Barack Obama and the Bush Tax Cuts
Case Analysis

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Problem Statement & Introduction
The economy of the United States continues to be on an unstable foundation, with the threat of a prolonged recession eminent. President Obama and his economic advisors have developed a strategy they believe will bring about economic growth. The question is, assuming Congressional approval, under what circumstances will President Obama’s plan to stabilize and repair the US economy be successful and are there alternatives that should be explored.

Pertinent Facts
- **Scenario 1** - What have been the previous implications of large increases in government expenditures (spending) on the economic performance?
  - Roosevelt increase government expenditures during Great Depression and WWII through deficit spending – attempting to follow theory advocated by Keynes
    - Some economists argue Roosevelt did not fully follow Keynes recommendation
    - Figure F – US Federal Debt Owed to Public as Percent of GDP
    - Unemployment decreased from 17% to 1%
  - President Obama’s plan calls for new spending towards energy efficiency, infrastructure investments, and modernizing school buildings
  - Deficits are supposed to continue through 2019 – data presented in Exhibit 6 from Congressional Budget Office
    - No plan to reduce deficits or payback the new debt incurred
- **Scenario 2** - What effects have previous tax cuts (one-time, temporary, and permanent) had on economic performance in the United States?
  - Average propensity to consume of between 20-40%
  - Historical data suggests that one-time tax rebates (refunds) only have moderate effect on household consumption
    - Examination of the 1975 rebate – only 12-24% used in quarter received
    - One-time tax reliefs were a popular tool under the Bush Administration
  - Deficit financed tax cuts (Kennedy proposed, Johnson implemented)
    - Lowered highest marginal tax rate from 91% to 65%; lowered corporate tax from 52% to 47%
  - Reagan tax cuts – was to bring about reduced government spending, but reductions never occurred and therefore deficits increased dramatically
    - Economists have argued about the impact of the Reagan tax cuts – some have argued that laid the foundation for boom of the 1990’s
  - Real GDP growth and reduced revenues from 1980 to 1985 – presented in Exhibit 7
  - Growth in real consumption of over 20% from 1980 to 1985 – calculated from Exhibit 7
- **Scenario 3** – Implications of self-correction or monetary policies?
  - Self-correcting mechanism is slow to respond and correct problems in the economy
    - Politicians have a short-term time horizon and care about things being fixed before the next election cycle
  - $700 billion bailout plan to buy up illiquid mortgage backed securities, also used to purchase major equity stakes in banks – known as the Troubled Asset Relief Program (TARP)
    - Expansionary vs. contractionary monetary policies – future impact of these types of policies

Alternative Courses of Action
*Effects of Government Spending*
Based on information presented in the case text, the course of action President Obama and his economic advisors have decided on pursuing to stimulate economic activity is increased federal government
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spending. To determine the implications of President Obama’s economic recovery plan, one must understand and analyze the effectiveness of government spending on economic activity in the United States. From a gross domestic product (GDP) perspective, government spending has a similar effect to investment spending because both inject money directly into the spending stream (Wessels, 2012). This effect is known as the multiplier effect. In theory, this essentially means that any increase in government spending has a larger impact on economic activity than its initial amount. Based on the case material, the three main tenants of President Obama’s recovery plan include increasing the energy efficiency of public buildings, authorize new investments in the nation’s infrastructure and modernize school buildings. Without hard figures, it is difficult to assess the actual economic impacts of these proposals, but using the theory of the multiplier effect it is reasonable to assume that these spending programs will have a much larger impact on economic activity than their supposed costs. For example, reducing the energy usage of public buildings would lead to increased business for construction firms, causing them to hire additional workers, expanding incomes and leading to a boost in consumption spending since more people will have disposable income to spend. Also, increasing the energy efficiency of public buildings will lead to decreased government energy consumption in the future, allowing the government to reallocate the energy savings to more stimulating economic activities or use it to pay down existing debts.

Another perspective that must be analyzed is the historical economic impacts of fluctuations in government spending. The case text does not give many specifics about how President Obama plans to finance these spending increases, but it is reasonable to assume that much of the increased spending will be deficit financed spending. John Maynard Keynes argued that temporary federal government deficits could be used to stimulate increased spending, with the stipulation that the debt incurred would have to be repaid during times of economic expansion. An example of deficit financed government spending leading to positive economic activities was during World War II. According to information presented in Figure F, federal government debt as a percentage of GDP peaked, at about 110 percent, during the mid-1940’s; the height of the US involvement in WWII. The expansion of federal government spending was used to finance the war effort of the United States, with the economy being turned into an engine for US military operations. The spending also helped lead the US out of the Great Depression, causing unemployment to decrease from over 17 percent to about 1 percent.

While there are certainly positive results of government spending increases, there are also economic negatives that must be addressed to determine the effectiveness of President Obama’s proposal. Since government spending is primarily financed through tax revenues, and if necessary debt, spending misallocations can have negative repercussions. One of these repercussions is the possible reductions of future incomes due to the need to service and repay the debt incurred. Based on the information provided in the case, under President Obama’s economic recovery plan, total government borrowing is projected to reach $1.5 trillion during the upcoming fiscal year and increase the United States total debt burden by more than 25 percent. Also, according to the Congressional Budget Office (Exhibit 6), government deficits are projected to continue through fiscal years 2009-2019, meaning the total debt burden by the United States will continue to rise. This trend raises some concerns over the impact of continued use of deficit spending and incurrence of new debt. Of concern is their impact on consumption rates through a reduction in future incomes. With an ever growing debt burden, people may decide to alter their consumption habits to reflect their perceived change in their future earnings potential. Continued deficit spending may also impact the ability of the US government to respond to future periods of economic difficulty. While this has yet to occur, US creditors may at some point become concerned their debt principal may not be guaranteed. Therefore, the US government could face difficulty in financing future increases in government spending without drastically increases taxes. Both of these scenarios would adversely impact current economic activity and slow any GDP growth that President Obama hopes to achieve through increased government spending.
Effects of Tax Changes
As opposed to increasing government spending, an alternative President Obama and his economic advisors could pursue to increase economy activity is through changes in tax policy. While as government spending injects money directly into the spending stream, taxes affect an individual’s level of disposable income and therefore effect their consumption of goods and services in the economy. The impact of tax changes can be determined using the tax multiplier, which is calculated by multiplying a negative marginal propensity to consume (MPC) with the spending multiplier (Wessels, 2012). As explained above, tax revenues have historically been used to finance government spending. From a broad political perspective, it is generally argued that the Democratic Party is in favor of increasing taxes, while the Republican Party is in favor of reducing taxes.

Using tax policy to stimulate economic growth can be a difficult avenue to pursue because the effects of tax policy changes can be complicated to judge. As presented in the case text, President Reagan was a strong proponent of reducing income and corporate taxes to spur economic growth. The main idea behind the tax cuts President Reagan pursued was to stimulate economic growth which would in time increase revenues to the federal government. According to Exhibit 7, the main goal of stimulating economic growth was achieved, with real GDP growing from $5.16 trillion in 1980 to $6.05 trillion in 1985. However, according to data presented in Figure H and Exhibit 7, the goal of increasing revenue to the federal government was not achieved since revenues as a percentage of GDP fell from 19 percent to 17.7 percent during the same period. This could primarily be based on the fact that the unemployment rate remained steady in the low seven-percent during this timeframe. It is evident that the tax cuts did little to correct the unemployment situation within the US and were therefore not as effective as they could have been given the economy returned to full employment. Further, examining the information presented in Exhibit 7, consumption in real dollars did increase by over 20% from 1980 to 1985. If, for instance, the unemployment rate had returned to the natural rate of unemployment of about five percent, the impact of the Reagan tax cuts could have been more economically positive. Economists have argued over the economic impacts of the Reagan tax cuts, but many acknowledge that the tax policies of the 1980’s did contribute to the economic boom experienced in the 1990’s. Unfortunately, politicians often have very short time horizons and judge the success of a proposal based on quickness, sacrificing to achieve short-term gains at the expense of long-term downfalls. In assessing plans to stimulate economic growth, President Obama and his economic advisors should not only focus on achieving short-term goals to fix the economy, but also develop a sustainable plan that can meet the needs of the United States in the future.

Another tax policy change President Obama and his economic advisors should examine is the one-time tax reliefs popular under the Bush Administration. President Bush and his advisors often turned to decreasing taxes as their way of stimulating economic growth. Similar to the Reagan Administration, the Bush tax cuts did lead to real GDP growth, but further reduced federal government revenues. A popular tool of the Bush Administration was deficit financed one-time tax reliefs. These reliefs were not permanent changes to the tax code as during the Reagan Administration, but rather one-time payments to taxpayers. Deficit financed one-time tax reliefs have been met with skepticism because of their lack of actual economic stimulus. According to the case, studies have suggested the one-time tax relief of 1975 did little to stimulate economic activity, with only 12% to 24% of the tax reliefs being consumed in the quarter in which they were received. This suggests that one-time tax relief do not provide the short-term economic stimulus they are purported to encourage. According to the case, the Bush Administration implemented one-time tax reliefs twice, both having mixed economic results. Based on this information, President Obama and his economic advisors should be aware at the varying results of temporary and permanent tax policy changes and understand that sometimes it make stronger economic sense to develop strategies with long-term time horizons, rather than focusing on short-term benefits.
**Effects of Nonintervention and Monetary Policy**

President Obama and his economic advisors could also choose to advocate for nonintervention in the economy through fiscal policy and instead let the economy use its self-correcting mechanism to repair itself. This theory assumes that prices are flexible and argues that a decrease in personal consumption will cause a decrease in the price level present in the economy (Wessels, 2012). The decreasing price level will cause cost of production to decrease as well, leading firms to increase production because of the lower costs. This increased production would cause an increase in aggregate supply and the economy would eventually return to an equilibrium level closer to the long-run aggregate supply of the economy. This theory would require no federal government resources to be implemented, but the economy will likely experience a recession for a longer period of time. One reason this theory of nonintervention is not implemented more frequently is because economists and policymakers argue the mechanism is not timely enough to correct problems. While in theory, this self-correcting mechanism will allow the economy to eventually return to full employment, it often operates too slowly for policymakers to advocate for its use.

In complement with nonintervention tendencies with fiscal policy, President Obama could choose to advocate for economic expansionary policies be implemented by the Federal Reserve Bank (Fed) through monetary policy. Monetary policy involves expansionary and contractionary techniques through making changes to the supply of money in the economy. To pursue expansionary monetary policies, the Fed should set a lower target interest rate to allow for businesses to more easily obtain access to credit. This access to credit is supposed to encourage businesses to expand and hire additional workers, thereby reducing unemployment and fighting off a recession. However, given the severity of the recession and the implementation of the Troubled Asset Relief Program (TARP) by the Fed to purchase the risky mortgage investments present in the market, it seems unlikely that advocating for changes solely in monetary policy will be effective in correcting the problems faced by the economy.

**Decision**

After comparing the effectiveness of pursuing economic stimulus through government spending, tax policy, and monetary policy, the recommendation for President Obama is to pursue a mixed strategy encompassing all three avenues. The strategies outlined above have produced positive economic stimulus in different ways and together they can complement each other. The economic difficulties the US is currently facing rivals that of the Great Depression, and therefore an increase in government spending that is deficit financed is warranted to stabilize the economy. However, one addition that President Obama should make to his already published plan is a mechanism for repaying the debt incurred by the increased government spending. Having a sound plan to repay the debt incurred will alleviate some of the concerns of growing deficits and debt. On the tax front, President Obama should pursue long-term tax relief by advocating for making permanent the Bush Administration’s tax cuts. President Obama should not pursue a strategy that only provides temporary tax relief because historically those reliefs have had little impact in encouraging economic growth. By making the tax relief permanent, President Obama will signal to households they can expect increased disposable incomes in the future, which will encourage households to increase their present consumption. The same argument applies to the business community as well, encouraging businesses to retain more workers and increased production which will lead to increased consumption and GDP growth. In complement with the increased government spending and tax relief, the Fed should also pursue expansionary monetary policies. By targeting a reduced interest rate, the Fed can encourage business to continue to hire new employees and help correct the employment situation present in the economy. There will be more people with disposable incomes that can be used towards personal consumption, thereby increasing current economic activity.

**Implementation and Control**

The first step President Obama and his economic advisors need to take is to redraft their initial economic proposal to include the added provisions discussed above. Once that is completed, the President faces the difficult task of gaining Congressional approval, and selling his economic plan to the American public.
While not discussed or addressed in the case, the Democrats currently hold supermajorities in both the House of Representatives and the Senate, and will likely vote to approve any plan put forth by a Democratic president. However, given the severity of the economic crisis and that President Obama is newly elected, the President should pursue Republican support for this plan. Developing a good faith relationship with the opposing party early in a presidency can help with future negotiations and signal that he is open to ideas from all parties. One concern the Administration should be aware of is the supposed readiness of the projects that are being proposed. If the projects are not adequately timed, then the drastic increase in government spending will have little immediate impact and the economy may decline further if implementation is time delayed. Another concern with the implementation of monetary policies is the impact of those expansionary policies on the economy once it recovers. Typically, once an economy begins to recover, inflation tends to increase leading the Fed to have to unwind the expansionary policies put in place to fight the recession. The Fed will have to closely monitor economic activity and determine the most appropriate time to begin to raise interest rates to prevent the price level in the economy from rising too rapidly and causing another recession.

In terms of deciding what metrics to follow to assess whether the implementation of the economic recovery plan is successful, President Obama and his economic advisors should focus on GDP growth and the unemployment rate. Within the GDP calculation, the President should monitor personal consumption expenditures and business investment spending. If consumers feel more confident about their incomes and employment situation, they will likely increase their consumption spending, leading to an increasing GDP. Another indicator of GDP growth the Obama Administration needs to be concerned with is business investment spending. This is an indication of how the business community feels about investment opportunities within the economy. A lack of investment spending will indicate that the business community does not feel that the recovery plan is adequate to correct the problems in the economy. Although unemployment is typically considered to be a lagging economic indicator, it does reflect the business community’s expectations for future growth. Similar to business investment spending, if unemployment begins to stabilize and recover from its highs, then the Administration can begin to call the recovery plan successful.

**Conclusion**

In conclusion, President Obama and his economic advisors should pursue an economic strategy that encompasses the strengths of government spending, tax cuts and expansionary monetary policies. If implemented correctly, the plan outlined will help stabilize and repair the damage caused by the sub-prime mortgage crisis and put the US economy on a stronger foundation for the future.
References