

by William G. Gale and Peter R. Orszag

Bush Administration Tax Policy: Revenue and Budget Effects

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I. Introduction

This article evaluates recent tax policies in light of the fiscal status of the federal government, and is the third article in a series that summarizes and evaluates tax policy in the Bush administration.¹ Our analysis highlights the following points:

- If the tax cuts are made permanent, the revenue loss will exceed \$3.3 trillion (1.7 percent of gross domestic product) over the period 2001 to 2014. The net budget loss (including higher debt service payments due to increases in federal debt) would be almost \$4.5 trillion (2.3 percent of GDP). These figures include the tax cuts enacted to date, the administration's proposal to make the 2001 and 2003 tax cuts permanent, and an adjustment to the alternative minimum tax that holds the number of AMT taxpayers the same under the tax cuts as it would have been under pre-Economic Growth and Tax Relief Reconciliation Act of 2001 law.
- Because the tax cuts phase in over time, the averages above understate the relevant long-term magnitudes. In 2014, for example, the revenue loss from the policies noted above would be \$373 billion (2 percent of GDP) and the budget costs would be \$583 billion (3.2 percent of GDP). Over the longer term, the tax cuts would reduce revenue by 2 percent of GDP on an ongoing basis.
- Even if the tax cuts are not made permanent, the federal government faces significant deficits over the next 10 years under plausible scenarios, and an unsustainable long-term budget path. Making the tax cuts permanent would significantly exacerbate both of those problems.

¹The first two articles provide background information and distributional analysis (Gale and Orszag 2004a, 2004b).

- Tax cuts have to be financed. They are not simply a matter of returning unneeded or unused funds to taxpayers; instead, tax cuts represent a choice by current voters either to require future taxpayers to pay for current spending, or to cut such spending. Making the tax cuts permanent would require sizable reductions in spending or increases in other taxes. For example, to pay for the tax cuts in 2014 would require a 45 percent reduction in Social Security benefits, a 53 percent cut in Medicare benefits, or changes of a similar magnitude.
- Over the next 75 years, the total costs of the tax cuts, if they are made permanent, are roughly the same order of magnitude of the actuarial shortfall in the Social Security and Medicare Part A trust funds. On a permanent basis, the tax cuts would cost significantly more than fixing the entire Social Security shortfall.
- The claim that the tax cuts were needed in 2001 to avoid paying off all marketable federal debt was overstated, and did not justify the timing, magnitude, or structure of the original tax cuts. Even if it were valid then, the claim does not apply to considerations of whether the tax cuts should be made permanent, given the decline in the fiscal outlook since 2001.
- Likewise, the claim that the tax cuts need to be made permanent to reduce uncertainty is flawed. The primary source of uncertainty in tax and spending programs is the underlying fiscal gap. By making the gap bigger, the tax cuts would likely increase policy uncertainty and instability, not reduce it.
- Another claim, that the tax cuts were and are needed to control government spending, is examined in more detail in the next article in the series.

(After this article was originally submitted for publication, both Houses of Congress passed an extension of selected features of the 2001 and 2003 tax cuts. The bill is expected to be signed by President Bush. The bill features five-year extensions of the expanded 10 percent bracket, marriage penalty relief, and the \$1,000 per-child tax credit. (See Gale and Orszag 2004a for descriptions of those provisions.) Those and other provisions would reduce revenues by \$146 billion through 2009. Incorporating those provisions into the analysis below would slightly increase the cost of tax provisions enacted to date and slightly reduce the cost of extending all of the tax cuts. The total costs of the tax cuts enacted to date, plus the costs of extending them would remain approximately same.)

Section II provides estimates of the budget outlook and the revenue and budgetary effects of the tax cuts over a 10-year budget window. Section III examines

Table 1 Revenue and Budget Effects of the 2001, 2002, and 2003 Tax Cuts, 2001-2014										
	2001-2011		2005-2014		2001-2014		2010		2014	
	Billions	% GDP	Billions	% GDP	Billions	% GDP	Billions	% GDP	Billions	% GDP
EGTRRA										
Revenue	1,349	0.9	1,039	0.7	1,349	0.7	187	1.2	0	0.0
Interest	344	0.2	596	0.4	619	0.3	68	0.4	96	0.5
Subtotal	1,692	1.2	1,634	1.1	1,967	1.0	255	1.6	96	0.5
JCWA										
Revenue	47	0.0	-82	-0.1	42	0.0	-10	-0.1	0	0.0
Interest	44	0.0	53	0.0	60	0.0	5	0.0	5	0.0
Subtotal	91	0.1	-29	0.0	102	0.1	-5	0.0	5	0.0
JGTRRA										
Revenue	354	0.2	140	0.1	350	0.2	4	0.0	0	0.0
Interest	125	0.1	198	0.1	201	0.1	22	0.1	27	0.1
Subtotal	479	0.3	338	0.2	550	0.3	26	0.2	27	0.1
All										
Revenue	1,749	1.2	1,097	0.7	1,740	0.9	181	1.2	0	0.0
Interest	513	0.4	847	0.6	879	0.4	95	0.6	129	0.7
Total	2,262	1.6	1,944	1.3	2,619	1.3	275	1.8	129	0.7

Source: Joint Committee on Taxation (2001, 2002, 2003). Interest costs calculated by authors using CBO debt service matrix.

similar issues over long-run horizons. Section IV discusses the key implications for making the tax cuts permanent. Section V discusses the key implications for the original tax cuts.

II. Within the 10-Year Budget Window

A. The Tax Cuts

Table 1 reports official estimates of the revenue loss from the tax cuts, as estimated by the Joint Committee on Taxation (2001, 2002, 2003). (Appendix Tables 1 and 2 provide the annual data in dollars and as a percent of GDP.) The tax cuts will reduce revenue by \$1.75 trillion, or 1.3 percent of GDP, between fiscal years 2001 and 2011. The 2001 tax legislation accounts for slightly more than three-quarters of that revenue loss, the 2003 tax legislation accounts for about one-fifth, and the remainder is a result of the 2002 tax legislation.

Relative to the official baseline, that revenue loss results in increased government debt. The overall impact on the budget is the sum of the revenue loss plus the additional debt service on the higher level of public debt. With debt service costs included, the budgetary cost of the tax cuts as legislated for fiscal 2001 to 2011 is \$2.3 trillion, or 1.6 percent of GDP.² All of these estimates assume that the tax cuts expire as scheduled under current law and that no adjustment to the AMT is made.

The added revenue loss and budget effects that would arise if the tax cuts were made permanent are shown in Table 2 (with annual data in Appendix Tables 1 and 2). The first panel follows the administration's exact proposal to make the tax cuts permanent (see OMB 2004 or Gale and Orszag 2004a), and so only adjusts the AMT

exemption through 2005. Under those assumptions, relative to the already existing tax cuts, making the tax cuts permanent would reduce revenues by an additional \$1.2 trillion and increase deficits by \$1.37 trillion.³ Within the 10-year budget window, about 90 percent of the revenue loss occurs after 2009, since the bulk of the current tax cuts expire in 2010. By 2014 the administration's proposal would reduce revenues by \$301 billion, or 1.6 percent of GDP.

As discussed in Gale and Orszag (2004a), though, those revenue estimates understate the likely costs of making the tax cuts permanent because they do not make any long-term adjustment for the AMT. The second panel of Table 2 shows that the revenue loss from making the tax cuts permanent is much higher when the AMT is adjusted to hold the number of AMT taxpayers in each year the same under the president's proposal to make the tax cuts permanent as it would have been under pre-2001 law for that year. With the AMT adjustment, making the tax cuts permanent would reduce revenues by \$1.6 trillion; including debt service payments, the 10-year deficit would rise by almost \$1.9 trillion. In 2014 the revenue loss would be \$373 billion, or about 2.0 percent of projected GDP.

Over the entire 2001-2014 period, the tax cuts enacted to date, their permanent extensions, and an AMT adjustment that holds the number of AMT taxpayers equal to what it would have been under pre-EGTRRA law, would reduce revenues by \$3.3 trillion, or 1.7 percent of GDP over the period. The same policies would increase budget

²We estimate debt service costs using projected interest rates generated by the Congressional Budget Office for this purpose.

³Technically, making the tax cuts permanent would involve some relatively minor outlay increases — for example, for the refundable portions of the earned income credit and child credit — as well as revenue losses. Our discussion of "revenue losses" includes those direct outlay components.

Table 2
Revenue and Budget Effects of Making the 2001 and 2003 Tax Cuts Permanent and Adjusting the AMT

	2005-2009		2010-2014		2005-2014		2014	
	Billions	% GDP	Billions	% GDP	Billions	% GDP	Billions	% GDP
Panel 1: Current Law Baseline/Administration Proposal								
Extend Estate Tax Repeal	7	0.0	198	0.2	206	0.1	61	0.3
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	130	0.2	866	1.0	997	0.7	240	1.3
Total Revenue Change	138	0.2	1,065	1.3	1,202	0.8	301	1.6
Interest	16	0.0	150	0.2	166	0.1	59	0.3
Total Budget Cost	153	0.2	1,215	1.4	1,368	0.9	360	2.0
Panel 2: Current Law Baseline/Administration Proposal and AMT Adjustment								
Extend Estate Tax Repeal	7	0.0	198	0.2	206	0.1	61	0.3
Extend Other Provisions of EGTRRA, JGTRRA and Adjust AMT	248	0.4	1,149	1.4	1,397	0.9	313	1.7
Total Revenue Change	255	0.4	1,348	1.6	1,603	1.1	373	2.0
Interest	27	0.0	221	0.3	248	0.2	81	0.4
Total Budget Cost	283	0.4	1,569	1.9	1,851	1.2	454	2.5
<i>Source: Authors' calculations using CBO debt service matrix, OMB (2004), and TPC Microsimulation Model.</i>								

deficits (including net interest costs) and the public debt by \$4.4 trillion, or 2.3 percent of GDP through 2014.

As shown in Figure 1, the adjusted revenue loss peaks at 2.6 percent of GDP in 2004, after which it declines somewhat as the bonus depreciation provision expires.⁴ In subsequent years, the revenue loss begins to climb again, as the remaining backloaded provisions of EGTRRA (including the estate tax reductions and the elimination of the phaseout of itemized deductions and the personal exemption) take effect. By 2011 the revenue loss again exceeds 2 percent of GDP.⁵ By 2014 the revenue loss associated with making the tax cuts permanent (assuming the AMT is adjusted) is \$373 billion and the budget cost with debt service is \$583 billion. These figures represent 2 percent and 3.2 percent of GDP in that year, respectively.

B. Budget Outlook as of September 2004

The top line of Figure 2 shows the Congressional Budget Office's (2004b) baseline projections for the deficit in the unified budget as of September 2004. The projec-

tions assume that all of the tax cuts expire as scheduled. CBO projects a 10-year baseline unified budget deficit of \$2.3 trillion, or 1.5 percent of GDP, for fiscal 2005 to 2014, with the deficits shrinking over time.

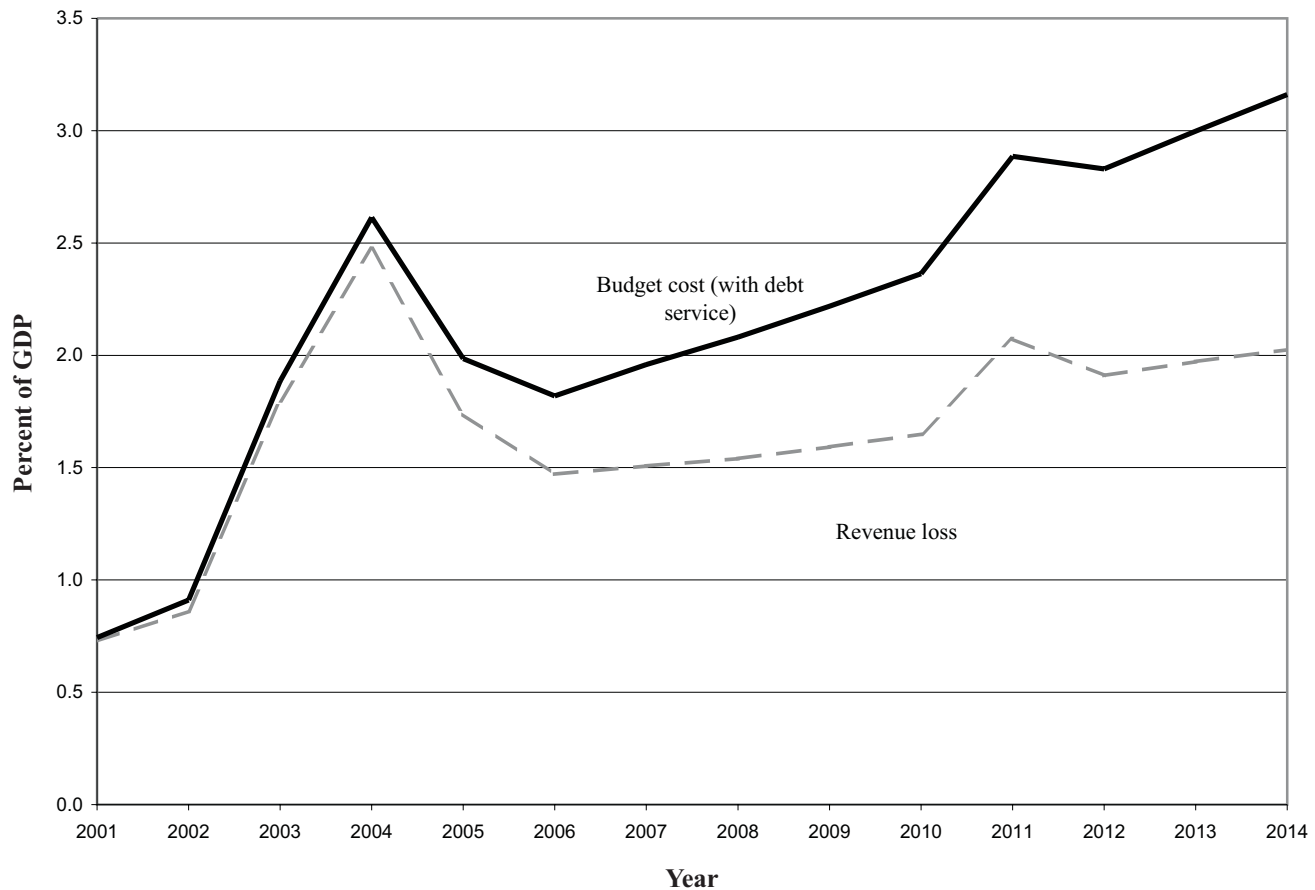
The baseline projection is intended to provide a benchmark for legislative purposes. It is explicitly not intended to be a projection of actual or likely budget outcomes, or a measure of the financial status of the federal government (CBO 2004a). Thus, adjustments to the baseline are required to generate a more plausible budget scenario and to develop more meaningful measures of the fiscal status of the government (Auerbach, Gale, Orszag, and Potter 2003). One concern is that the baseline assumes that all temporary tax provisions — including the 2001, 2002, and 2003 tax acts — expire as scheduled. Most of the smaller temporary tax provisions have been routinely extended in the past, and the president has made permanent extension of his tax cuts a high priority in every budget.⁶ A second issue is that the baseline assumes that the AMT follows current law, which, as noted above, few observers regard as plausible. Third, the baseline uses cash flow accounting, which is appropriate for many programs but can distort the financial status of programs with liabilities that increase substantially outside the projection period. Another potential concern is that the baseline holds real discretionary spending constant over

⁴The jagged pattern of revenue losses around 2011 in Figure 1 likely reflects the fact that these figures combine estimates from different sources; some of the estimates are intended to measure the cost of the tax cuts as enacted and others to measure the cost of extending the tax cuts.

⁵The estimates in Table 1 and Figure 1 omit the effects of any changes in GDP and interest rates caused by the recent tax policies. Those effects are discussed in a separate article in this series. Allowing for changes in GDP would have a small positive impact on the revenue effects during the 10-year budget window, but a negative effect over longer horizons. Allowing interest rates to change would likely raise debt service costs, but it is difficult to make such an adjustment appropriately because it is unclear to what degree the CBO baseline already incorporates such adjustments and because it is unclear to what degree participants in financial markets view the sunsets as credible.

⁶The run-of-the-mill expiring provisions include a number of provisions (often dubbed "the extenders" and including items such as tax credits for work opportunity or for research and experimentation) that have existed for years, are narrow in scope, have relatively minor budget costs, and for which extensions occur as a matter of routine. The "temporary" provisions having to do with the 2001 and 2003 tax cuts are quite different in nature and scope. Whether they are extended is a major fiscal policy choice, not a matter of routine. See Gale and Orszag (2003b) for further discussion of expiring provisions.

Figure 1
Revenue and Budget Effects of the 2001, 2002, and 2003 Tax Cuts, Extensions, and AMT Adjustment, 2001-2014



Source: Authors' calculations using JCT (2001, 2002, 2003), imputed debt service using the CBO interest matrix, and the TPC Microsimulation Model.

time. In a growing economy with an expanding population and evolving security needs, this assumption is not credible. In the September 2004 budget projections, though, the discretionary spending baseline contains different biases that roughly offset each other over the 10-year horizon, so we use the baseline spending figures.⁷

Adjusting for these factors has an enormous impact on 10-year budget projections. Figure 2 shows that if (a) the expiring tax provisions that are not related to extension of the 2001 and 2003 tax cuts are extended, and (b) the AMT

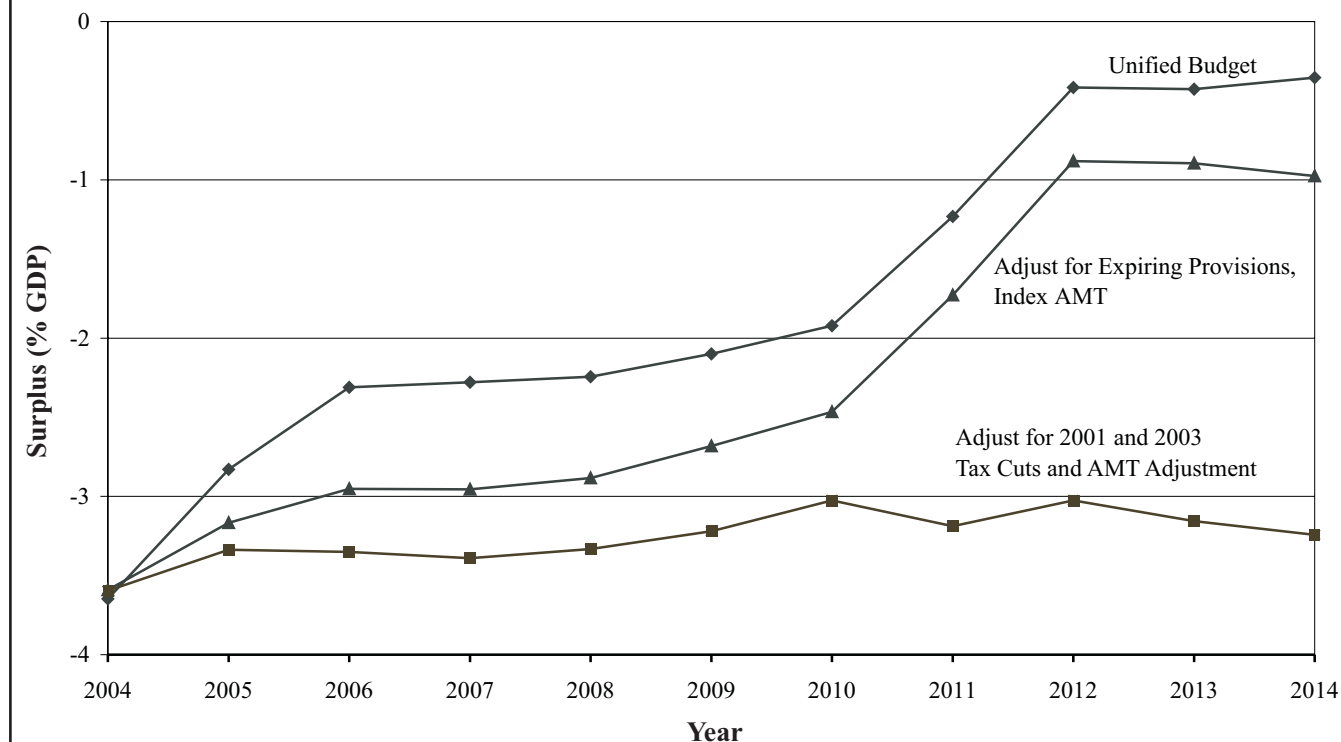
problem is resolved by indexing the AMT for inflation,⁸ the adjusted unified budget deficit rises to 2.3 percent of GDP over the decade and 1 percent of GDP in 2014.

In addition, it is well-known that the trust funds for Social Security, Medicare Part A, and government employee pensions are projected to run surpluses over the next decade but face shortfalls in the long term. It is misleading to include those programs as generating surpluses when they are well-known to face long-term deficits. One way to control for those effects is to extend the time horizon considered to include the future shortfalls. That is the approach taken in the next section. Here, continuing our focus on the 10-year budget window, we simply separate the retirement trust funds from the rest

⁷In particular, the baseline extends a large current supplemental discretionary spending allocation, which is unlikely to persist, but it also allows spending to grow only with inflation, not population. Removing the supplemental allocation and allowing spending to rise with population as well as inflation has a very small net effect on the 10-year figures, so we simply use the baseline discretionary spending estimates in the calculations reported in the text.

⁸To ensure that our calculations of the cost of indexing the AMT do not overlap with the costs of the AMT adjustment noted in the previous section that are counted as a cost of the 2001 and 2003 tax cuts below, we calculate the costs of indexing the AMT for inflation using pre-EGTRRA law.

Figure 2
Unified and Adjusted Federal Budget Projections, 2004-2014
(as a share of GDP)



Source: Authors' calculations using CBO (2004b), imputed debt service using the CBO interest matrix, and the TPC Microsimulation Model.

of the budget as in Figure 3. Figure 3 shows that outside of the retirement trust funds, the rest of the federal government faces projected adjusted deficits of about 3.9 percent of GDP over the next decade and 2.6 percent of GDP in 2014.

All of the discussion above assumes that the tax cuts are allowed to expire as scheduled. Figures 2 and 3 show that, even before consideration of making the tax cuts permanent, the federal budget faces substantial deficits over the 10-year horizons. If the tax cuts are made permanent, the adjusted unified deficit would average 3.3 percent of GDP over the decade and would equal 3.2 percent of GDP in 2014 (Figure 2). Figure 3 shows that, omitting the retirement trust funds, which face long-term deficits, the rest of the budget would face deficits of 4.9 percent of GDP over the decade, and of 4.8 percent of GDP in 2014 if the tax cuts were made permanent. In 2014 the adjusted unified budget deficit would be almost \$600 billion and the adjusted non-retirement-trust-fund deficit would be almost \$900 billion. Both measures would be growing relative to the economy.

One way to gauge the implications of the adjusted unified baseline is to examine the implied ratio of public debt to GDP, as in Figure 4. Under the adjusted unified baseline, the debt-GDP ratio would rise steadily throughout the decade and by 2014 would equal 52 percent of GDP, well above the most recent high of 49 percent in 1992 and the highest level since 1956. As discussed below, the debt-GDP ratio would continue to rise thereafter.

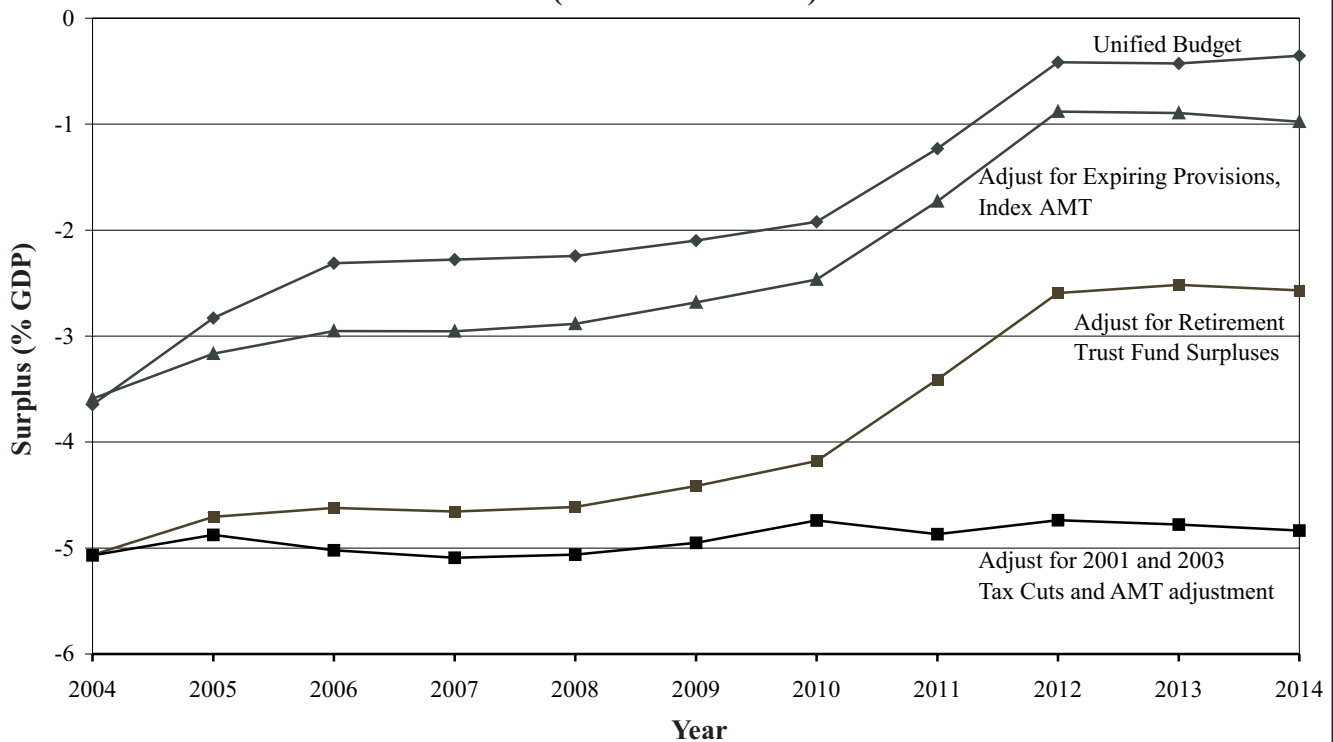
C. The Changing Budget Outlook, 2001-2004

The budget outlook has changed substantially since January 2001. The January 2001 CBO budget baseline formed the basis of tax and fiscal policy discussions in the winter and spring of 2001. Under the baseline, the federal budget faced a projected surplus of \$5.6 trillion over the subsequent decade, with surpluses rising over time (top line, Figure 5). Using this information, supporters argued that the tax cuts were affordable and simply involved refunding to the American people an over-charge on their taxes.

As noted above, however, the baseline is a misleading indicator of the government's financial status under plausible policy trajectories. Extending the expiring provisions, adjusting the AMT to hold the number of AMT taxpayers constant over time, allowing discretionary spending to grow with population as well as inflation, and removing the trust fund surpluses for Social Security, Medicare, and government pensions left a 10-year surplus of just \$1.6 trillion (Auerbach and Gale 2001). Thus, even in the heady budget days of early 2001, a realistic and meaningful projection would have generated a 10-year budget surplus much lower than the official figures indicated and actually smaller than the budget cost of EGTRRA reported in Table 1.

Between January 2001 and September 2004, the fiscal status of the government deteriorated markedly, as shown in Figure 5. By September 2004, the baseline budget for 2002-2011 projected a deficit of \$3.0 trillion.

Figure 3
Unified, Nonretirement, and Adjusted Federal Budget Projections, 2004-2014
(as a share of GDP)



Source: Authors' calculations using CBO (2004a), imputed debt service using the CBO interest matrix, and the TPC Microsimulation Model.

This represents a decline in fiscal status of \$8.6 trillion since January 2001, equivalent to 6.5 percent of projected GDP over the decade. The decline appears to be permanent, with a substantial decline in every year. Figure 5 also shows the sources of the deterioration in the budget. The tax cuts, as legislated, explain 26 percent of the decline.⁹ Changes in defense and homeland security and economic and technical changes account, respectively, for 23 percent and 38 percent of the change. Other non-interest spending accounts for about 14 percent.

III. Long-Term Horizons

A. Revenue Effects of Tax Cuts

To examine the long-term budgetary effects of making the tax cuts permanent, we assume that the revenue loss remains constant as a share of GDP after 2014 and report the results in Table 3. Making the tax cuts permanent would reduce revenues (and raise the fiscal gap) by 1.8 percent of GDP through 2080 (and 1.9 percent over an infinite horizon, not shown). In present value, making the

⁹This estimate follows the baseline in assuming that the tax cuts expire as scheduled and the AMT is not adjusted. If instead the tax cuts are made permanent as described above and the AMT as described above, the share of the projected fiscal decline caused by tax cuts would rise.

tax cuts permanent would reduce revenue by \$9.2 trillion through 2080 (and \$15.6 trillion over an infinite horizon). The overall effect of the tax cuts — including the cost before the tax cuts officially expire in 2010 or before — would reduce revenues by \$10.2 trillion (2 percent of GDP) through 2080.¹⁰

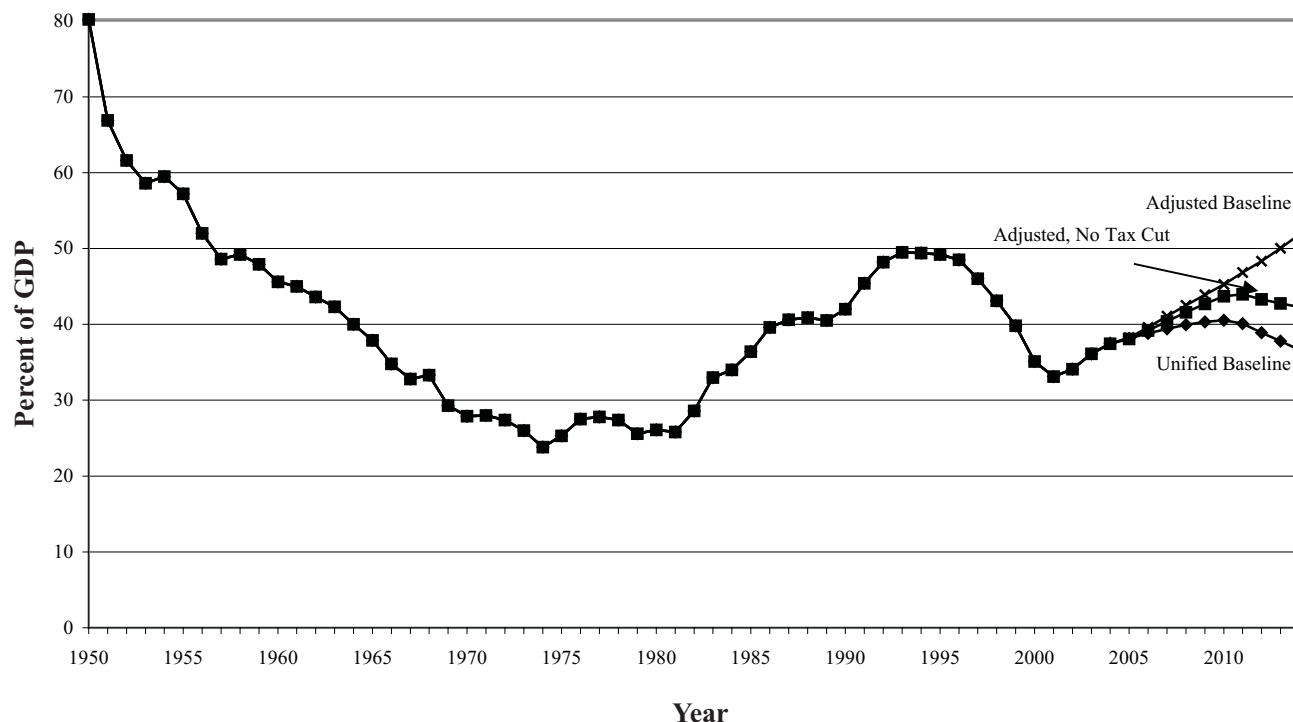
B. The Long-Term Budget Outlook as of 2004

The fiscal gap measures the size of the immediate and permanent increase in taxes or reductions in noninterest expenditures that would be required to establish the same debt-GDP ratio in the long run as holds currently.¹¹ Results in Auerbach, Gale, and Orszag (2004) imply that,

¹⁰These results are consistent with the results in Orszag, Kogan, and Greenstein (2003), who estimate that the 2001 and 2003 tax cuts, if made permanent, would reduce revenues by between \$9.5 trillion and \$11.6 trillion in present value over the 75 years between 2003 and 2077, depending on the specifics of the AMT reform.

¹¹See Auerbach (1994). Over an infinite planning horizon, the requirement is equivalent to assuming that the debt-GDP ratio does not explode. Alternatively, the adjustments 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, Orszag, and Potter (2003) discuss the relationship between the fiscal gap, generational accounting, accrual accounting, and other ways of accounting for government.

Figure 4
Public Debt, 1950-2014
(as a share of GDP)



Source: Authors' calculations using CBO (2004a), imputed debt service using the CBO interest matrix, U.S. Budget (2004), and the TPC Microsimulation Model.

even if the tax cuts are *not* made permanent, the nation faces a long-term fiscal gap in 2004 of 5.1 percent of GDP through 2080 and 8.2 percent of GDP on a permanent basis.¹² In short, the government's budget path is unsustainable, even if the tax cuts are not made permanent. If the tax cuts are made permanent, the long-term fiscal gap rises by 2 percentage points of GDP, to 7.1 percent through 2080 and 10.2 percent on a permanent basis.¹³ The administration has made similar forecasts (OMB 2004).

C. The Changing Long-Term Outlook, 2001-2004

Auerbach and Gale (2001) estimate that, despite running large cash flow surpluses at the time, the federal government faced a fiscal gap in 2001 of 1.45 percent of

GDP through 2070 and 4.14 percent of GDP on a permanent basis.¹⁴ The increase of roughly 6 percentage points of GDP in the long-term fiscal gap approximates the decline in the 10-year baseline budget projections noted in Figure 5.

D. Uncertainty in Budget Projections

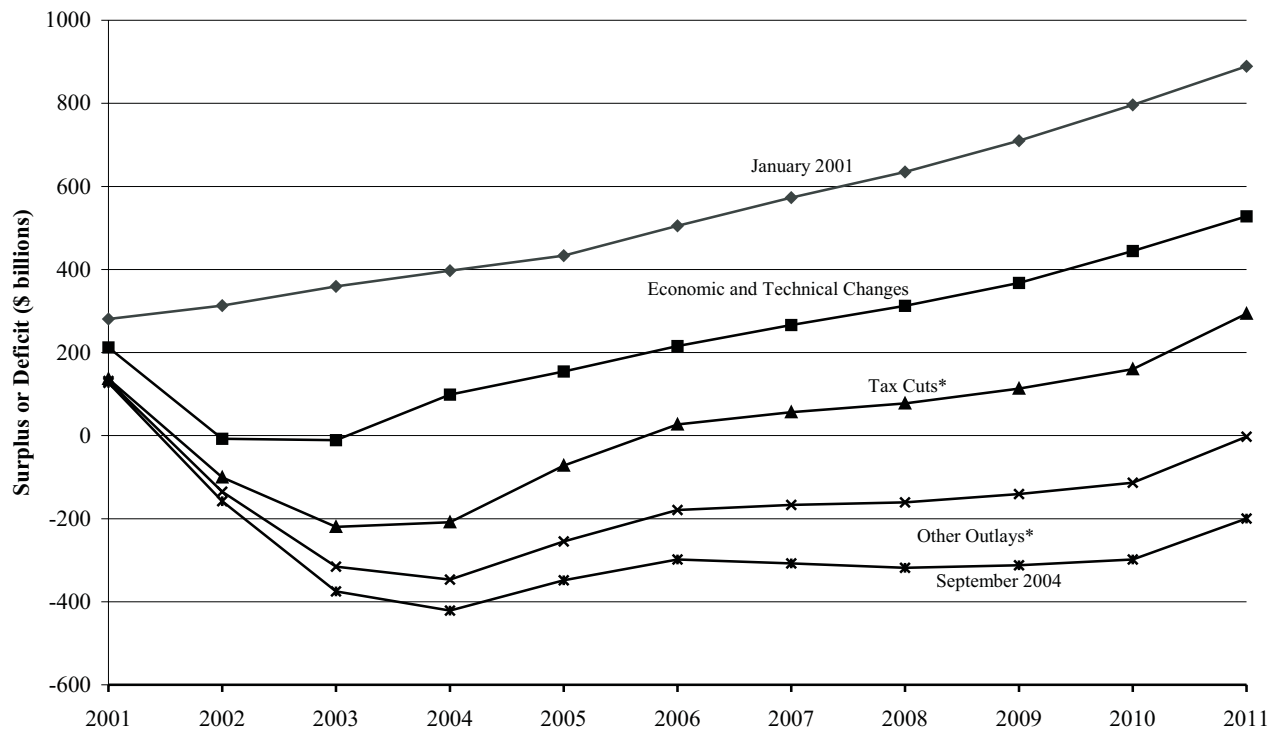
Substantial uncertainty surrounds the short- and long-term budget projections described above. Much of the problem stems from the fact that the surplus or deficit is the difference between two large quantities — taxes and spending. Small percentage errors in either one can cause large percentage changes in the difference between them. Furthermore, small differences in growth rates sustained for extended periods can have surprisingly large economic effects. That uncertainty makes budget projections imprecise. Nonetheless, almost all studies that have examined the issue suggest that even if major sources of uncertainty are accounted for, serious long-term fiscal

¹²In perhaps more familiar terms, the primary deficit would be 2.6 percent of GDP in 2030, 4.6 percent in 2060, and 5 percent by 2080; the unified deficit would rise much faster because of accruing interest payments and would be 7 percent of GDP in 2030, 26 percent by 2060, and nearly 50 percent by 2080. Public debt would be 76 percent of GDP in 2030, 339 percent in 2060, and 680 percent in 2080.

¹³Auerbach, Gale, and Orszag (2004) obtain slightly larger estimated fiscal gaps because they estimate the long-term costs at 2.2 percent of GDP. The difference is mostly due to a different AMT adjustment.

¹⁴The figures in Auerbach and Gale (2001) and Auerbach, Gale, and Orszag (2004) are not strictly comparable because the two studies make slightly different assumptions regarding the AMT, but the difference is rounding error compared to an increase in the fiscal gap of 6 percent of GDP.

Figure 5
Source of Change to Unified Budget Projection, 2001-2011



problems will remain (Auerbach, Gale, Orszag, and Potter 2003 provide additional discussion).

IV. Implications for Permanent Tax Cuts

A. Are the Tax Cuts 'Affordable'?

Even if it is assumed that the tax cuts are allowed to expire as scheduled, the federal budget faces significant deficits over the standard 10-year budget window (Figures 2 and 3) and over longer horizons. That alone should raise significant questions about the overall affordability of the tax cuts.

If making the tax cuts permanent was not affordable in 2001 — and Congress not only balked at making the cuts permanent but also trimmed back the size of the president's proposal because of concerns about whether the \$5.6 trillion in projected surpluses would materialize — it is hard to see how it has become more affordable since then, given the deterioration in the budget outlook shown in Figure 5.

Granted, "affordability" is a vague concept. But if massive tax cuts are justified in the face of an already unsustainable fiscal policy, it is hard to see that the concept has any meaning at all. Certainly, if the government were running surpluses as far as the eye can see, tax cuts of some form could be justified. That is certainly not the case currently, and as Auerbach and Gale (2001) and CBO (2000) and many others have shown, it was certainly not the case in 2001, despite the strong 10-year baseline projections at that time. The presence of a

long-term fiscal gap in 2001, despite current cash flow surpluses, suggests that making the tax cuts permanent was not affordable at that time. The vast deterioration in both the 10-year and long-term budget outlook since then suggests that permanent tax cuts were not affordable in 2001, it is far less so today.

B. What Would It Take to Pay for the Tax Cuts?

No discussion of making the tax cuts permanent should ignore the costs, in terms of other tax increases or spending cuts, that would be required to finance the tax cuts. In fact, the spending cuts or other tax increases required to pay for making the tax cuts permanent would be monumental. For example, Table 4 shows the spending cuts or tax increases needed in 2014 just to pay for the revenue losses (not the increase in net interest payments) in that year from making the tax cuts permanent (and adjusting the AMT to keep the number of AMT taxpayers the same as under pre-EGTRRA law). Financing the tax cuts in 2014 would imply one of the following options or changes of a similar magnitude (relative to the CBO baseline):

- a 45 percent cut in Social Security benefits;
- a 53 percent cut in Medicare benefits;
- complete elimination of the federal component of the Medicaid program;
- an 11 percent cut in all noninterest spending;
- a 49 percent cut in all spending other than interest, defense, homeland security, Social Security, Medicare, and Medicaid;

Table 3
Long Term Budget Effects: Social Security, Medicare Part A, and the 2001 and 2003 Tax Cuts, 2003-2080

	Trillions of \$2004	Percent of GDP ^a
Extend 2001, 2003 Tax Cuts ^b	7.3	1.5
Extend Cuts and Adjust AMT ^c	9.2	1.8
2001, 2003 Tax Cuts and Extension	8.3	1.7
2001, 2003 Tax Cuts, Extension, and AMT Adjustment	10.2	2.0
Social Security Trust Fund Shortfall ^d	3.7	0.7
Medicare Part A Trust Fund Shortfall ^d	8.2	1.4

^aThe present value of GDP through 2080 is calculated using nominal GDP growth rates and interest rates from Table VI.F7 of the 2004 OASDI Trustees Report.

^bCost of extending the 2001 and 2003 tax cuts as proposed in the Administration's fiscal 2005 Budget and assuming the revenue loss remains a constant share of GDP after 2014. The resulting stream is discounted to 2004 dollars and summed.

^cAuthors' calculations using the AMT adjustment in panel 2 of Table 2, and assuming the combined revenue loss remains a constant share of GDP after 2014. The resulting stream is discounted to 2004 dollars and summed.

^dAuthors' calculations using the Social Security and Medicare Trustee reports, Snow, *et al.* (2004a), Snow, *et al.* (2004b).

- a 75 percent cut in all domestic discretionary spending;
- a 32 percent increase in payroll taxes; or
- a 117 percent increase in corporate tax revenues.

The implied spending cuts and revenue increases are well beyond the range of those currently in any public discussion.

C. Tax Cuts, Social Security, and Medicare

To help provide perspective on the magnitude of the tax cuts, we show in Table 3 that over the next 75 years, the actuarial deficit in the Social Security system is 0.7 percent of GDP under the trustees' assumptions and 0.4 percent of GDP under new projections issued by CBO (2004c). Thus, if the 2001 and 2003 tax cuts were made permanent, the total discounted revenue loss through 2080 (2.0 percent) would be roughly three to five times as much as the actuarial shortfall in Social Security over the same period. The actuarial deficit in Social Security over an infinite horizon amounts to 1.2 percent of GDP under the trustees' assumptions, which is smaller than the 1.9 percent of GDP in revenue losses from extending the tax cuts over the same horizon, even without counting the costs of the currently legislated tax cuts. The deficit in the Medicare Part A trust fund is about 1.4 percent of GDP over the next 75 years. Thus, extending the tax cuts would reduce revenue over the next 75 years by an amount about as large as the entire shortfall in the Social Security and Medicare Part A trust funds over the same period.

The purpose of these comparisons is simply to show that to the extent that the shortfalls in Social Security and Medicare Part A are considered significant budget problems, as they should be, the tax cuts create budget shortfalls of an equivalent magnitude. These comparisons are often obscured in the public debate because the revenue effects of tax cuts are usually measured over at most a 10-year horizon, whereas the entitlement shortfalls are typically examined over much longer periods. The comparison thus shows that making the tax cuts permanent would set the nation on a fiscal course that would generate deficits that, by the standards applied to the entitlement programs, are substantial. Contrary to the claims of some critics of these comparisons, the fact that such a comparison is made is not meant to imply that if

the tax cuts are made permanent, the money would literally be taken away from Social Security or Medicare. Nor does the comparison imply that the tax cuts can not be reversed.

D. Bush and Reagan Tax Cuts

Another way to put the tax cuts in perspective is to compare them to the 1981 Reagan tax cut (the Economic Recovery Tax Act (ERTA)). Those comparisons are complicated by two factors. First, the tax code was not indexed to the price level before 1985, generating a natural upward "creep" in tax collections over time, as inflation pushed individuals into higher tax brackets. This means that some "tax reductions" were really just offsetting the effects of inflation. Second, realizing that the 1981 tax cut was excessively costly, the Reagan administration worked to scale it back one year later. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) increased revenue significantly.¹⁵ The revenue costs of ERTA, measured against an inflation-indexed baseline and net of the revenue increase in TEFRA, amounted to about 2.1 percent of GDP (Orszag 2001a). Thus, under reasonable interpretations of the size of the Reagan tax cuts, the recent tax cuts are approximately the same size.

Although the Bush and Reagan tax cuts are approximately the same share of the economy, the nation was much better prepared — fiscally and otherwise — to deal with large tax cuts and fiscal deficits in the 1980s and early 1990s than it is now. The retirement of the baby boomers is 20 years closer now, giving the budget little time to recover before the fiscal pressures begin in earnest. Private saving was significantly higher in the early 1980s than it is now, public debt was a smaller share of GDP, and the United States was an international creditor then, but a substantial international debtor today (Gale and Orszag 2003a). Assuming an increasing risk premium associated with government debt or with the nation's net indebtedness to foreigners (Rubin, Orszag,

¹⁵CBO (1983, p. 27) notes that these "tax increases partly offset the revenue effects of ERTA by offsetting almost two-thirds of the ERTA corporate income tax reductions and about 10 percent of the ERTA individual income tax reductions."

Table 4 Paying for Permanent Tax Cuts		
	Extend Tax Cuts and Adjust AMT ^a	Memo: 2014 Baseline Revenue/Spending (\$ Billions) ^b
Revenue Loss in 2014 (in \$ billions)	373	
Required Percentage Change in ^c		
All Non-interest Outlays	-11	3,278
Discretionary Spending	-32	1,149
Defense, HS, International	-57	651
Other	-75	498
Mandatory Spending	-18	2,129
Social Security	-45	827
Medicare	-53	698
Medicaid	-107	348
All Three	-20	1,873
Other	-146	256
All Spending Except: Interest, Social Security, Medicare, Medicaid, Defense, and Homeland Security	-49	754
Revenue		
Payroll Tax	32	1,173
Corporate Tax	117	320

^aAuthor's calculations. See Table 2.
^bCongressional Budget Office. 2004. The Budget and Economic Outlook: Fiscal Years 2005-2014. Table 1-2.
^cPercentage cuts that exceed 100 are arithmetic artifacts.

and Sinai 2004), the facts that publicly held debt is a higher share of GDP now and that the net international investment position has declined markedly since the early 1980s increases the marginal cost of a tax cut now, relative to then.

The economic benefit, furthermore, was likely higher in the 1980s, because marginal tax rates were substantially higher then, raising the economic benefit of marginal tax rate cuts relative to today.¹⁶ Finally, the nation was willing to respond to the 1981 tax cut by raising taxes in 1982, 1984, 1990, and 1993. Currently, however, the administration shows no interest in considering corrective tax measures — the president has signed the “no new taxes” pledge — and it is doubtful that the spending cuts that would be needed to finance the proposed tax cuts will emerge, especially since defense and mandatory

spending are slated to increase as a percentage of GDP. An administration that has pledged not to raise taxes, is actively raising spending (see below), and faces unsustainable future budget shortfalls has no fiscal grounds to make its tax cuts permanent.

E. Reducing Uncertainty

The perspectives above on the size of the tax cut and the cost of financing it cast doubt on the claim, often put forward by proponents of extending the tax cuts, that such extensions are necessary to reduce uncertainty (see, for example, Rosen 2004). The fundamental source of uncertainty surrounding spending and tax programs is the existence of a large long-term fiscal gap; households and firms do not know how or when that fiscal gap will be eliminated, as eventually it must be to avoid fiscal collapse. Making the tax cuts permanent increases the underlying fiscal gap and hence actually raises uncertainty by expanding the size of the gap that must eventually be closed. Given the size of the fiscal shortfall, making the tax cuts permanent may also raise legitimate questions about whether implicit or explicit default is a non-trivial possibility, which could spark further uncertainty, most notably in financial markets (Rubin, Orszag, and Sinai 2004).

It would be utterly nonsensical to claim that doubling the size of the 75-year actuarial shortfall in Social Security and Medicare Part A would *reduce* uncertainty about future tax and spending policy. But making the tax cuts permanent would increase the fiscal gap by as much as doubling the actuarial shortfall would. Likewise, the contentious fiscal policy debates of the 1980s and 1990s suggest strongly that cutting revenues by as much as the Reagan tax cuts should not be seen as a way to instill

¹⁶A marginal tax cut of, say, 5 percentage points has a more pronounced effect the higher the initial marginal tax rate. A variety of economic activities are affected by the after-tax return, which depends on $(1-t)$. Since $(1-t)/(1-t.05)$ is larger, the larger is t , the effect of a 5 percentage point tax cut is larger the higher the initial tax rate. For example, reducing tax rates from 70 percent to 65 percent raises the after-tax return from 30 percent to 35 percent, or by one-sixth; reducing tax rates from 40 percent to 35 percent raises the after-tax return from 60 percent to 65 percent, or about one-twelfth. Similarly, the distortions caused by a tax are proportional to the square of the tax rate. See Rosen (1988) for a textbook exposition. The implication is that even if marginal tax cuts have the potential to stimulate growth and improve economic performance, a given marginal reduction is less likely to do so now than in the 1980s when marginal rates were higher.

stability in the nation's tax and spending systems. Thus, the notion that making the tax cuts permanent would reduce uncertainty is misguided.

V. Implications for the Original Tax Cuts

The previous section presents several fiscal arguments against making the tax cuts permanent. Because the budget outlook has changed so dramatically since 2001, however, it is worth revisiting the fiscal issues that applied to the original tax cuts, both to test their validity at the time and to examine their applicability to making the tax cuts permanent. In 2001 three principal fiscal claims were made to justify the tax cuts: The budget situation at that time made tax cuts affordable; tax cuts were needed to avoid paying off the entire marketable public debt in the near future; and tax cuts were needed as a way to "starve the beast" and thereby control government spending. It is questionable whether any of those claims were valid in 2001, and hence whether they truly justified the original tax cuts. The decline in the budget outlook, however, unambiguously implies that none of the original arguments are valid today and hence they cannot be used to justify making the tax cuts permanent.

The affordability argument is discussed above. Even in 2001, with a large 10-year projected baseline surplus, long-term projections showed the government facing a significant fiscal gap (Auerbach and Gale 2001, CBO 2000), and the budget outlook has deteriorated markedly since then (Figure 5).

The prospect of paying off the public debt is obviously no longer a pressing policy concern, if it ever was one. Federal Reserve Chair Alan Greenspan (2001) argued that tax cuts were needed in 2001 to avoid having the government pay off all available marketable Treasury debt by 2006. Greenspan and others argued that the consequences of eliminating the market for Treasury bonds and of investing additional government surpluses in private assets were so costly that immediate tax cuts could be justified. An alternative view noted that the prospect of paying off the public debt required a continuation of high productivity growth, which was uncertain, challenged the view that paying off the public debt would cause the serious problems that Greenspan envisioned, and noted that even if the feared events did have significant costs, there was plenty of time to make the needed corrections in the future (Rivlin 2001, Gale and Potter 2002). In any case, even if the tax cuts are allowed to expire, federal debt is now projected to be 35 percent of GDP in 2014 in the CBO (2004a) baseline and to grow at rapid, indeed unsustainable, rates in the future. Hence, the risk that the public debt will be paid off cannot be used to justify making the tax cuts permanent.

Last, the tax cuts have likely failed to restrain government spending. It is hard to believe that spending would actually have increased by much more than it did between 2000 and 2004 if the tax cuts had not been enacted. Discretionary spending rose from 6.3 percent of GDP in 2000 to 7.6 percent in 2003 and a projected 7.7 percent in 2004, while a massive new entitlement program (the Medicare prescription drug benefit) was also created (see Bartlett 2004 for further discussion). Those spending increases are contrary to the so-called "starve-the-beast"

theory that tax cuts reduce government spending, because the spending boom occurred during a period with several tax cuts and several other large downward revisions to the technical and economic components of the budget forecast.¹⁷ Perhaps most importantly for purposes of evaluating whether the tax cuts should be made permanent, whatever resonance the "starve-the-beast" theory had in 2001 when the government ran current, cash flow surpluses, current fiscal prospects as shown in Figures 2 and 3 already involve substantial deficits under plausible assumptions — and thus the concomitant pressure to reduce spending — even without making the tax cuts permanent. A later article in this series examines the "starve-the-beast" theory and evidence in more detail.

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¹⁷A variety of theoretical considerations, as well as evidence from historical budget deals and voting records, also suggest the starve-the-beast strategies are difficult to implement (see Gale and Kelly 2004, Gale and Orszag 2004a). Moreover, even if the starve-the-beast strategy "worked" in the sense that tax cuts restrained government spending and that such restraint was desirable, the result would not justify the *structure* of the Bush administration's tax cuts. Many components of government spending predominantly benefit low- and middle-income households (Steuerle 2001). On fairness grounds, a tax cut whose goal or effect is to cut spending should offset the negative impact on low- and middle-income households by giving them a disproportionately large share of the tax cut. The 2001 and 2003 tax cuts, however, do just the opposite — they benefit high-income households at the expense of all others.

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Appendix Table 1 Revenue and Budget Effects of the 2001, 2002, and 2003 Tax Cuts, 2001-2014 (\$ billions)																	
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2001- 2011	2005- 2014	2001- 2014
Enacted Tax Cuts																	
EGTRRA																	
Revenue	74	38	91	108	107	135	152	160	168	187	130	0	0	0	1,349	1,039	1,349
Interest	2	4	7	10	16	24	34	44	56	68	79	87	91	96	344	596	619
Subtotal	75	42	97	118	123	159	186	205	223	255	209	87	91	96	1,692	1,634	1,967
JCWA																	
Revenue	0	51	43	29	3	-16	-17	-16	-14	-10	-7	-5	0	0	47	-82	42
Interest	0	1	2	4	5	6	6	6	5	5	5	5	5	5	44	53	60
Subtotal	0	52	46	33	9	-10	-11	-11	-9	-5	-2	0	5	5	91	-29	102
JGTRRA																	
Revenue	0	0	61	149	82	21	14	17	11	4	-4	-3	-2	0	354	140	350
Interest	0	0	1	2	9	13	16	18	20	22	23	24	25	27	125	198	201
Subtotal	0	0	61	151	91	34	30	35	32	26	19	22	24	27	479	338	550
All																	
Revenue	74	89	195	286	193	140	148	161	165	181	118	-7	-2	0	1,749	1,097	1,740
Interest	2	5	10	16	30	43	56	68	81	95	107	116	122	129	513	847	879
Subtotal	75	94	204	302	223	183	204	229	246	275	225	108	120	129	2,262	1,944	2,619
Extending Tax Cuts With No AMT Adjustment																	
Extend Estate Tax Repeal	1	1	1	1	1	1	2	2	2	2	29	51	55	61	39	206	206
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	0	12	29	29	12	29	29	26	34	31	140	224	231	240	302	997	997
Total Revenue Change	1	13	30	31	13	30	31	28	36	33	169	275	286	301	341	1,202	1,203
Interest	0	0	1	1	0	1	3	5	7	9	14	26	42	59	39	166	166
Total Budget Cost	1	13	31	31	13	31	34	33	42	42	184	301	328	360	379	1,368	1,369
Extending Tax Cuts With an AMT Adjustment																	
Extend Estate Tax Repeal	1	1	1	1	1	1	2	2	2	2	29	51	55	61	39	206	206
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA	0	12	29	29	12	29	29	26	34	31	140	224	231	240	302	997	997
Adjust AMT	0	8	21	21	8	21	25	30	35	42	49	56	64	72	208	401	401
Total Revenue Change	1	21	50	55	21	50	55	58	71	75	218	331	350	373	549	1,603	1,603
Interest	0	0	2	2	0	2	5	8	12	16	25	40	59	81	68	248	248
Total Budget Cost	1	21	52	52	21	52	60	66	83	91	243	371	409	454	618	1,851	1,852
Tax Cuts and Extensions With AMT Adjustment																	
Revenue	74	89	195	286	214	190	204	218	236	256	336	323	348	373	2,298	2,700	3,344
Interest	2	5	10	16	30	45	61	77	93	111	132	156	181	209	581	1,095	1,127
Total	75	94	204	302	244	235	265	295	329	367	468	479	530	583	2,879	3,795	4,471
GDP in \$ billions	10,150	10,337	10,841	11,559	12,304	12,909	13,522	14,173	14,846	15,526	16,220	16,931	17,667	18,433	142,387	152,530	195,417
Source: See Tables 1 and 2.																	

Appendix Table 2 Cost of Tax Cuts, 2001-2014 (Figures in % GDP)																	
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2001- 2011	2005- 2014	2001- 2014
Enacted Tax Cuts																	
EGTRRA																	
Revenue	0.7	0.4	0.8	0.9	0.9	1.0	1.1	1.1	1.1	1.2	0.8	0.0	0.0	0.0	0.9	0.7	0.7
Interest	0.0	0.0	0.1	0.1	0.1	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.5	0.5	0.2	0.4	0.3
Subtotal	0.7	0.4	0.9	1.0	1.0	1.2	1.4	1.4	1.5	1.6	1.3	0.5	0.5	0.5	1.2	1.1	1.0
JCWA																	
Revenue	0.0	0.5	0.4	0.3	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	-0.1	0.0
Interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Subtotal	0.0	0.5	0.4	0.3	0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.1
JGTRRA																	
Revenue	0.0	0.0	0.6	1.3	0.7	0.2	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.2	0.1	0.2
Interest	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Subtotal	0.0	0.0	0.6	1.3	0.7	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.3	0.2	0.3
All																	
Revenue	0.7	0.9	1.8	2.5	1.6	1.1	1.1	1.1	1.1	1.2	0.7	0.0	0.0	0.0	1.2	0.7	0.9
Interest	0.0	0.1	0.1	0.1	0.2	0.3	0.4	0.5	0.5	0.6	0.7	0.7	0.7	0.7	0.4	0.6	0.4
Subtotal	0.7	0.9	1.9	2.6	1.8	1.4	1.5	1.6	1.7	1.8	1.4	0.6	0.7	0.7	1.6	1.3	1.3
Extending Tax Cuts With No AMT Adjustment																	
Extend Estate Tax Repeal				0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.3	0.3	0.0	0.1	0.1
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA				0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.9	1.3	1.3	1.3	0.2	0.7	0.5
Total Revenue Change				0.0	0.1	0.2	0.2	0.2	0.2	0.2	1.0	1.6	1.6	1.6	0.2	0.8	0.6
Interest				0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.3	0.0	0.1	0.1
Total Budget Cost				0.0	0.1	0.2	0.2	0.2	0.3	0.3	1.1	1.8	1.9	2.0	0.3	0.9	0.7
Extending Tax Cuts With an AMT Adjustment																	
Extend Estate Tax Repeal				0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.3	0.3	0.0	0.1	0.1
Extend Other Non-AMT Provisions of EGTRRA, JGTRRA				0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.9	1.3	1.3	1.3	0.2	0.7	0.5
Adjust AMT				0.0	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.4	0.4	0.1	0.3	0.2
Total Revenue Change				0.0	0.2	0.4	0.4	0.4	0.5	0.5	1.3	2.0	2.0	2.0	0.4	1.1	0.8
Interest				0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2	0.3	0.4	0.0	0.2	0.1
Total Budget Cost				0.0	0.2	0.4	0.4	0.5	0.6	0.6	1.5	2.2	2.3	2.5	0.4	1.2	0.9
Tax Cuts and Extensions With AMT Adjustment																	
Revenue	0.7	0.9	1.8	2.5	1.7	1.5	1.5	1.5	1.6	1.6	2.1	1.9	2.0	2.0	1.6	1.8	1.7
Interest	0.0	0.1	0.1	0.1	0.2	0.3	0.5	0.5	0.6	0.7	0.8	0.9	1.0	1.1	0.4	0.7	0.6
Total	0.7	0.9	1.9	2.6	2.0	1.8	2.0	2.1	2.2	2.4	2.9	2.8	3.0	3.2	2.0	2.5	2.3
GDP in \$ billions	10,150	10,337	10,841	11,559	12,304	12,909	13,522	14,173	14,846	15,526	16,220	16,931	17,667	18,433	142,387	152,530	195,417
Source: See Tables 1 and 2.																	