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The 2001 and 2003 Bush Tax Cuts: Economic Effects of Permanent Extension

Tracy L. Foertsch, Ph.D., and Ralph A. Rector, Ph.D.

If Congress does not act soon, millions of taxpayers will see their tax bills rise after 2010 as key provisions of the 2001 and 2003 tax acts expire. Worse still, millions more Americans will experience a slower economy and slimmer job prospects as the economy adjusts to the higher tax burden on labor and capital income.

While policymakers are getting more and more insight into how revenues will change when the Bush tax cuts expire, they appear to have little sense of how revenues and the economy would likely react if the tax cuts were extended. This paper summarizes recent research by the Center for Data Analysis on this question.

Between 2011 and 2016, extending the tax cuts would likely, relative to the current-law baseline¹:

- Raise real gross domestic product (GDP) by an average of over \$75 billion annually, and by nearly \$100 billion in 2012;
- Add an average of 709,000 jobs annually, and roughly 900,000 in 2012;
- Lower the unemployment rate, which means that about 270,000 unemployed workers in 2012 alone would find jobs; and
- Increase real personal income by an average of almost \$200 billion annually.

Estimating the Economic and Fiscal Effects of Extending the Tax Cuts. For the fourth year in a row, President George W. Bush's budget calls for extending expiring tax provisions. The most significant are the major provisions of two tax laws: the

lower marginal tax rates on ordinary income enacted under the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and the preferential rates on individual net capital gains realizations and dividend income enacted under the 2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA). The President's budget also proposes temporarily raising the alternative minimum tax (AMT) exemption amount and continuing the AMT's unrestricted use of some nonrefundable personal tax credits.² Without such an AMT fix, extending EGTRRA and JGTRRA would spur significant growth in the number of taxpayers subject to the AMT.

This paper summarizes an analysis of the economic and budgetary effects of permanently extending certain key provisions of EGTRRA and JGTRRA. The extension plan considered is similar to that included in every budget proposed by the President since JGTRRA was signed into law in 2003.³ It would extend:

- JGTRRA's preferential tax rates on individual capital gains and dividend income,
- EGTRRA's lower marginal tax rates on ordinary income,⁴ and
- EGTRRA's provisions raising after-tax income.

This paper, in its entirety, can be found at:
www.heritage.org/research/taxes/wm1361.cfm

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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

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Those provisions include the \$1,000 child tax credit, repeal of the phase out of itemized deductions and personal exemptions, and marriage penalty relief. The extension plan reduces marriage penalties by raising the standard deduction and widening the 15-percent tax bracket for married couples filing a joint return.

This analysis uses the Center for Data Analysis's microsimulation model of the federal individual income tax and the Global Insight (GI) short-term U.S. Macroeconomic Model⁵ to analyze the economic and budgetary effects of the extension plan. Those effects are measured against the Congress-

sional Budget Office's (CBO's) January 2006 baseline projections, which assume current-law tax policy.⁶ That is, the CBO projects GDP, prices, individual and corporate income, federal tax revenues, and net federal saving, among other economic and budget variables, over the 10-year budget period assuming that JGTRRA's preferential tax rates on capital gains and dividends expire in 2008⁷ and EGTRRA's lower marginal rates on ordinary income expire in 2010. As a result, the CBO projects a sharp increase in federal income tax revenues and some slowdown in economic activity after 2010.

1. The analysis and conclusions presented here are discussed in greater detail in a November 2006 *Center for Data Analysis Report*. See Tracy L. Foertsch and Ralph A. Rector, "A Dynamic Analysis of the 2001 and 2003 Bush Tax Cuts: Applying Alternative Techniques for Calibrating Macroeconomic and Microsimulation Models," Heritage Foundation *Center for Data Analysis Report* No. CDA06-10, November 22, 2006, at www.heritage.org/Research/Taxes/cda06-10.cfm. That Report is an expanded version of a methodological paper prepared for the 2006 Federal Forecasters Conference, held in Washington, D.C., on September 28, 2006.
2. For additional details, see U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals*, February 2007, at www.ustreas.gov/offices/tax-policy/library/bluebk07.pdf. See also U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2007 Revenue Proposals*, February 2006, at www.ustreas.gov/offices/tax-policy/library/bluebk06.pdf.
3. The extension plan analyzed is also similar to one considered by the Treasury Department's Office of Tax Analysis (OTA) in a July 2006 dynamic analysis of the President's fiscal year (FY) 2007 tax relief proposals. See U.S. Department of the Treasury, Office of Tax Analysis, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," July 25, 2006, at www.treasury.gov/press/releases/reports/treasurydynamicanalysisreportjuly252006.pdf. The OTA analysis does not include permanent repeal of the estate tax. For comparison purposes, this analysis also excludes permanent repeal. However, permanently repealing the estate tax would provide a further boost to the economy. See Alfredo Goyburu, "The Economic and Fiscal Effects of Repealing Federal Estate, Gift, and Generation-Skipping Taxes," *Center for Data Analysis Report* No. CDA02-08, November 15, 2002, at www.heritage.org/Research/Taxes/CDA02-08.cfm.
4. For additional information on EGTRRA's expiring provisions, see Joint Committee on Taxation, "Summary of Provisions Contained in the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001," JCX-50-01, May 26, 2001, at www.house.gov/jct/x-50-01.pdf.
5. The Global Insight model is used by private-sector and government economists to estimate how changes in the economy and public policy are likely to impact major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts at The Heritage Foundation's Center for Data Analysis. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the Global Insight model.
6. CBO's baseline projections also embody the rules and conventions governing a current-services federal budget. Thus, the CBO projects GDP, prices, individual and corporate income, net federal saving, and other variables over the 10-year period assuming the continuation of current levels of federal spending. For additional details on the CBO's January 2006 baseline projections, see Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2007 to 2016," January 2006, at www.cbo.gov/ftpdocs/70xx/doc7027/01-26-BudgetOutlook.pdf. For a discussion of the CBO's current-law federal budget baseline, see Christopher Williams, "What Is a Current-Law Economic Baseline?" *Economic and Budget Issue Brief*, June 2, 2005, at www.cbo.gov/ftpdocs/64xx/doc6403/EconomicBaseline.pdf.
7. This is because the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005 was not current law at the time the CBO prepared its January 2006 baseline projections. For additional details on TIPRA's provisions, see Joint Committee on Taxation, "Estimated Revenue Effects of the Conference Agreement for the 'Tax Increase Prevention and Reconciliation Act of 2005,'" JCX-18-06, May 9, 2006, at www.house.gov/jct/x-18-06.pdf. Here, "current law" refers to current law as defined by CBO in January 2006.

Table 1

WM 1361

Economic Effects of the Extension Plan Relative to CBO's January 2006 Baseline Projections, Fiscal Years 2011-16

(Dollar figures in billions)

	2011	2012	2013	2014	2015	2016	(Average) 2011-16
Real GDP ^a	\$67.8	\$97.2	\$85.5	\$78.8	\$70.2	\$60.2	\$76.6
Total Employment ^b	568,000	880,000	870,000	750,000	647,000	539,000	709,000
Unemployment Rate ^c	-0.1%	-0.2%	-0.2%	-0.2%	-0.1%	-0.1%	-0.1%
Real Disposable Personal Income ^a	\$148	\$203	\$204	\$209	\$211	\$208	\$197
Real Personal Consumption ^a	\$73	\$115	\$122	\$125	\$125	\$123	\$114
Personal Saving Rate ^d	0.7%	0.8%	0.8%	0.8%	0.8%	0.7%	0.8%
Real Gross Private Domestic Investment ^a	\$22	\$30	\$13	\$6	\$3	\$2	\$13
Real Non-Residential Investment ^a	\$13	\$21	\$12	\$4	\$2	\$2	\$9
Full-Employment Capital Stock ^a	\$19	\$39	\$48	\$47	\$45	\$44	\$40
CPI Inflation ^e	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%
Treasury Bill, 3 Month ^f	0.1%	0.3%	0.2%	0.2%	0.2%	0.1%	0.2%
Treasury Bond, 10 Year ^f	0.1%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%

Notes: The economic effects of the extension plan are measured relative to the Congressional Budget Office's January 2006 baseline economic and budgetary projections. A more detailed table is available upon request.

a. Difference in inflation-adjusted dollars (indexed to 2000 price levels); b. Difference in jobs; c. Difference in the percent of the civilian labor force; d. Difference in the percent of disposable personal income; e. Difference in the percent change from the previous year; f. Difference in an annualized percent.

Source: Center for Data Analysis, The Heritage Foundation

When compared to the CBO's baseline projections, this analysis indicates that permanently extending certain provisions of EGTRRA and JGTRRA would boost economic activity. Between 2011 and 2016, real (inflation-adjusted) GDP would be, on average, over 0.5 percent higher. Individual incomes and the federal personal income tax base would also expand, helping to reduce the cost of the extension plan to the Treasury.

Macroeconomic (Dynamic) Economic Effects of the Extension Plan. Table 1 summarizes the macroeconomic effects of the extension plan. Between 2011 and 2016, total employment expands by an average of over 700,000 jobs annually, and the unemployment rate drops an average of 0.1 percentage point. That drop in the unemployment rate occurs despite an increase in the rate of labor force participation spurred by lower marginal tax rates on labor income. Over the same period, real disposable income rises by an average of nearly \$200 billion annually, and personal

saving climbs sufficiently to push the personal saving rate 0.8 percentage point above the baseline level.

Permanently extending JGTRRA's preferential rates on capital gains and dividend income permanently reduces the cost of capital to business. Real, non-residential fixed investment responds positively, climbing an average of nearly \$9 billion annually between 2011 and 2016. The economy's stock of productive capital is bolstered as a result, and real potential GDP expands in every quarter between 2009 and 2016. Reflecting that increase in the economy's productive potential, real GDP exceeds the CBO's January 2006 baseline projections by \$60.2 billion by 2016.

Making the tax cuts permanent avoids the disincentive effects on working, saving, and investing that would arise from higher taxes after 2010. The CDA simulation shows that the greatest positive effects of permanent extension come from lowering marginal tax rates on capital gains, dividend

income, and ordinary income.⁸ Permanently extending the \$1,000 child tax credit, repeal of the phase out of itemized deductions and personal exemptions, and marriage penalty relief also has some effect on economic activity. However, they tend to do so by increasing after-tax incomes.⁹

In general, tax relief measures that reduce marginal tax rates on capital and labor income will produce bigger gains in GDP than measures that only tinker with the size of after-tax income. This is because cuts in marginal tax rates both increase the after-tax wage rate and lower the cost of capital. They therefore tend to encourage individuals to work more and businesses to invest. Increases in labor supply, saving, and the domestic capital stock follow.

New or bigger personal deductions and tax credits typically do not have the same incentive effects. They do little to spur employment or new business investment. And they boost after-tax incomes, not after-tax wage rates. Thus, individuals can increase or even maintain the same level of after-tax income by working the same or fewer hours.

Two additional factors mitigate the economic benefits of the extension plan. First, in the simulations, rising output and falling rates of unemployment prompt the Federal Reserve to increase the federal funds rate despite little change in the rate of CPI inflation.¹⁰ Yields on Treasury notes and bills and on corporate and other debt rise as a result, increasing the cost of capital to business. Second, the ever-expanding reach of the AMT nearly halves the size of the tax reduction under the extension

plan, reducing gains in personal disposable income, personal consumption, and saving. It also boosts the average effective marginal tax rate on ordinary income, in some cases offsetting incentives for supplying more labor.¹¹

Dynamic Budgetary Effects of the Extension Plan. Extending EGTRRA's and JGTRRA's expiring provisions has a positive effect on U.S. GDP, incomes, and employment over the 10-year budget period. It also generates substantial revenue feedbacks (\$295.5 billion). Ignoring the macroeconomic effects of the extension plan on individual, non-corporate business, and corporate incomes puts federal tax revenues \$991.9 billion below the CBO's projected baseline levels over 10 years. Taking the dynamic effects of the extensions into account reduces the estimated revenue loss to the Treasury to \$696.4 billion over 10 years.¹² In 2009 and 2010, dynamic revenue feedbacks do not exceed about \$9 billion. But they more than treble in size in each of the final 6 years, reaching \$56 billion in 2016.

The estimated change in federal income tax revenues would be significantly higher if not for the AMT. The extension plan does not include a permanent increase in the AMT exemption amount or indexation of the AMT brackets to inflation. Without these, an ever larger number of middle-to-upper-income taxpayers will fall prey to the AMT.¹³

Conclusion. With no change in current law, EGTRRA's lower marginal rates on ordinary income and JGTRRA's preferential rates on individual net

8. For additional details on how this analysis simulates the responses of labor and investment to permanent extension of EGTRRA's lower marginal rates on ordinary income and JGTRRA's preferential rates on capital gains and dividend income, see Tracy L. Foertsch and Ralph A. Rector, "A Dynamic Analysis of the 2001 and 2003 Bush Tax Cuts: Applying Alternative Techniques for Calibrating Macroeconomic and Microsimulation Models."
9. This analysis models refundable credits as a change in federal transfer payments to persons and, thus, a change in federal outlays.
10. This analysis uses an econometrically-estimated reaction function in the GI model that adjusts the effective interest rate on federal funds in response to changes in the unemployment rate and the rate of inflation in the CPI.
11. For additional details on the impact of AMT on average marginal tax rates and labor supply, see Joint Committee on Taxation, "Present Law and Background Relating to the Individual Alternative Minimum Tax," JCX-37-05, May 20, 2005, at www.house.gov/jct/x-37-05.pdf.
12. These estimated changes in federal individual income tax revenues exclude net refundable credits. The dynamic revenue feedback is calculated as the difference between -\$696.4 billion and -\$991.9 billion.

capital gains realizations and dividend income will expire at the end of 2010. Extending these provisions would boost U.S. GDP, employment, incomes, and federal tax collections over the 10-year budget period. However, the President's fiscal year 2008 budget includes only a one-year extension of AMT relief for individuals. The AMT's expanding reach

partially offsets simulated economic gains from the extension plan.

—Tracy L. Foertsch, Ph.D., is a Senior Policy Analyst and Ralph A. Rector, Ph.D., is a Senior Research Fellow and Project Manager in the Center for Data Analysis at The Heritage Foundation.

13. For example, in 2006, Treasury estimated that with permanent extension of EGTRRA and JGTRRA and no additional AMT relief, the number of individual AMT taxpayers would jump from 5.5 million in 2006 to almost 26 million in 2007 and over 56 million in 2016. See U.S. Department of the Treasury, Office of Tax Policy, "Tax Relief Kit—The Toll of Two Taxes: The Regular Income Tax and the AMT," 2006, at www.ustreas.gov/offices/tax-policy/library/tax_relief_kit.pdf.