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SPECIAL BRIEF

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One-Time Tax Rebates Will Fall Short of Political Promises and Public Expectations

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The continuing drift in the performance of the American economy has prompted many members of Congress to propose as much as $60 billion in tax rebates this year, under the assumption that a quick infusion of cash into taxpayers' wallets will boost the economy. One such measure, advocated by Senator Joe Lieberman, would give every worker a tax rebate of at least $300, while other initiatives would couple a rebate with a reduction in the lowest income tax rate, say, from 15 percent to 12 percent.

> ***In their attempt to "do something" to spur the economy, Congress and the Administration should not abandon the principles of sound tax policy outlined by Chairman Greenspan during his recent testimony before the Senate Budget Committee.***

> ***If lawmakers are intent on cutting taxes by $60 billion this year, they would get a bigger bang for the buck by immediately cutting income tax rates, preferably to either the first-year or second-year levels specified under the Bush plan.***

Despite the popular appeal of such measures, lawmakers should not forget the warning of Federal Reserve Chairman Alan Greenspan that such quick-fixes "historically have proved difficult to implement in the time frame in which recessions have developed and ended." Instead, Congress and the Administration should quickly move to implement measures — such as reducing all marginal tax rates — that create the conditions for long-term economic growth.

Taxes as a percentage of GDP are clearly too high, so any tax relief would be better than no tax relief. That said, some tax cut measures produce better economic results than others. In their attempt to "do something" to spur the economy, Congress and the Administration should not abandon the principles of sound tax policy outlined by Chairman Greenspan during his recent testimony before the Senate Budget Committee:

> As for tax policy over the long run, most economists believe that it should be directed at setting rates at the levels required to meet spending commitments, while doing so in a manner that minimizes distortions, increases efficiency, and enhances incentives for saving, investment and work.

The tax cuts most clearly in line with these principles are meaningful and proportional cuts in each of the current five individual income tax rates: 15, 28, 31, 36, and 39.6 percent. Thus, if lawmakers are intent on cutting taxes by $60 billion this year, they would get a bigger bang for the buck by immediately cutting income tax rates, preferably to either the first-year or second-year levels specified under the Bush plan. Taxpayers should not have to wait as long as two years for what is clearly affordable today.

The Shortcomings of One-Time Tax Rebates

A variety of complaints can be lodged against the kind of quick-fix remedies under discussion now in Washington, from the theoretical to the empirical.

One-time Tax Rebates Are a Misuse of the Tax Code

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The primary purpose of the tax system is to raise revenue, not to micromanage the economy with subsidies. It should create a level playing field in which individual and business decisions are made to achieve the best economic outcomes.

One-time Rebates Have No Impact on Economic Growth

There have been only a few instances in which tax rebates have been seriously considered at the federal level as a means to stimulate the economy. When they have been tried, they have not proven successful.

Many politicians and pundits argue that a one-time tax rebate will "jump-start" the economy by increasing consumer spending. However, there is little economic evidence to support that view.

As Tax Foundation economists wrote in November 1977 when the Carter Administration was considering such measures:

> We have seen how easily total concern over the immediate economic situation can produce questionable remedies — the phantom $50 rebate of last spring being the latest example. Such fine tuning devices have been likened to "throwing money off the Washington Monument," and many are convinced that they are simply counterproductive as far as establishing the right climate for a solid and sustained economic advance. [1]

In a similar critique of a Carter Administration quick-fix proposal, Tax Foundation economists noted in October 1977 that, "Haste to pep up the economy can sweep in ill-conceived reform. We had a taste of that in the Tax Reduction Act of 1975." [2]

These measures can also prove to be too little, too late, as Chairman Greenspan has pointed out: "Although President Ford proposed in January of 1975 that withholding rates be reduced, this easiest of tax changes was not implemented until May, when the recession was officially over and the economy was gathering force."

People Respond to Long-term Tax Changes, not Short-term

A $300 rebate will not spur any American to work harder, volunteer for overtime, or invest in a business start-up. However, cutting marginal tax rates will prompt people to work overtime, invest, and take risks because they will know that the next dollar of income they earn would not be taxed at today's higher rates.

Many politicians and pundits argue that a one-time tax rebate will "jump-start" the economy by increasing consumer spending. However, there is little economic evidence to support that view. Indeed, its highly unlikely that giving taxpayers a one-time cash rebate later this year can counter the drag that today's high rates are inflicting on the economy.

[1] "Tax Reform — The Pause That Refreshes," *Tax Foundation Federal Tax Policy Memo,* November 4, 1977.
[2] "Tax Reform Twists," *Tax Foundation Federal Tax Policy Memo,* October 7, 1977.

Moreover, economists such as Nobel laureate Milton Friedman, argue that people are just as likely to save a large portion of any one-time windfall as they are to rush out and spend it. People do, however, change their spending patterns if they know that their disposable income will rise over the long term. For example, a one-time $300 tax rebate is hardly sufficient for a family to commit to four years worth of payments to purchase a new car. However, if that family received a permanent tax cut large enough to cover one or two car payments during each of the next four years, then they would be more likely to make the commitment to buy a car because of the long-term expectations they have of their future income.

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A Rebate Will Not Fix "Real Bracket Creep"

One of the most pressing problems facing middle-class taxpayers today is the return of "Bracket Creep." During the 1970s and early 1980s, many Americans found themselves pushed into higher tax brackets because their salaries and wages were pegged to the soaring rate of inflation. Indexation solved the problem of inflationary bracket creep, but today many Americans are finding themselves in higher tax brackets because productivity gains are boosting real incomes and because of the growing number of dual-income working families.

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Bracket creep is one of the largest contributing factors to the glut of tax revenues Washington has enjoyed in recent years. Chairman Greenspan has noted that:

> "[T]he experience of the past five to seven years has been truly without recent precedent. The doubling of the growth rate of output per hour has caused individuals' real taxable income to grow nearly two and one-half times as fast as it did over the preceding ten years and resulted in the substantial surplus of receipts over outlays that we are now experiencing."

All levels of government have benefited from the productivity gains of the past eight years. Since 1992, total personal income has grown by more than $2.8 trillion. However, nearly half of all of this new wealth went to taxes at the federal, state, and local level. The largest share of this new income (18 percent) went to federal income taxes, while state and local taxes took 16 percent and all other federal taxes — including payroll taxes — took 15 percent.

During this time, income tax collections not only grew the fastest, but outpaced the growth in Americans' personal incomes. Since 1992, income tax collections grew by an average of 9.1 percent per year, 64 percent faster than the growth rate of personal income. Put in dollar terms, the magnitude of tax collections above and beyond the growth of personal income is quite large. Had, for example, the growth rate of income tax collections been held to the same growth rate as personal income since 1992, taxpayers would have saved $950 billion in taxes during the period.

Lowering Only the Bottom Tax Rate Will Not Noticeably Affect Economic Behavior

Combining "fiscal stimulus" with an understandable sympathy for low-income taxpayers, a number of lawmakers have proposed an immediate cut in the lowest rate from 15 percent to as low as 10 percent. This proposal would barely outperform the rebate by itself because workers and entrepreneurs are driven to work harder and invest more by how much (or little) they are taxed on the *next* dollar of income, not the *first* dollar they earn.

To be sure, reducing the bottom tax rate would be a great boon to lower income

Cutting only the bottom tax rate would not change the working and saving behavior of middle-income taxpayers, and it would certainly give no incentive to the upper-income individuals whose sole proprietorships, limited partnerships, and S-Corporations have contributed to the wondrous productivity gains that Washington's budget surpluses depend on.

people trying to work their way up the ladder. But cutting only the bottom tax rate would not change the working and saving behavior of middle-income taxpayers, and it would certainly give no incentive to upper-income individuals, who tend to be business owners and entrepreneurs (such as sole proprietorships, limited partnerships, and S-Corporations). Their high level of saving, investing and risk taking have contributed to the wondrous productivity gains that Washington's budget surpluses now depend on.

Many Americans are unaware that these "upper-income" business owners typically file their tax returns as individual taxpayers. Indeed, according to IRS estimates, there are more than 22 million business returns filed under the individual income tax code, a remarkable 5 million more businesses that file as individuals than did a decade ago.

Cutting all tax rates immediately (including the highest tax rates of 31, 36, and 39.6 percent) not only would free up capital that could be reinvested in these small companies, it would also create the proper conditions for long-term economic growth. History has shown that a one-time tax rebate will fall far short of political promises and Americans' expectations.

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The Tax Foundation has monitored tax and fiscal activities at all levels of government since 1937.

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