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Is it time to repeal Bush's $1 trillion tax cut?

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George Bush's 2001 tax cut was controversial almost from its inception. Many economists and analysts opposed the tax cut because they felt it wasn't necessary, given that the U.S. economy was already recovering from the 2001 recession. Now, with a record U.S. budget deficit and increased social services spending as a result of the recession, policy makers are wondering if the time has come to repeal the $1 trillion tax cut.

As many have noted, the tax cut was heavily tilted toward rich and upper-income citizens, who formed the basis of President Bush's political base. In addition to angering much of the country, this strategy guaranteed that, over time, middle-income and working families would not create as much broad-based demand as they would under a more balanced tax cut.

Furthermore, the Bush tax cut devastated the U.S.'s fiscal condition. It's hard to believe today, but the United States actually ran a $69 billion budget *surplus* in fiscal 1998, a $125 billion surplus in 1999, a $236 billion surplus in 2000, and a $128 billion surplus in 2001. These surpluses, the budgetary legacy of President Bill Clinton's administration, look odd in today's deficit-laden times.

The Bush tax cut ended that surplus era, driving the budget into a $157 billion deficit in fiscal year 2002. However, it should be noted that the 2001 recession also reduced federal revenue that year. Later, increased government spending for the Iraq/Afghanistan wars quickly sent the deficit spiraling to $250 billion in 2003 and to $412 billion in 2004. In fiscal year 2009, the bank bailout and financial crisis rocketing the deficit over the $1 trillion mark for the first time in the nation's history.

When President Barack Obama took office in January 2009, he received a chilling inauguration present: a $1 trillion (and counting) deficit. This year's fiscal stimulus package is expected to swell the deficit to an ugly $1.8 trillion.

With record deficits pushing the nation's debt service capacity to its limits, and major U.S. debt holders China, Japan, and Saudi Arabia becoming concerned about possible rising U.S. inflation and an even weaker dollar, many are arguing that now is a good time to repeal the Bush tax cut. For example, The Brookings Institute, a liberal think tank, argues that the deficit will average an intolerable -- and unsustainable -- $1 trillion per year over the next 10 years. Not only does Brookings see a need for tax increases and spending cuts to bring the deficit down, it estimates that a new revenue source, such as a value added tax (vat) of 15-20 percent, will be needed to close the fiscal gap.

Conversely, The Cato Institute, a conservative think tank, argues that neither tax increases nor entitlement reform will eliminate the budget deficit. Concerning Social Security, Cato asserts that the pension system would gain just seven more years of solvency from a payroll tax increase. A better solution, they say, is for the nation to create personal, private-based savings accounts for citizens.

Fiscally, from a revenue standpoint, an argument can be made that income taxes should increase to cut the deficit, although it's uncertain whether a majority of Americans would support these changes.

From a GDP standpoint, things are less clear. Most economists agree that, if past economic cycles are any indicator, this is not a good time to repeal the tax cut. Right now, the U.S. economy is suffering from a lack of demand: more than 6.5 million job lay-offs, stagnant wages in many job categories, and a high U.S. savings rate of 6.9 percent prompted by belt-tightening, have combined to decrease consumer spending. Historically, spending accounts for 60-65 percent of the U.S. economy, but one doesn't have to be a sector analyst to see the how the economy's performing. A visit to the local indoor mall or shopping center will typically reveal light crowds, with window shoppers far outnumbering buyers. At this stage, a tax increase -- even one that hits upper income citizens harder -- would further decrease demand by reducing disposable income. This, of course, is exactly what the U.S. economy does not need now.

In the final analysis, a careful distinction should be made between a potential income tax surcharge for universal health care and a repeal of the 2001 Bush tax cut. Even the former, which would represent a minor tax increase, would hurt the GDP. Further, the 2001 Bush tax cut is set to expire in 2011, if Congress does not renew it. Given the U.S. economy's current weakness, 2011 would probably represent the earliest the tax cut could be repealed; doing it any earlier would run the risk of snuffing-out a recovery at its inception.

Financial Editor Joseph Lazzaro is writing a book on the U.S. presidency and the U.S. economy.

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