taxanalysts tax break

by Alan J. Auerbach, William G. Gale, and Peter R. Orszag

The 2001 and 2003 Tax Cuts: A Response to Jenn and Marron

Alan J. Auerbach is Robert D. Burch Professor of Economics and Law and director of the Burch Center for Tax Policy and Public Finance at the University of California, Berkeley, and a research associate at the National Bureau of Economic Research. William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution and codirector of the Urban-Brookings Tax Policy Center. Peter R. Orszag is the Joseph A. Pechman Senior Fellow at Brookings and codirector of the Urban-Brookings Tax Policy Center. The authors thank Matthew Hall and Brennan Kelly for research assistance and Richard Kogan for helpful comments. All opinions and any mistakes are the authors' and should not be attributed to the staff, officers, or trustees of any of the institutions with which they are affiliated.

In previous work, we have estimated the long-term revenue costs of the 2001 and 2003 tax cuts, assuming they are made permanent and are not gradually eroded by the alternative minimum tax, and compared those costs to the actuarial deficits over an equivalent time period in Social Security and Medicare Part A. We found that the tax cuts would cost about 2 percent of GDP over a 75-year horizon (Auerbach, Gale, and Orszag 2004), an amount that is approximately the same size as the sum of the actuarial deficits in Social Security (0.7 percent of GDP) and Medicare Part A (1.4 percent of GDP) combined.

Jenn and Marron (2004) claim that the long-term cost of the 2001 and 2003 tax cuts is substantially lower. They reach this conclusion through a remarkably straightforward device: They simply assume the majority of the 2001 and 2003 tax cuts are not really tax cuts. More specifically, they postulate that the 2001 and 2003 tax cuts simply substitute for other tax cuts that would have occurred because policymakers will unfailingly adhere to an invariant revenue target as a share of GDP. That assumption, coupled with their best guesses about what the target is, leads to the conclusion that the tax cuts do not reduce revenue substantially: Because in the long term some other tax cuts would have occurred in place of the 2001 and 2003 tax cuts to keep revenue at the specified target, the tax cuts do not significantly reduce revenues.

Jenn and Marron also dispute our calculation that the long-term costs of the tax cuts are about the same size as the Social Security and Medicare Part A trust fund shortfalls. They obtain different results for two principal reasons: (a) they report much lower costs from the tax cuts for the reasons described above, and (b) they include all components of Medicare rather than just the part A trust fund that we examine.

This article is divided into three sections. The first explains our methods and results. The second examines the approach adopted by Jenn and Marron. A final section offers some brief conclusions.

I. Our Previous Analysis

A. Estimating the Long-Term Cost of Tax Cuts

Our preferred method for evaluating the long-term cost of any policy change, whether on the revenue or spending side of the budget, is to examine its impact on the fiscal gap. The fiscal gap measures the size of the immediate and permanent increase in taxes or reductions in noninterest expenditures, as a share of GDP, that would be required to establish the same debt-GDP ratio in the long run as holds currently (Auerbach 1994).[1] The change in the fiscal gap caused by implementation of a given policy provides the best indication of the long-term cost of that policy.

A key question in implementing this approach is the assumptions used to compute the fiscal gap before and after a specific policy is adopted. Our standard method is to start with the 10-year projections provided by the Congressional Budget Office, adjust these projections to reflect more realistic policy assumptions,[2] and then extend these adjusted 10-year projections for the period beyond 10 years using supplemental projections from CBO or other sources, depending on their availability. After the first decade, we assume that federal tax revenues and discretionary spending remain constant as a share of GDP at the shares prevailing in the 10th year of the budget window. CBO (2000) and GAO (2004) make the same assumption in undertaking long-term budget projections. We adopt Social Security and Medicare

[1]Over an infinite planning horizon, this requirement is equivalent to assuming that the debt-GDP ratio does not explode. Stated differently, the fiscal gap measures the size of the budget adjustments needed to set the present value of all future primary surpluses equal to the current value of the national debt, where the primary surplus is the difference between revenues and noninterest expenditures. Auerbach, Gale, and Orszag (2004) provide recent estimates of the fiscal gap. Auerbach, Gale, Orszag, and Potter (2003) discuss the relationship between the fiscal gap, generational accounting, accrual accounting, and other ways of accounting for government.

[2]These adjustments are needed because CBO's methods follow a variety of rules and customs and are not intended to reflect current policy in any but the most mechanical manner.

spending projections for the period after 2014 directly from the 2004 Trustees Reports' intermediate projections, and base Medicaid spending projections on those from Scenario 2 of CBO's most recent long-term projections (CBO 2003).[3] After 75 years, spending in these three categories is assumed constant at the shares of GDP in the 75th year. Interest payments are determined by debt accrual and interest rates, with the gap between the nominal interest rate and the GDP growth rate based on the intermediate projections of the Social Security Trustees.

To examine the long-term budgetary effects of the tax cuts, we assume that the revenue loss remains constant as a share of GDP after 2014. Under these assumptions, the tax cuts raise the fiscal gap by 2.2 percent of GDP through 2080 and over an infinite horizon (Auerbach, Gale, and Orszag 2004).[4] Contrary to an assertion in Jenn and Marron, the analysis undertaken by us, CBO (2000), and GAO (2004) does *not* assume that revenue continues to increase as a share of GDP after a decade. Instead, these analyses assume that revenue is maintained at the share of GDP attained in the 10th year of the budget window. Tax cuts that reduce revenue as a share of GDP in that 10th year are assumed to reduce long-run revenue by the same share of GDP — in this case, 2 percent.

Other analyses make the assumption that Jenn and Marron assert we have made: They project tax revenue into the distant future based on projections of demographic and economic variables. This approach does indeed show an increasing share of GDP in revenue over time, mostly because of real bracket creep. Analyses adopting this approach include Gokhale and Smetters (2003), who assume that individuals' tax payments depend on their age and sex (and that this relative function stays constant over time). The Office of Management and Budget (2004), in the *Analytical Perspectives* section of the administration's budget, uses a similar approach to project administration policy far into the future.

For our immediate purposes, the key point is that the estimated size of a tax cut over the long term will be similar under our approach and under these alternative approaches. If anything, given the same assumptions about how the alternative minimum tax is addressed and revenue lost in each of the first 10 years, the approach adopted by Gokhale and Smetters (2003) and also by OMB (2004) should generate a somewhat *larger* estimate of the cost of the tax cuts than our approach.[5]

B. Trust Fund Shortfalls

As noted above, we compared the size of the tax cut to the size of the actuarial shortfall in Social Security and Medicare's Part A (Hospital Insurance) program. Those programs are financed almost exclusively from payroll taxes. According to the 2004 Trustees Reports, the actuarial deficit in Social Security is 0.7 percent of GDP and the actuarial deficit in Social Security and Medicare's Hospital Insurance combined amounts to roughly 2.1 percent of GDP over the next 75 years. As noted above, our estimate of the cost of the tax cuts (estimated with the same growth and discount rate assumptions as in the estimates of trust fund shortfalls) is slightly more than 2 percent of GDP over the same time period. In other words, the tax cuts are substantially larger than the actuarial deficit in Social Security over the next 75 years, and about the same size as the *combined* actuarial deficit in Social Security and Medicare's Hospital Insurance program.

Jenn and Marron assert that the shortfall in Social Security and Medicare is much larger because they add the projected net expenditures on Medicare Part B and Part D over the next 75 years to the projected deficits in Social Security and Medicare's Hospital Insurance program. There are two problems in using their calculation to critique our work. First, as noted above, it is simply making a different comparison than the one we made.

Second, as we discuss in Auerbach, Gale, and Orszag (2004), the approach Jenn and Marron have taken makes little sense. Roughly three-quarters of Medicare's Part B program and its entire Part D program are *supposed* to be financed by general revenue, just like defense spending or nondefense discretionary spending. Yet the calculation by Jenn and Marron allocates no general revenue to the health programs. The obvious flaw in this approach is immediately apparent from Table 4 in Auerbach, Gale, and Orszag (2004): Because Jenn and Marron do not allocate any general revenue to any budget category, the fiscal gap from all spending programs is substantially larger than the overall fiscal gap. Indeed, ''general revenue'' under this approach is running a massive projected ''surplus'' amounting to more than 12 percent of GDP (or more than $100 trillion in present value) over an infinite horizon. Failing to allocate tens of trillions in general revenue in present value creates a misleading impression regarding the programmatic contributions to the fiscal gap. This issue is examined in more detail in Auerbach, Gale, and Orszag (2004).

II. The Jenn-Marron Approach

Jenn and Marron reject the approach to undertaking long-term projections adopted by OMB (2004), CBO (2000), GAO (2004), and Gokhale and Smetters (2003), as well as the approach we use. Instead, they argue that the cost of the tax cuts is merely the degree to which they cause revenue to decline below one of three shares of

[3]Scenario 2 assumes that medical costs per beneficiary increase at 1 percent per year faster than per capita GDP growth, which is the same long-term assumption made in the Medicare trustees' projections. The CBO projections end in 2050. After 2050, we assume that Medicaid spending grows at the same rate as Medicare. CBO (2004) provides a different set of Social Security projections. Incorporating these projections would have little effect on the main results presented here.

[4]Greenstein, Orszag, and Kogan (2004) estimate a slightly lower figure, 2 percent of GDP over 75 years, mostly because of a slightly different AMT assumption than in Auerbach, Gale, and Orszag (2004).

[5]The reason is that the tax cuts provide relatively larger reductions in taxes at higher real incomes than at lower real incomes. Real bracket creep should thus raise the cost of the tax cuts over time. Furthermore, the revenue loss from repealing the estate tax is likely to rise as a share of GDP.

(Footnote continued in next column.)

GDP: 17.9 percent, 18.4 percent, or 19 percent.[6] For example, consider the 19 percent threshold. If revenue were projected to be 20 percent of GDP forever, and policymakers enacted policy changes that reduced revenue by 1.5 percent of GDP, Jenn and Marron argue that the long-term cost of the tax cut is only 0.5 percent (since revenue would wind up 0.5 percent below the 19 percent threshold). Under the same assumptions, a policy change that reduces revenue by 1 percent of GDP (from 20 percent to 19 percent) would have no long-term cost under the Jenn-Marron approach.

The rationale that Jenn and Marron offer for that approach is that policymakers have some intended share of GDP that should be collected in revenue over the long term. Therefore, ''tax cuts that lower revenues below previously intended or desired levels have fiscal 'costs'. . . . Tax cuts that rein in unintended tax growth, on the other hand, do not impose such costs.'' They then define different ''intended'' shares of GDP through various historical comparisons, such as the average ratio of taxes to GDP in the postwar era.

That is the reason that Jenn and Marron assert that the long-term cost of the tax cuts is lower than previous studies have found: Under their view, the tax cuts are simply substituting for other tax cuts that would have occurred to bring revenue to the intended threshold. The tax cuts are thus not really tax cuts, because they do not reduce revenue relative to the assumed alternative. Not surprisingly, Jenn and Marron conclude that the tax cuts, which have effectively been assumed away, are not costly.

The Jenn and Marron approach contains several fundamental flaws: First, as suggested by the discussion above, the Jenn-Marron approach induces Orwellian discussions in which ''tax cuts'' do not reduce revenue (even on a completely static basis). Even the discussion in Jenn and Marron betrays this semantic confusion: Jenn and Marron talk repeatedly about the 2001 and 2003 tax cuts, but most of those tax cuts do not provide any net reduction in taxes to households under the Jenn-Marron hypothesis.

Second, Jenn and Marron do not explain how their system would apply to tax increases instead of tax cuts. Assume for simplicity that the CBO baseline has revenue at the Jenn-Marron threshold. Then consider an increase in taxes equal to 1 percent of GDP.[7] Would Jenn and Marron suggest that such a policy change generates a long-term revenue increase of 1 percent of GDP (because revenue has actually increased by 1 percent of GDP), or zero (because their intended tax threshold would be exceeded, presumably meaning that other future tax cuts would be assumed to undo the revenue increase)?

If the answer is that Jenn and Marron would record the change as a tax increase, then enacting the tax increase and immediately reversing it would generate a fiscal gain. The tax increase would be scored as an increase in revenue, but the tax reduction would not be scored as a reduction in revenue, because by their assumptions it would have happened anyway. Under this system of asymmetric scoring, policymakers could ''erase'' the entire long-term deficit merely by enacting drastic policy changes and then instantaneously reversing them!

The other possibility is that Jenn and Marron would not record any increase in revenue above their threshold as a tax increase.[8] In this case, *no* revenue increases would be scored as such in the long term, since Figure 5 in their report shows that revenue exceeds their intended thresholds in the long term either with or without the 2001 and 2003 tax cuts. Under this logic, the entire fiscal gap could be eliminated by raising taxes, but those changes would not be characterized as a tax increase by Jenn and Marron. Or perhaps more mundanely, Sen. Kerry's proposed tax changes could not be characterized as a tax increase.

Third, the Jenn-Marron approach is fundamentally dependent on choosing an ''intended'' share of GDP. But that intended share is inherently ambiguous and ultimately unknowable. Even the historical averages that Jenn and Marron rely on are arbitrary: Instead of limiting the average to various years of the postwar era, why not include the entire history of the republic, where taxes averaged less than 3 percent of GDP for the first 160 years? Or the years since the introduction of the income tax? The substantial variance in revenue costs that Jenn and Marron themselves compute for different intended thresholds should raise a red flag because there is no objective basis for choosing among the thresholds.

Fourth, the Jenn-Marron approach deals with revenues and expenditures in a starkly asymmetric manner. Why not also assign historical benchmarks to the shares of GDP devoted to Social Security and Medicare? Under this more consistent version of their approach, Jenn and Marron would find no cause for concern about increases in entitlement spending, such as last year's introduction of Medicare Part D because those increases were assumed to be reversed in the future and thus would have no impact on their expenditure projections.

Finally, the entire idea of using historical thresholds to examine future policy choices is unlikely to be insightful. History does not teach us what Congress or the public ''intend'' when faced with a choice between permanent, deep cuts in Social Security and Medicare or allowing revenues to rise under current law, because the issue has not previously arisen. The baby boom retirement has never before occurred; the past is not necessarily prologue in this particular regard.

---

[6]More precisely, the Jenn-Marron revenue baseline is current law or the intended threshold for revenue as a share of GDP, whichever is lower.

[7]Similar asymmetries arise regarding tax increases from a baseline below their threshold.

[8]This outcome is the implication of a literal reading of the formula proposed by Jenn and Marron. In particular, if current law revenue were equal to their threshold, then the minimum of current law and their threshold would be the threshold itself. If the proposed law had revenue above current law, the minimum of the proposed law and the threshold would also be the threshold. Thus both terms in their formula (Jenn and Marron 2004, p. 283) would equal the threshold in each year, and the calculated change would be zero.

III. Conclusion

Long-term budget analyses are sensitive to methodological assumptions, and the proper methods to employ should be examined carefully. At least with regard to the issue raised by Jenn and Marron, however, the existing methods used by CBO (2000), GAO (2004), Gokhale and Smetters (2003) and in our own work are not in need of modification. Those methods, unlike the one proposed by Jenn and Marron, generate roughly similar answers to the same question: Assuming the AMT is reformed, and the tax cuts are extended, what is the long-term reduction in revenue from the 2001 and 2003 tax cuts? The method proposed by Jenn and Marron generates a different answer, but only through an inherently arbitrary choice of an ''intended'' revenue threshold that effectively assumes away a substantial portion of the tax cuts, generates a variety of internally inconsistent results, and ignores the context in which future policies will be made.

References

Auerbach, Alan J. 1994. ''The U.S. Fiscal Problem: Where We Are, How We Got Here, and Where We're Going. '' In Stanley Fischer and Julio Rotemberg, eds., *NBER Macroeconomics Annual*. Cambridge, Mass.: National Bureau of Economic Research.

Auerbach, Alan J., William G. Gale, Peter R. Orszag, and Samara R. Potter. 2003. ''Budget Blues: The Fiscal Outlook and Options for Reform.'' In H. Aaron, J. Lindsay, and P. Nivola, eds., *Agenda for the Nation,* 109-144. Washington, D.C.: Brookings Institution Press.

Auerbach, Alan J., William G. Gale, and Peter R. Orszag. 2004. ''Sources of the Long-Term Fiscal Gap.'' *Tax Notes.* May 24, pp. 1049-59.

Congressional Budget Office. 2000. *The Long-Term Budget Outlook.* October.

Congressional Budget Office. 2003. *The Long-Term Budget Outlook*. December.

Congressional Budget Office. 2004. ''The Outlook for Social Security.'' June.

General Accounting Office. 2004. ''GAO's Long-Term Simulations.'' Available at http://www.gao.gov/special.pubs/longterm/simulations.html, accessed August 17, 2004.

Gokhale, Jagadeesh and Kent Smetters. 2003. *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities*. Washington, D.C.: The AEI Press.

Greenstein, Robert, Peter Orszag, and Richard Kogan. 2004. ''The Implications of the Social Security Projections Issued by the Congressional Budget Office.'' Center on Budget and Policy Priorities. June.

Jenn, Brian H. and Donald B. Marron. 2004. ''The Long-Run 'Cost' of Tax Cuts.'' *Tax Notes*. July 19, pp. 279-87.

Office of Management and Budget. 2004. *Analytical Perspectives: Fiscal Year 2005 Budget of the United States.*