"The Budget and the Economy"
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Mr. Chairman and Members of the Committee, it is an honor to appear before you to discuss the interactions between the budget and the economy. The focus of my testimony is the economic and budgetary effects of the tax cuts that were passed as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), but that have not yet been implemented.

An appendix table to this testimony presents the major provisions in EGTRRA by the year in which they take effect. Assuming that all the sunsets in the legislation are removed, the long-term cost of the tax bill as a whole is roughly 1.6 percent of GDP.[2] About half of that long-term cost reflects provisions that are already in effect, and the other half reflects provisions that take effect after 2002.

The tax cuts that have already taken effect have supported aggregate demand in the economy at a time when such stimulus was beneficial. For example, the rebates sent out in August and September provided timely stimulus to the economy by helping to boost consumer spending in a weak economy. The early evidence, however, suggests the beneficial impact was likely to have been quite modest. The evidence suggests that most households saved, rather than spent, the rebates. [3]

The focus of my testimony, however, is the tax cuts that are scheduled for future years, not the ones already in place. Although the future scheduled tax cuts have some benefits, their economic costs outweigh their economic benefits in both the short run and the long run.

To summarize my results:

- The tax cuts scheduled for the future raise long-term interest rates and therefore impede economic activity today. The important linkage between future fiscal policy and long-term

[1] The views expressed in this testimony are those of the author and should not be attributed to the staff, officers or trustees of the Brookings Institution. I thank Robert Cumby, William Gale, Robert Greenstein, Richard Kogan, and Gene Sperling for helpful discussions, and David Gunter and Jennifer Derstine for excellent research assistance. For further discussion of many of these issues, see Peter Orszag and Robert Greenstein, "Future Tax Cuts and the Economy in the Short Run," Center on Budget and Policy Priorities, January 28, 2002.

[2] This figure reflects the present value of the tax cut relative to the present value of GDP over the next 75 years, using the same discount rate as applied by the Social Security actuaries under their intermediate cost estimates for that period and assuming that all sunsets in EGTRRA are removed.

[3] See Matthew Shapiro and Joel Slemrod, "Consumer Response to Tax Rebates," NBER Working Paper 8672, December 2001. It should be noted that the tax cuts already in effect have contributed to higher long-term interest rates (as have the tax cuts not yet in effect), so the net impact on the economy in the short run from the already implemented cuts is unclear and may not be positive.

interest rates is recognized in all major macroeconomic models (such as that of the Federal Reserve), as well as in analyses by such noted policy-makers and economists as Chairman Greenspan, former Secretary Rubin, the Council of Economic Advisers under the Reagan Administration and the (first) Bush Administration, Professor Martin Feldstein of Harvard, and Professor John Taylor (the current Undersecretary of the Treasury for International Affairs).

- Any short-run benefit from the scheduled future tax cuts -- which could arise if the tax cuts induced households to spend today based on the expectation of lower taxes in the future -- is likely to be minimal. Evidence, including from the phase-in of the 1981 Reagan tax cuts, strongly suggests that households do not respond to tax cuts until they take effect. In any case, any potential positive effect in the short run from future tax cuts is likely to be dominated by the negative effect from higher interest rates.

- The long-run benefits of the tax cuts scheduled for the future are similarly minimal because any positive incentive effects from lower tax rates in the long run are offset by the adverse effects from lower national saving. The overall effect of the yet-to-be-implemented tax cuts on economic activity in the long run may, if anything, be negative.

- The nation faces severe budgetary pressures as the baby boomers begin to retire. The tax cuts scheduled for the future make these budgetary pressures more severe. For example, the tax cuts not yet implemented cost about 0.8 percent of GDP in present value over the next 75 years, which is slightly larger than the projected deficit in Social Security over the same period. In addition, the future tax cuts disproportionately benefit high-income households, raising the issue of whether proceeding with the scheduled reductions will benefit high-income families (who will disproportionately enjoy the tax reductions) at the expense of low- and moderate-income families (who may disproportionately bear the burden of any spending reductions necessitated by the future tax cuts and the desire to avoid excessive debt levels).

- In light of the long-term budgetary pressures facing the nation, as well as the confusion created by the sunsets in EGTRRA, a possible compromise would freeze the tax cuts that have not yet taken effect while also removing the sunset on the tax cuts already in effect. More precisely, the compromise would freeze the tax cuts that have not yet been implemented until the projected 10-year surplus outside Social Security is as large as it was immediately following passage of the tax cut. But to clarify budget accounting and eliminate any ambiguity about whether the tax cuts already in effect will be continued, the compromise would also remove the sunsets on the tax cuts that have already been implemented.

Short-run economic effects of scheduled future tax cuts

The scheduled future tax cuts adversely affect the economy in the short run because financial markets are forward-looking, and the fiscal deterioration caused by the future tax cuts therefore raises long-term interest rates today. The increase in long-term interest rates, in turn, increases the cost of business investment and home mortgages – and restrains economic activity.

There are two ways to see how the scheduled tax cuts affect shorter-term interest rates in the future, and therefore affect longer-term interest rates immediately:

- First, one effect of the future tax cuts is that the government will be saving less than it otherwise would (i.e., it will be running smaller surpluses). As a consequence, the pool of saving available for investment will be reduced. Firms competing for this smaller pool of investment funds will push up the price of borrowing funds -- that is, raise future interest rates.

- An alternative, but fundamentally equivalent, way of grasping the relationship between the tax cut and interest rates recognizes that the amount of debt the government is projected to pay down in the future will be smaller (and the national debt will consequently be larger) as a result of the tax cut. The amount of Treasury bonds held by the public will therefore be higher in the future than it would be without the tax cut. To persuade investors to hold more bonds, the government will have to offer a higher interest rate.

The scheduled tax cuts thus exert upward pressure on future interest rates. Since financial markets determine long-term interest rates *today* largely on the basis of what they expect shorter-term interest rates to be in the future, the expected increase in shorter-term interest rates in the future drives up long-term interest rates now. By raising long-term interest rates now, tax cuts scheduled for the future discourage investment and interest-sensitive consumption, thereby impeding economic activity today.

Recent interest rate movements

It is perhaps instructive to review what has happened to interest rates recently. Over the past year, as the Federal Reserve has moved aggressively to bolster a weakening economy, short-term interest rates have declined sharply. Between the beginning of 2001 and the beginning of 2002, for example, the interest rate on 3-month Treasury bills fell from 5.5 percent to 1.7 percent.

Normally, when short-term rates decline, long-term interest rates tend to do so as well. Over the past year, however, long-term rates have remained fairly flat despite the steep decline in short-term rates. The interest rate on 10-year Treasury bonds actually increased slightly during 2001, from 5.0 percent to 5.2 percent. In other words, short-term interest rates have declined substantially but long-term rates have not.

Although the precise relationship may depend on many factors and fluctuates over time, long-term rates have tended to move by about half as much as short-term rates, on average, over the past two decades.[4] Based on this historical relationship, the 3.8 percentage point decline in short-term rates during 2001 should have corresponded to a decline in long-term rates of a bit

[4] A regression of the annual change in the 10-year constant maturity yield on the annual change in the 3-month constant maturity yield from 1982 to 2001 yields a coefficient on the change in the 3-month yield of 0.52 (using the Prais-Winston transformed regression estimator to address serial correlation in the errors). The coefficient is slightly lower if the time period is restricted to the late 1980s to the present, but is roughly 0.5 if the time period is restricted to the 1990s.

under two percentage points. Instead, long-term rates increased slightly. In other words, given the decline in short-term rates and the average historical relationship between changes in long-term rates and short-term rates, one would have expected long-term rates to be almost two percentage points lower than they are today.[5]

An alternative perspective is obtained by examining what happened during the 1990-1991 recession relative to what has happened thus far during the current recession. The current recession began in March 2001. In the nine months since March, short-term interest rates have fallen by 280 basis points (2.8 percentage points) and long-term rates have risen slightly. In the nine months following the beginning of the 1990-1991 recession, by contrast, short-term interest rates fell by 200 basis points (2 percentage points) and long-term rates fell by more than 40 basis points (0.4 percentage points). Based on this relationship from the 1990-1991 recession, we would have expected long-term rates to fall by about 60 basis points since March 2001. Instead, they rose by about 20 basis points – so that 80 basis points is "missing."

The upshot is that given the declines in short-term rates, one would have expected long-term rates to be somewhere between 80 basis points (based on the relationship between short rate and long rates from the 1990-1991 recession) and 200 basis points (based on the historical average relationship over the past two decades) lower than their current levels. To be sure, long-term rates remain relatively low today, which has helped to shore up the housing market, but they would have been expected to be lower given historical relationships and the decline in short-term rates.

This failure of long-term rates to decline with short-term interest rates has an adverse effect on the economy. For example, a decline of 100 basis points in mortgage rates would reduce the annual payment on a $150,000 mortgage by more than $1,000. The substantial decline in long-term rates that would have been expected, given the decline in short-term rates, would also boost investment spending, thereby spurring the economy. A critical question is *why* long-term rates have failed to decline.

The tax cut and long-term interest rates

Many factors influence interest rates, including fiscal policy, economic growth projections, investment expectations, savings trends, international capital flows, and expected inflation. It is difficult, if not impossible, to parse out precisely the specific impact of the various factors that affect interest rates. Nevertheless, Federal Reserve Chairman Alan Greenspan, former Treasury Secretary Robert Rubin, and others have concluded that the tax cut enacted last year appears to have played an important role in keeping long-term rates higher than they would otherwise be.

For example, in a speech delivered on January 11, 2002, Chairman Greenspan noted that "over the past year, some of the firmness of long-term interest rates probably is the consequence

[5] It should be noted that long-term rates did decline during 2000, and part of that decline in long-term rates could have reflected an anticipated decline in short-term rates during 2001. But short-term rates appear to have fallen by more than had been anticipated in late 2000. This story therefore does not explain the failure of long-term rates to decline in response to the unanticipated decline of short-term interest rates during 2001.

of the fall of projected budget surpluses and the implied less-rapid paydowns of Treasury debt."[6] In earlier Congressional testimony, Greenspan indicated there was "no question" that the tax cut enacted last year affected long-term interest rates.[7]

Secretary Rubin has similarly noted, "If you look at interest rates over the course of the last year, market interest rates, they, basically, have not come down, 5-year and 10-year government rates. Fixed rate mortgages rates did not come down last year. They came down vs. two years ago, but they did not come down over the course of last year. And I believe one factor responsible for that was the enormous deterioration in our fiscal position over time..."[8]

Furthermore, every major macroeconomic model -- such as the one used by the Federal Reserve -- suggests that the tax cut would raise long-term rates relative to what they would be in the absence of the tax cut.[9] For example, previously published results from the macroeconomic model used by the Federal Reserve Board, adjusted to reflect the size of the tax cut passed last year, would suggest that the tax cut would raise 10-year interest rates by between 56 basis points and 80 basis points after one year (i.e., by between 0.5 and 0.8 percentage point), and by between 77 and 112 basis points after 10 years.[10] I should emphasize that these figures reflect an interpretation of previously published estimates from the Federal Reserve, roughly adjusted to fit the cost of EGTRRA; they do not reflect an official estimate from the Federal Reserve of the effects of the tax cut.

In 1995, the Congressional Budget Office evaluated the impact of a fiscal shift that was somewhat larger (amounting to a cumulative reduction in the 10-year budget balance of roughly 2.6 percent of GDP) than the EGTRRA produced.[11] CBO concluded that the interest rate movement from such a fiscal policy change would not credibly amount to as much as 400 basis points (which was the estimate from the DRI macroeconomic model), but that "those who expect [budget shifts] to have little or no impact on interest rates probably overstate their case as

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[6] Alan Greenspan, "The Economy," Remarks at the Bay Area Council Conference, San Francisco, January 11, 2002. It is important to distinguish, as Chairman Greenspan does in his speech, the most recent uptick in long-term interest rates, which are now higher than they were in October 2001, from the fact that long-term rates failed to decline over 2001 as a whole. The more recent increase is likely tied to expectations of faster growth in the future, not the tax cut; the effects of the tax cut were already reflected in long-term rates by October and thus cannot explain the increase in rates since then. But, as Greenspan indicated, the tax cut likely played a significant role in keeping long-term rates as high as they already were in October.

[7] Testimony of Alan Greenspan before Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 24, 2001.

[8] Face the Nation, CBS, January 6, 2002.

[9] See William G. Gale and Samara R. Potter, "An Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," forthcoming, *National Tax Journal.*

[10] David Reifschneider, Robert Tetlow, and John Williams, "Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/US Perspective," *Federal Reserve Bulletin*, January 1999, Table 4. The figures in the text assume the tax cut amounts to between 1.1 and 1.6 percent of GDP. Over the next 10 years, the tax cut costs roughly 1.1 percent of GDP; over the next 75 years, it costs roughly 1.6 percent of GDP (in present value and assuming all sunsets are removed). See Richard Kogan, Robert Greenstein, and Peter Orszag, "Social Security and the Tax Cut: The 75-Year Cost of the Tax Cut is More than Twice as Large as the Long-term Deficit in Social Security," Center on Budget and Policy Priorities, revised December 13, 2001.

[11] See William G. Gale and Samara R. Potter, "An Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," forthcoming, *National Tax Journal.*

well."[12] CBO concluded that the budget shift it studied would change 10-year interest rates by 170 basis points after 5 years, with more modest interest rate changes in years one through four.[13] The implication is that EGTRRA would raise 10-year rates by about 90 basis points after five years.

In 1994, the Council of Economic Advisers used the Solow growth model, which is commonly used to study long-term economic performance, to examine the impact of the 1993 deficit reduction package on interest rates. It estimated that raising government saving by 1.75 percent of GDP would reduce interest rates by 200 basis points in the long-term.[14] The implication is that a permanent tax cut of 1.6 percent of GDP (as under EGTRRA) would ultimately raise long-term rates by about 180 basis points.

Despite these results from mainstream macroeconomic models and the considered judgment of experienced market observers like Alan Greenspan and Robert Rubin, some officials have argued that the tax cut has not played any role in keeping long-term rates high. When asked recently to respond to Greenspan's comments on long-term rates, for example, one top White House official responded: **"**I disagree with the implication here that it was the tax cuts."[15]

To support their argument that the tax cuts do not affect long-term interest rates, these officials contend that the econometric literature does not demonstrate a robust relationship between budget shifts and interest rates. To be sure, the results from the literature are mixed; one review of the literature noted that "it is easy to cite a large number of studies that support any conceivable position."[16] But it is assuredly *not* the case that the literature conclusively demonstrates that fiscal policy does *not* affect interest rates. The wide array of results found in the literature simply suggests that efforts to quantify any relationship between fiscal policy and interest rates have been flawed. As two leading economists, Douglas Elmendorf of the Federal Reserve and Gregory Mankiw of Harvard, conclude in a summary of the literature: "Our view is that this literature...is not very informative."[17]

In case you have any lingering doubts about the connection between long-term interest rates and fiscal policy, I would refer you to four impeccable sources: the Reagan Administration, the first Bush Administration, the current Undersecretary of the Treasury for International Affairs, and Professor Martin Feldstein of Harvard:

- In 1984, the Reagan Administration wrote: "Measures to reduce the budget deficit would lower real interest rates and thus allow the investment sector to share more fully in the

[12] Congressional Budget Office, "Analysis of the President's Budgetary Proposals for Fiscal Year 1996," April 1995, page 56.
[13] Congressional Budget Office, "Analysis of the President's Budgetary Proposals for Fiscal Year 1996," April 1995, Table B-2, page 53.
[14] Council of Economic Advisers, *Economic Report of the President*, February 1994, pages 81-87.
[15] Novak, Hunt, and Shields, CNN, January 12, 2002.
[16] B. Douglas Bernheim, "A Neoclassical Perspective on Budget Deficits," *Journal of Economic Perspectives*, Spring 1989.
[17] Douglas Elmendorf and Gregory Mankiw, "Chapter 25: Government Debt," in *Handbook of Macroeconomics* (1998), page 1658.

recovery that is now taking place primarily in the government and consumer sectors."[18] The same logic would suggest that reducing future surpluses would raise real interest rates and discourage investment.

- In analyzing the 1990 budget agreement, the Bush Administration -- that is, the first Bush Administration -- wrote: "The new budget law, for example, reduces the budget deficit from what otherwise would be expected. Economic theory and empirical evidence indicate that expectations of deficit reduction in future years, if the deficit reduction commitment is credible, can lower interest rates as financial market participants observe that the government will be lowering its future demand in the credit market. That can mitigate a potential short-run contractionary effect. In other words, expectations of lower interest rates in the future will lower long-term interest rates today. Lower long-term interest rates will reduce the cost of capital, stimulating investment and economic growth relative to what would be predicted if expectations were ignored."[19]

- John Taylor, the current Undersecretary of the Treasury for International Affairs, constructed a sophisticated, forward-looking, multi-country model that contained strong linkages between fiscal policy shifts and long-term interest rates. He estimated that a fiscal policy tightening that amounted to 3 percent of GDP would reduce long-term interest rates by more than 150 basis points in the long run.[20]

- Professor Martin Feldstein of Harvard has attempted to overcome one of the shortcomings of the econometric literature by including a measure of projected deficits in his analysis. (One reason that the literature is not particularly informative is that, as noted above, expectations of future fiscal surpluses or deficits have important effects on interest rates, but many econometric analyses ignore them.) A paper by Feldstein finds a large effect on interest rates; he concludes that "each percentage point increase in the five-year projected ratio of budget deficits to GNP raises the long-term government bond rate by approximately 1.2 percentage points…"[21]

The bottom line is that unless the major macroeconomic models -- as well as the analyses of Chairman Greenspan, Secretary Rubin, the Reagan Administration, the (first) Bush Administration, Professor Taylor, and Professor Feldstein -- are wrong, the conclusion must be that the tax cut has played some role in the failure of long-term rates to decline over the past year. Indeed, my conclusion from the major macroeconomic models is that the tax cut as a whole may be keeping long-term rates between 50 and 100 basis points higher than they would otherwise be, and may ultimately raise long-term rates by between 75 and 200 basis points.

The same reasoning suggests that the scheduled future tax cuts alone are keeping long-term rates higher than they would otherwise be. Indeed, since the scheduled future cuts represent

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[18] Council of Economic Advisers, *Economic Report of the President*, February 1984, page 62.
[19] Council of Economic Advisers, *Economic Report of the President*, February 1991, page 64.
[20] John Taylor, *Macroeconomic Policy in a World Economy* (WW Norton: New York, 1993), pages 270-273. It should be noted that Taylor explicitly modeled a reduction in government purchases, not a change in taxes.
[21] Martin Feldstein, "Budget Deficits, Tax Rules, and Real Interest Rates," Working Paper No. 1970, National Bureau of Economic Research, July 1986, page 48.

about half of the long-term cost of the tax package as a whole, the estimates above would suggest that the scheduled future cuts themselves are keeping long-term rates between 25 and 50 basis points higher than they would be in the absence of the scheduled future reductions, and may ultimately raise long rates by between 35 and 100 basis points.

The failure of long-term rates to decline impedes economic activity today. It raises the costs of home mortgages, and discourages both interest-sensitive consumption and business investment.

Positive short-run effects from future scheduled tax reductions

Administration officials not only deny the adverse immediate consequences of future tax cuts through this interest rate effect. They also argue affirmatively that future tax cuts spur economic activity in the short run. For example, Bush economic adviser Lawrence Lindsey argues in a recent op-ed article that expected future tax reductions have a *positive* effect on the economy in the short run.[22]

Some supporters of the future tax cuts are internally inconsistent on this issue. They simultaneously argue that the future tax cuts will not raise interest rates, by invoking a theory under which households offset expected budget shortfalls in future years by saving more today, and that the future tax cuts will spur spending today. But if households must raise their saving to fully offset the impact of the tax cut on the budget in future years, they could not also increase their spending today in response to the tax cut. These two arguments contradict each other.[23]

More importantly, the argument that future tax cuts have significant effects on economic activity today is belied by several studies of previous policy changes that were announced before they were implemented. These studies strongly suggest that people tend *not* to spend tax cuts prospectively; instead, they largely wait until the money is in their pockets.[24]

For example, one recent paper examined the Reagan tax cuts; those tax cuts took effect in phases, with one set of tax reductions occurring in October 1981, another set occurring in July 1982, and a third set of cuts taking effect in July 1983. The paper found that households generally did not increase their spending until the tax cuts actually were in effect.[25] Another paper, by economist James Poterba of MIT, studied the 1975 tax rebate, which was announced before it was paid. This research, too, concluded that "consumers do not adjust consumption in anticipation of tax changes."[26] Still other research by David Wilcox of the Federal Reserve

[22] Lawrence B. Lindsey, "Why We Must Keep the Tax Cut," *Washington Post*, January 18, 2002, Page A25.

[23] It is also worth noting that a reduction in future tax rates could induce individuals to substitute work effort from the current period into the future period. Many supporters of EGTRRA believe that individuals are highly responsive to tax rates, which would make this concern loom larger than if individuals were (as my interpretation of the empirical evidence suggests) largely unresponsive to marginal tax rate changes.

[24] One factor suggesting a somewhat stronger short-run effect from the future tax cuts is that those tax cuts disproportionately accrue to higher-income families, who are less likely to be liquidity constrained than lower-income families. On the other hand, higher-income families may also have a lower marginal propensity to consume out of permanent income, mitigating the short-run impact.

[25] Nicholas Souleles, "Consumer Response to the Reagan Tax Cuts," forthcoming, *Journal of Public Economics*.

[26] James Poterba, "Are Consumers Forward Looking? Evidence from Fiscal Experiments?" *AEA Papers and Proceedings* (1988), pages 413-418.

Board suggests that households do not respond to announced changes in Social Security benefits until the cash is actually in their hands.[27] The evidence strongly suggests that households do not respond much to tax cuts or other policy changes until the cash is in their hands. These findings suggest that any short-run stimulus to spending from tax cuts that will not take effect until future years is quite limited. And to my knowledge, the idea that future tax cuts will raise saving now receives no support from the literature whatsoever.

In summary, the overall net effect on the economy from tax cuts scheduled for the future is likely to be negative in the short run. The adverse impact from higher long-term interest rates is considerably larger than any small, positive impact that may result from increased spending now in response to future tax cuts.

Long-run economic effects of scheduled future tax cuts

The analysis above has focused on the short-run effects from the future scheduled tax cuts. This section briefly analyzes the longer-run effects. It first examines the longer-run economic effects from the future scheduled tax cuts, and then turns to the longer-run budgetary effects.

Economic effects in the long run

The short-run economic costs of the future scheduled tax cuts may be worth bearing, even though the economy is currently in a recession, if the impact of those cuts on economic activity in the long run were positive and substantial. Unfortunately, however, the available evidence suggests that the long-run economic benefits from the future scheduled tax cuts are likely to be minimal, and the overall long-run effect may even be negative.

Some proponents of the tax cut package -- including the tax cuts scheduled for the future under EGTRRA -- argue that it will significantly raise economic output in the long run by cutting marginal tax rates. For example, a Heritage Foundation report argued, "Because of steep personal income tax rates, highly productive entrepreneurs and investors can take home only about 60 cents of every dollar they earn, not including state and local taxes or other federal taxes. This reduces the incentive to be productive. Lower tax rates will reduce this 'tax wedge' and encourage additional work, savings, investment, risk-taking, and entrepreneurship."[28]

The basic logic of this argument is that reducing marginal tax rates can increase the incentives to work, to take risks, and to save, all of which can encourage additional economic activity.[29] The crucial question, however, is the *size* of these effects. The most recent academic

[27] David Wilcox, "Social Security Benefits, Consumption Expenditure, and the Life Cycle Hypothesis," *Journal of Political Economy* (1989), pages 288-304.

[28] Daniel Mitchell, "Reducing Tax Rates Across the Board: A Cornerstone of Pro-Growth Tax Relief," Heritage Foundation Report No. 711, January 16, 2001.

[29] It is worth noting that even theoretically, the impact of tax reductions on work effort, risk-taking, and saving can be ambiguous.

evidence suggests that marginal tax rate reductions would have only modest effects on future economic activity in the long run.[30]

Tax cuts, furthermore, have an important downside from an economic standpoint: they reduce national saving. Tax cuts result in lower national saving because funds used for the tax cuts would primarily result in increased consumption, while funds used to pay down debt primarily increase savings. The fundamental benefit of higher national saving is that it will expand income in the future. Higher national saving leads to higher investment, which means that future workers have more capital with which to work and are more productive as a result.[31] The increased productivity generates a larger economy, a higher national income, and a higher standard of living in the future.[32]

In evaluating the impact of the future tax cuts on long-run economic performance, one must include both any potential positive effects from reducing marginal tax rates *and* the negative effects from reducing national saving.

Studies that have examined EGTRRA as a whole have generally found minimal long-term benefits.[33] For example, an early paper that I wrote (before the tax legislation was passed) concluded that the benefits of the lower tax rates from EGTRRA would raise economic output in 2012 by 0.5 percentage points, but that the reduction in national saving caused by the tax cut could reduce real GDP in 2012 by between 0.6 and 0.9 percentage points.[34] The overall effect was thus a small *reduction* in GDP in 2012, because the benefits of the marginal tax rate changes were too small to offset the costs of the fall in national saving. The Congressional Budget Office has similarly concluded, "The cumulative effects of the new tax law on the economy are uncertain but will probably be small. Labor supply may rise modestly as a result of the reductions in marginal tax rates (the rates that apply to the last dollar earned); however, national saving may fall. Whether the tax cut will raise or lower real (inflation-adjusted) gross domestic product (GDP) in the long run is unknown, but any effect is likely to be less than half of a percentage point in 2011."[35] Finally, an authoritative examination of the tax legislation by

[30] See the summaries of the relevant literatures in Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform* (MIT Press: Cambridge, 1996).

[31] More precisely, higher national saving today increases national income in the future regardless of whether the increase in national saving is absorbed in higher domestic investment or net foreign investment. In the latter case, the increase in future income would reflect an increase in receipts from abroad (relative to the baseline), rather than an increase in domestic output.

[32] For a specific application in the context of the recent budget debates, see Peter R. Orszag, "The Budget and Long-term Fiscal Policy," Committee on the Budget, U.S. Senate, February 7, 2001.

[33] These estimates apply to EGTRRA as a whole. But even if *all* the positive long-run benefits from EGTRRA arose from the tax cuts that are not yet in effect -- which is clearly a gross overestimate of the economic benefits from those future tax cuts -- the net effect of those future tax cuts on the economy in the long run would still be roughly zero. In other words, the available evidence suggests that the long-run economic gains from the future tax cuts would be minimal at best, because the adverse effects from reduced national saving offset the beneficial effects from reduced tax rates.

[34] Peter R. Orszag, "Marginal Tax Rate Reductions and the Economy: What Would Be The Long-Term Effects of the Bush Tax Cut?" Center on Budget and Policy Priorities, March 15, 2001.

[35] Congressional Budget Office, "The Long-Term Macroeconomic Effects of the Economic Growth and Tax Relief Reconciliation Act of 2001," Box 2-3, *The Budget and Economic Outlook: An Update*, August 2001.

William Gale and Samara Potter of Brookings has concluded that the overall impact on economic activity in the long run will be minimal, and may well be negative.[36]

Budget effects in the long run

In addition to its long-term economic effects, we should consider the impact of the future tax reductions on the budget itself. As Director Crippen emphasized in recent testimony before this Committee, budgetary pressures are severe over the longer term. As he noted, "long-term pressures on spending loom just over the horizon…According to midrange estimates, if current policies continue, spending on Social Security, Medicare, and Medicaid combined will nearly double by 2030, to almost 15 percent of GDP. Taking action sooner rather than later to address long-term budgetary pressures can make a significant difference."[37]

The tax cuts scheduled for the future under EGTRRA, assuming they are continued after 2010, are large relative to the projected fiscal gaps over the next 70 to 75 years. Economists define the "fiscal gap" as the magnitude of the immediate and permanent increase in taxes or reduction in primary expenditures that would be required to keep the long-run ratio of government debt to GDP at its current level given other current policies. In other words, the fiscal gap basically measures the projected long-term imbalance in the budget as a share of GDP.

Alan Auerbach of the University of California at Berkeley and William Gale of Brookings have estimated the fiscal gap through 2070 using CBO baseline assumptions about discretionary spending (which assume that discretionary spending remains constant in real terms for the next decade and then remain constant as a share of GDP thereafter).[38] Before passage of EGTRRA, Auerbach and Gale estimated that the fiscal gap through 2070 amounts to 0.67 percent of GDP.[39] The provisions of the tax cut that have already been implemented more than double that gap, to about 1.5 percent of GDP. The tax cuts scheduled for the future would raise it still further, to about 2.3 percent of GDP.

In other words, the tax cuts scheduled for the future would increase the long-term fiscal gap from about 1.5 percent of GDP to about 2.3 percent of GDP. To be sure, these types of calculations are subject to substantial uncertainty. But such uncertainty does not change the basic conclusion that the scheduled tax cuts represent a significant share of the nation's long-term fiscal imbalance. In any case, uncertainty should make us even more hesitant to proceed with policy changes that significantly reduce revenue or raise expenditures.[40]

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[36] William G. Gale and Samara R. Potter, "An Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," forthcoming, *National Tax Journal*.

[37] Daniel Crippen, "The Budget and Economic Outlook: Fiscal Years 2003-2012," Testimony before the Committee on the Budget, United States Senate, January 23, 2002.

[38] Alan J. Auerbach and William G. Gale, "Tax Cuts and the Budget," *Tax Notes* 90, March 26, 2001, pages 1869-82.

[39] This figure is subject to substantial uncertainty. For example, it is extremely sensitive to assumptions about discretionary spending trends: Assuming that discretionary spending would remain constant as a share of GDP from today forward, rather than only from 2011 forward, raises the fiscal gap to 1.45 percent of GDP over the next 70 years.

[40] See, for example, Alan Auerbach and Kevin Hassett, "Uncertainty and the Design of Long-Run Fiscal Policy," NBER Working Paper 7036, March 1999.

Another perspective on the cost of the tax cuts scheduled for the future is that their cost over the next 75 years -- about 0.8 percent of GDP -- is slightly larger than the projected imbalance in Social Security over the same period.[41] According to the Social Security actuaries, the 75-year projected deficit in Social Security (under the intermediate cost assumptions) amounts to roughly 0.7 percent of GDP. In other words, freezing the future tax cuts and using the funds instead as general revenue transfers to the Social Security system would eliminate the deficit in Social Security over the next 75 years.[42] To be clear, I am not advocating such a policy as the only "solution" to addressing Social Security's deficit, but it does help to put the size of the scheduled tax cuts in perspective.

The Social Security comparison also helps to highlight a crucial distributional concern: The tax cuts scheduled for the future will accrue disproportionately to higher-income taxpayers. Yet the budget cuts that may be required if the tax cuts are implemented would likely be borne disproportionately by lower-income and middle-income families.

Conclusion

In conclusion, the tax cuts scheduled for the future are likely restraining the economic recovery in the short run – by keeping long-term rates higher than they would otherwise be -- and they would do little to boost economic output in the long run because any positive incentive effects would be offset by reduced national saving. They would also add significantly to the long-term budget challenge facing the nation.

Let me therefore put forward a possible compromise that my colleague William Gale and I have advocated. The tax cuts embodied in EGTRRA expire in 2010. The debate at this point is whether those cuts should be restricted or made permanent. Senator Kennedy recently proposed that some of the already-legislated future tax cuts for high-income households be frozen to help pay for a variety of social programs. The Administration, however, opposes any trimming of the tax cut and instead wants to make the tax cuts permanent.

Here are two things that both sides would have to agree upon:

- First, whatever one thought about whether the tax cuts were affordable last year, it has to be the case that they are less affordable now. After all, since then, the economic outlook has soured, homeland security and anti-terrorism spending needs have become apparent, and budget surpluses have withered.

[41] For more on comparing the tax cut and the long-term deficit in Social Security, see Richard Kogan, Robert Greenstein, and Peter Orszag, "Social Security and the Tax Cut," Center on Budget and Policy Priorities, Revised December 13, 2001.

[42] Under the Social Security actuaries' intermediate projections, the projected 75-year deficit amounts to 1.86 percent of taxable payroll. Over this 75-year-period, taxable payroll will amount to 37.6 percent of the Gross Domestic Product when both are expressed in present value. As a result, the 75-year imbalance amounts to 0.7 percent of GDP, which is equal to 1.86 percent of taxable payroll multiplied by 37.6 percent. The figure of 0.7 percent of GDP appears in Table VI.E5 on page 150 of the Trustees Report of March 19, 2001.

- Second, the tax cuts that have already been implemented will be extremely difficult to reverse, even when they officially sunset in 2010.

In light of these lonely points of agreement, allow me to put forward a simple compromise: Make the tax cuts that are already in place permanent, but postpone the other ones until they are affordable. The artificial sunsets of the tax cuts that are already in effect should be removed. But none of the future tax cuts should be allowed to take effect until they are affordable. Specifically, any tax cuts not yet in effect should be frozen until the projected 10-year budget surplus outside of Social Security and Medicare grows to be at least as large (relative to the economy) as it was immediately following passage of the tax cut.

Since about half of the tax cuts are already in effect, the result gives each side of the tax debate half of what it wants: Half of the tax cut would be made permanent, and half would be frozen until it was clearly affordable. Freezing the future tax cuts until they are affordable -- while also making the existing tax cuts permanent -- would thus offer a little to both sides. And it would help to end the budget charade that has confused the debate over the nation's political and economic choices.

YEAR-BY-YEAR PROVISIONS UNDER THE ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

2001

- New 10% income tax bracket on the first $12,000 in taxable income for couples, $10,000 for single parents and $6,000 for others (no indexing for inflation).
- Income tax rates of 39.6%, 36%, 31% and 28% each reduced by one percentage point, effective July 1, 2001--in essence, a half point reduction for calendar 2001.
- Child credit increased from $500 to $600, with expanded refundability based on 10% of earnings above $10,000 (the $10,000 figure is adjusted in future years for inflation).

2002:

- Earned-income tax credit phase-out range increased by $1,000 for married couples ($1,000 is not indexed).
- Maximum expenses for child-care and maid-service credit raised from $2,400 to $3,000 for one child under 13 and from $4,800 to $6,000 for two or more children under 13; maximum credit rate increased from 30% to 35%; credit rate phased down to 20% between $15,001 and $43,001 in income rather than from $10,001 to $28,001.
- IRA annual contribution limit increased to $3,000 (from $2,000). Limit on elective deferrals raised from $10,000 to $11,000. Other retirement savings changes take effect. IRA tax credits for lower-income workers established.
- Alternative minimum tax exemptions increased by $4,000 for couples and $2,000 for singles.
- Top estate tax rate cut from 55% to 50%; recapture of lower rates repealed; estate tax credit converted to an exemption (worth more for larger estates) and exemption increased from $700,000 to $1 million (double those amounts for couples).

2003:

- Limit on elective retirement savings deferrals raised from $11,000 to $12,000.
- Top estate tax rate cut to 49%

2004:

- Top four income tax rates cut by an additional percentage point (to 37.6%, 34%, 29% and 27%).
- Limit on elective retirement savings deferrals raised from $12,000 to $13,000.
- Top estate tax rate cut to 48%. Exemption increased to $1.5 million (double that for couples).

2005:

- Child credit increased to $700, with further expansion in refundability, based on 15% of earnings above about $12,000 (the $12,000 figure will be adjusted for inflation in later years).
- Earned-income tax credit phase-out range increased by an additional $1,000 for married couples ($2,000 total increase is not indexed for inflation).
- Married standard deduction increased to 174% of the single amount (up from 167%).
- Starting point for the 26% tax bracket for couples increased to 180% of the single bracket starting point (up from 167% under prior law).

- IRA annual contribution limit increased to $4,000. Limit on elective deferrals raised to $14,000.
- Alternative minimum tax exemptions reduced by $4,000 for couples and $2,000 for singles.
- Top estate tax rate cut to 47%

2006:

- Top four income tax rates cut to 35%, 33%, 28% and 25%.
- Starting point for the 25% tax bracket for couples increased to 187% of the single bracket starting point.
- Married standard deduction increased to 184% of the single amount.
- Limit on elective retirement savings deferrals raised to $15,000 (indexed thereafter).
- Current law's phase-out of the personal exemption and disallowance of a portion of itemized deductions at high income levels are reduced by one-third.
- Top estate tax rate cut to 46%. Exemption increased to $2 million (double that for couples).

2007:

- Starting point for the 25% tax bracket increased for couples, to 193% of the single bracket starting point.
- Married standard deduction increased to 187% of the single amount.
- IRA tax credits for lower-income workers eliminated.
- Top estate tax rate cut to 45%.

2008:

- Earned-income tax credit phase-out range increased by an additional $1,000 for married couples ($3,000 total increase is indexed for inflation after 2008).
- Income amounts for the ten-percent tax bracket increased to $14,000 for couples and $7,000 for childless singles ($10,000 for single parents remains unchanged). Indexed for inflation starting the following year.
- Married standard deduction increased to 193% of the single amount.
- Starting point for the 25% tax bracket for couples increased to double the single bracket starting point.
- IRA annual contribution limit increased to $5,000 (indexed thereafter).
- Current law's phase-out of the personal exemption and disallowance of a portion of itemized deductions at high income levels are reduced by two-thirds.

2009:

- Child credit increased to $800.
- Married standard deduction increased to double of the single amount.
- Estate tax exemption increased to $3.5 million (double that for couples).

2010:

- Child credit increased to $1,000 (no indexing for inflation).
- Current law's phase out of the personal exemption and disallowance of a portion of itemized deductions at high income levels are fully repealed.
- Estate tax fully repealed (gift tax retained; limited carryover basis).

Source: Citizens for Tax Justice