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Debunking Four Election-Year Budget Myths

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Facts often are the first casualty of any political battle, and never more so than during an election year. But sometimes—as the following four myths illustrate—the debate in Washington goes beyond routine exaggeration and distortion and becomes flagrantly misleading.

MYTH #1: The sluggish economy proves that tax cuts do not boost growth.

FACT: The economy began to weaken in 2000, almost one year prior to the enactment of tax cut legislation. The economy began to weaken in mid-2000, according to Commerce Department figures, and growth averaged less than 1 percent in the final six months of the year. This anemic performance occurred long before the 2001 tax cut was enacted. Even more important, the economy started to contract in the first three months of 2001. Thus, this decline began while President Bill Clinton was still in office, and certainly well before any tax cuts were approved.

FACT: The vast majority of the pro-growth provisions in the 2001 tax cut do not take effect until 2004, 2006, and 2010. It is preposterous to say that supply-side tax cuts do not work when they have yet to take effect. Because the tax cut is being implemented over a period of 10 years, personal income tax rates so far have been reduced by only one percentage point for taxpayers that were in the 28 percent, 31 percent, 36 percent, and 39.6 percent tax brackets. There will be another one percentage point reduction in these tax rates in 2004, followed by the final stage of reductions in 2006. The death tax, meanwhile, will not be repealed until 2010.

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MYTH #2: The tax cut is driving interest rates higher by increasing the budget deficit.

FACT: Fiscal policy has shifted from large surpluses to mid-size deficits, yet interest rates have dropped dramatically. In 2000, the federal government had a record budget surplus of $236 billion. The same year, according to the Federal Reserve Board, the average interest rate on 10-year government bonds was 6.03 percent. Recent projections, by contrast, show that the budget will have a $157 billion deficit in 2002, a shift of nearly $400 billion. But instead of rising—as critics of tax cuts argue should have happened—interest rates have declined. The Federal Reserve Board reported that the 10-year government bond rate in

September was only 3.87 percent. This decline does not mean that larger deficits cause interest rates to fall, to be sure, but it does demonstrate that it is incorrect to claim that rising budget deficits will cause interest rates to increase.

FACT: Reducing tax rates enables investors to achieve a desired rate of return at a lower rate of interest. High tax burdens drive up interest rates because investors require a higher return to compensate them for the money taken by government. This relationship is clearly seen by examining the difference between interest rates charged on tax-free municipal bonds and interest rates charged on taxable government bonds. Over the past 16 years, for instance, AAA-rated 10-year municipal bonds have yielded, on average, 150 basis points (1.5 percentage points) less than 10-year Treasury Notes—a particularly notable difference, considering that Treasury debt is regarded as the safest investment and therefore has the lowest yield of all taxable instruments.

MYTH #3: Fiscal discipline requires a balanced budget.

FACT: Limiting the size of government is the right way to demonstrate fiscal discipline. Special-interest groups seek to obtain unearned wealth by convincing politicians to give them other people's money. Resisting these demands is the correct way to demonstrate fiscal discipline. It is not a sign of fiscal discipline for politicians to impose high tax burdens in order to fund excessive spending. Many European nations maintain this version of fiscal balance, and their tax burdens sometimes consume 50 percent of economic output. These nations inevitably suffer from sluggish growth and high unemployment, but nations that limit the size and growth of government enjoy more growth and create more jobs—regardless of whether their budgets are balanced.

FACT: Reducing tax rates helps control the growth of federal spending. The shift from budget deficits to budget surpluses in 1998 significantly undermined fiscal discipline. Budget surpluses were viewed as extra money, and lawmakers dramatically increased the growth rate of federal spending. Indeed, federal spending has grown about twice as fast in the four years since 1998 as it did in the four years before 1998. One of the best—albeit unintended—consequences of the Bush tax cut is that it takes money away from Washington that otherwise would be used to fuel even bigger increases in government.

MYTH #4: The Bush tax cuts caused the deficit.

FACT: The weak economy is the main reason the deficit has reappeared. According to Congressional Budget Office figures, lower tax revenues from the tax cut account for just 8 percent of the change in fiscal balance for 2002. Most of the change is due to the economy's sluggish performance and forecasting errors—much as the budget surpluses of the late 1990s were caused by strong economic growth. Spending increases, primarily for domestic programs, also have contributed to deficits.

FACT: The economy drives the budget, not the other way around. Fiscal balance should not be the goal of fiscal policy. Instead, lawmakers should control the size of government and lower tax rates. These policies will boost growth by leaving more resources in the productive sector of the economy and giving people greater reason to work, save, and invest. As a result, the amount of taxable income will increase, and the government will collect additional revenue. Combined with reduced demands for government programs, this fact explains why economic growth is the best way to seek fiscal balance.

Conclusion. President Bush's tax cut should not be immune from criticism, but the debate should be based on fact rather than election-year rhetoric. It appears that many critics condemn the tax cut because they are unwilling to concede that their real agenda is bigger government.

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