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Do Tax Cuts for the Wealthy Stimulate Employment?

By ROBERT H. FRANK

THE centerpiece of the Bush administration's economic policy has been large federal income tax cuts aimed mainly at top earners. These tax cuts account for much of the $2 trillion increase in the national debt projected to occur during the Bush presidency. They prompted a large group of Nobel laureates in economics to issue a statement last year condemning the administration's "reckless and extreme course that endangers the long-term economic health of our nation."

The question of whether to make the tax cuts permanent is still on the Congressional agenda. So it is an opportune moment to examine the president's argument in support of them.

Mr. Bush never pretended that the tax cuts were needed to make life more comfortable for the well to do. After all, with the bulk of all pretax income gains having gone to top earners in recent years, this group has prospered as never before.

Rather, the president portrayed his tax cuts as the linchpin of his economic stimulus package. He argued that because most new jobs are created by small businesses, tax cuts to the owners of those businesses would stimulate robust employment growth. His policy thus rests implicitly on the premise that if business owners could afford to hire additional workers, they would. But whether owners can afford to hire is not the issue. What matters is whether hiring will increase their profits.

The basic hiring criterion, found in every introductory textbook (including those written by the president's own economic advisers), is straightforward: If the output of additional workers can be sold for at least enough to cover their salaries, they should be hired; otherwise not. If this criterion is met, hiring extra workers makes economic sense, no matter how poor a business owner might be. Conversely, if the criterion is not satisfied, hiring makes no economic sense, even for billionaire owners. The after-tax personal incomes of business owners are irrelevant for hiring decisions.

The president's defenders might respond that business owners often need money up front to cover the hiring and training costs incurred before new workers can effectively contribute to extra production. The tax cuts put that money in their pockets. That is true but does nothing to alter the basic hiring rule.

Owners who used their tax cuts to finance the initial costs of new hiring would be acting, in effect, as their own bankers, lending money to themselves in the hope of future returns. The test for whether such internal loans make economic sense is exactly the same as the test for external loans.

A loan from a bank makes sense if the firm's ultimate gain from hiring extra workers is enough to cover not only their salaries but also repayment of the loan plus interest. Internal loans must meet the same standard. They are justified only if the firm's gain from hiring extra workers is enough to cover their salaries and repayment of the loan, including the interest that owners could have earned had they left their tax cuts in the bank. In hiring decisions, the implicit costs of internal loans have exactly the same economic standing as the explicit costs of external loans.

In brief, the president's claim that tax cuts to the owners of small businesses will stimulate them to hire more workers flies in the face of bedrock principles outlined in every introductory economics textbook.

A second way the Bush tax cuts might have stimulated employment is by inducing the wealthy to spend more on consumption. But a large share of the tax windfalls received by the wealthy are not spent in the short run. And even among those who are induced to spend more, the main effect is not increased demand for domestically produced goods and services, but rather increased bidding for choice oceanfront property and longer waiting lists for the new Porsche Carrera GT. Such spending does little to stimulate domestic employment.

Had the dollars required to finance the president's tax cuts been used in other ways, they would have made a real difference. Larger tax cuts for middle- and low-income families, for example, would have stimulated immediate new spending because the savings rates for most of these families are low. And their additional spending would have been largely for products made by domestic businesses - which would have led, in turn, to increased employment.

Grants to cash-starved state and local governments would have prevented layoffs of thousands of teachers and police officers. And many useful jobs could have been created directly. For instance, people could have been hired to scrutinize the cargo containers that currently enter the nation's ports uninspected.

Economists from both sides of the political aisle argued from the beginning that tax cuts for the wealthy made no sense as a policy for stimulating new jobs. And experience has proved them right. Total private employment was actually lower in January 2005 than in January 2001, the first time since the Great Depression that employment has fallen during a president's term of office.

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