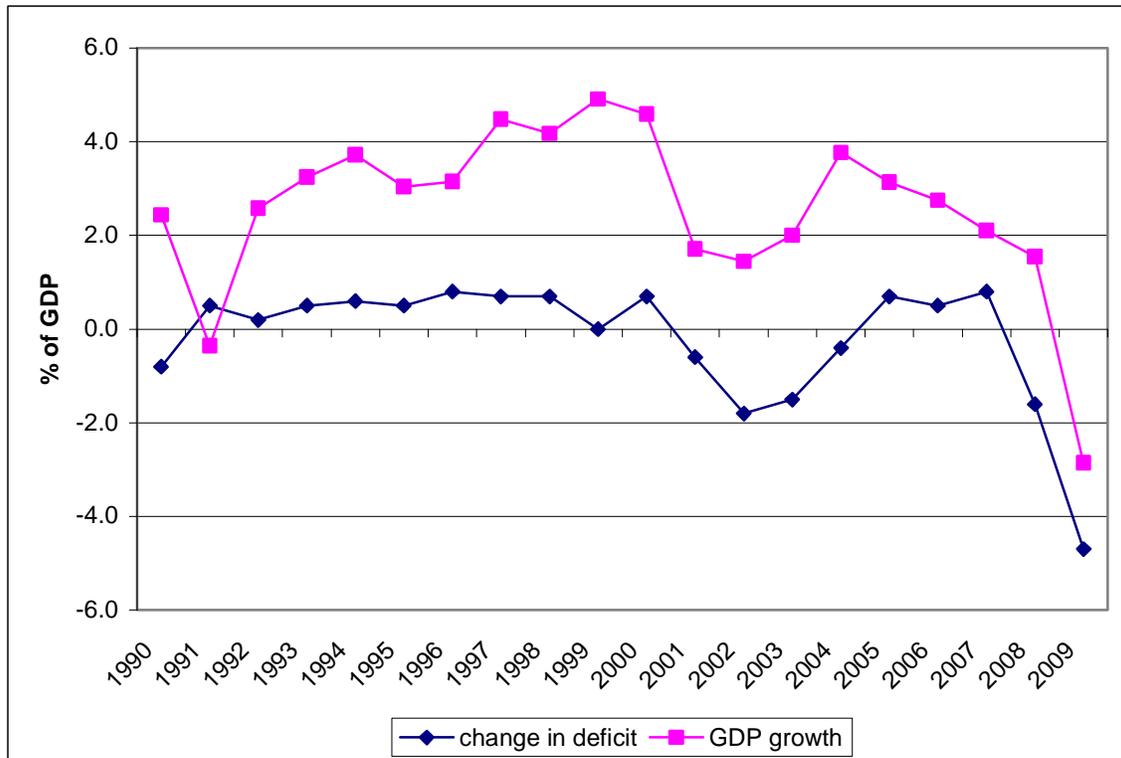
<sup>21</sup> Blue Chip, *Economic Indicators*, vol. 35, no. 9, September 2010. Blue Chip is the average forecast for a group of more than 50 business economists.

<sup>22</sup> The cyclically adjusted deficit strips out the effect of economic changes on the deficit due to “automatic stabilizers.” The cyclically adjusted budget deficit is not a perfect proxy for policy changes because built in features of the budget can lead to changes in the deficit without explicit policy changes. For example, “real bracket creep” (the fact that the income tax system is not indexed for income growth) causes more revenue to be collected over time without policy changes to the tax code.

<sup>23</sup> The fact that negative or low growth in 2001-2003 and 2008-2009 coincided with increases in the deficit do not prove that deficits cause growth to fall because of the counterfactual problem—it is impossible to observe what growth rate would have prevailed had the government not increased the budget deficit.

income tax rates beginning in 1991. The strains on the economy in the recent recession were much greater than the 1990-1991 recession, however. A more disconcerting historical example is 1937, when a tightening of both monetary and fiscal policy is credited by many economists with causing another recession at a time when the economy was still recovering from the end of the 1929 to 1933 contraction.

**Figure 1. GDP Growth and the Change in the Cyclically Adjusted Budget Balance, FY1990-2009**



**Source:** CRS calculations based on data from the Congressional Budget Office and the Office of Management and Budget.

**Notes:** Negative change in the budget balance represents an increase in the deficit. cyclically adjusted budget balance from the previous year. Data is on a fiscal year basis.

## Conclusion

By almost any economic indicator, the economy performed better in the period before the tax cuts than after the tax cuts were enacted, regardless of whether recession years are omitted from the comparison. GDP growth, median real household income growth, weekly hours worked, the employment-population ratio, personal saving, and business investment growth were all lower in the period after the tax cuts were enacted. The average unemployment rate was the same over the two periods, and productivity growth was slightly higher after the tax cuts were enacted.

How should these findings be interpreted? One interpretation is that the tax cuts contributed to the deterioration in economic performance, because income effects on work and saving dominated or because of the negative economic effects of the higher budget deficits. An alternative

interpretation is that the tax cuts did not have significant enough effects to show up in the data at a time when other factors were causing the economy to perform relatively poorly. In this interpretation, the tax cuts could have small positive, small negative, or no effects on the economy.

These results speak mainly to the tax cuts' long-run effects on the economy. The short-term effects of allowing the tax cuts to expire depend greatly on the state of the economy at that time. At the present, the recession ended more than a year ago, the economy has recorded four consecutive quarters of positive growth since then, and it is expected to continue to grow in the near term. Double dip recessions are rare, but given that unemployment is still high, allowing the tax cuts to expire and using the saving to reduce the budget deficit could weaken the pace of economic recovery, particularly if AMT relief were also allowed to expire.

A comparison of economic growth and changes in fiscal policy since 1990 indicates that deficit reduction need not lead to subpar growth if other spending is growing strongly. Interestingly, the deficit was also reduced in 1991 during a recession, but the economy grew in 1992 and grew solidly in 1993.

Eventually, policy changes are needed to move the deficit onto a sustainable path, and allowing the tax cuts to expire would help move the deficit in that direction. The large deficit has not been a drag on the economy through the expected channels to date, but a case could be made for reducing the deficit now on the grounds that as long as the deficit is on an unsustainable path, it exposes the economy to the unlikely but potentially costly possibility of a fiscal crisis.

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