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Link Between Taxation, Unemployment Is Absent

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When President Bill Clinton raised taxes in 1993, the unemployment rate dropped, from 6.9 to 6.1 percent, and kept falling each of the next seven years. When President Bush cut taxes in 2001, the unemployment rate rose, from 4.7 to 5.8 percent, then drifted to 6 percent last year when taxes were cut again.

It has become conventional wisdom in Washington that rising tax burdens crush labor markets. Bush castigated his political opponents last week for "that old policy of tax and spend" that would be "the enemy of job creation."

Yet an examination of historical tax levels and unemployment rates reveals no obvious correlation.

"The fact of the matter is, we have much higher rates of employment today than we did in 1954, but our level of taxation is considerably higher," said Gary Burtless, a labor economist at the Brookings Institution. "You simply can't look at total taxation to find employment levels."

The issue has become particularly relevant as Congress debates budget resolutions that would extend tax cuts that otherwise would expire over the next five years, and as Bush clashes daily with Sen. John F. Kerry (Mass.), his Democratic rival, over tax policies and job creation. The Senate voted Wednesday night to place new barriers on future tax cuts.

Republican economists -- and White House officials -- contend that higher marginal tax rates stifle business investment, hiring and the desire to work.

Senior Treasury Department officials said the correlation is "standard macroeconomics" dating to the Kennedy administration. Last year's surge in economic growth can be timed to the week that tax refunds arrived in American mailboxes, they said.

"The bottom line is, cuts in taxes lead to economic growth, which leads to improvements in the labor market to levels that are better than they otherwise would have been," said Mark J. Warshawsky, acting assistant Treasury secretary for economic policy.

But finding the proof in historical data is difficult, conceded Eric M. Engen, a Republican economist at the American Enterprise Institute.

"If you could hold everything else constant, yes," the correlation would be there, he said. "But everything else isn't the same. That's the big problem that economists have always had."

Engen cautioned that total tax takes are affected by economic growth as well as tax levels. A booming economy -- driven not just by tax issues but also by interest rates, trade policies, inflation rates and other factors -- will pump money into the government's coffers as it pushes unemployment down, he said.

Still, Burtless noted, some prominent conservative economists, including Harvard University's Martin S. Feldstein, predicted wrongly that the Clinton tax cuts would choke off the 1990s recovery and kill jobs, while the millions of new jobs that Bush said his $1.7 trillion in tax cuts would generate have not materialized. The historical disconnect does not stop there.

In 1964, federal taxation as a share of the economy stood at 17.5 percent, while unemployment was at 5.2 percent. That year, income taxes were slashed, lowering the tax rate in 1965 to 17 percent of the economy. Unemployment dropped as well, to 4.5 percent.

But then tax levels rose sharply, to 19.7 percent of the economy in 1969, while unemployment fell steadily, to 3.5 percent.

In 1981, President Ronald Reagan again slashed taxes. Taxation fell from 19.6 percent of the economy that year to 17.4 percent in 1983. The unemployment rate, however, rose over that period, from 7.6 percent to 9.6 percent. By 1989, taxation had drifted upward again, to 18.3 percent of the economy, but unemployment had fallen to 5.3 percent.

Total taxation in Sweden, including local taxes, is equal to 59.2 percent of that country's economy, the highest level in the 27-member Organization for Economic Cooperation and Development. In contrast, the U.S. total tax burden is 30.6 percent, lowest among the OECD members. Yet unemployment for the past two years in Sweden has been considerably lower than U.S. levels.

Burtless suggested that the issue is not tax levels but tax structures. Sweden has high taxation, but its generous social welfare system rewards citizens for the number of years spent working.

The Clinton tax increase was focused on upper-income households, but it included a sizable increase in the earned income credit for low-wage workers, making it more profitable for them to find and keep jobs.

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