

## **Tax Cuts and the Budget**

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## **Abstract**

This paper provides new evidence on the magnitude of the budget surplus under responsible and realistic accounting procedures, and on the wisdom of a large-scale tax cut. We show that although the current projected surplus is about \$5.6 trillion over the next 10 years, basic corrections to incorporate responsible approaches to budgeting and plausible notions of current policy reduce the available 10-year surplus to between \$1.0 and \$1.7 trillion. A full recognition of the growth of unfunded entitlement programs makes the surplus vanish entirely.

These findings suggest that the President's proposed tax cut—which is billed as a \$1.6 trillion proposal but which would in fact cost well over \$2 trillion—is excessively large. Moreover, we show that the President's tax proposal is poorly designed to stimulate the economy, and that arguments that tax cuts are needed to stop wasteful government spending and to avoid fully paying off the government's debt are flawed. Taken together, these factors suggest that tax cuts that consume all or more of the available surplus over the next 10 years and significantly worsen the long-term fiscal outlook remain a poor idea.

## **I. Introduction**

In a series of recent papers, we have presented evidence that the case for a substantial federal tax cut is weak, challenging many of the underlying assumptions and arguments used to support proposed cuts (Auerbach and Gale 1999a, 1999b, 2000). Since our most recent contribution in the fall of 2000, several significant political and economic changes have led to renewed calls for tax cuts. The projected 10-year surplus rose significantly. The economy slowed, evoking Keynesian arguments for fiscal stimulus not heard in years. A spurt in discretionary spending raised new concerns that money not returned to taxpayers might be poorly spent. The prospect of paying off the national debt, and the problems it could create for financial markets and for government policy, moved into the political spotlight. And perhaps most importantly, a new President took office, committed by campaign pledge to cutting taxes.

In response to these changes, this paper updates our earlier work and investigates the new arguments put forward in favor of tax cuts. Section II examines the budget outlook over the next 10 years and the longer term. The Congressional Budget Office baseline projects surpluses of \$5.6 trillion over the next 10 years. But \$3.3 trillion is due to accumulations in retirement trust funds—which should not be allocated to other programs—and another \$0.6 trillion to \$1.3 trillion is due to overly optimistic assumptions about the course of tax and spending policy. Thus, with responsible budgeting practices and realistic assumptions, the amount available for a tax cut or new spending is between \$1.0 and \$1.7 trillion over the next 10 years. Moreover, over the longer-term, the government remains in deficit, not in surplus. Indeed, for reasons discussed below, the long-term imbalance now appears substantially larger than it did just months ago.

Section III describes President Bush's budget and tax proposals. The budget contains three significant proposals that would affect the underlying fiscal situation. The first would

divert the Medicare surplus—which is intended to pay for hospital insurance—into other medical programs. The second could lead to the diversion of \$600 billion of Social Security surpluses. Together these programs could divert over \$1 trillion from their intended uses, and would fly in the face of recent and virtually unanimous Congressional agreements not to invade the Social Security and Medicare trust funds. The third proposal, of course, is the President’s tax cut.

Section IV evaluates several issues regarding tax cuts. Over the next 10 years, the President’s proposal would reduce surpluses by much more than the \$1.6 trillion figure that is often quoted, and would, in fact, cost significantly more than the available surplus. The tax cut would leave no resources available for other policy uses over the next decade, unless Congress is willing to raid the retirement funds. Over the longer-term, the President’s proposal would significantly exacerbate the government’s fiscal shortfall.

The President’s proposal would be a particularly inappropriate and ineffective way to generate an immediate economic stimulus. The possibility that surpluses could lead either to bloated spending or to substantial government investment in private assets raises serious concerns, but we argue that neither potential problem justifies a large tax cut. Section V is a short conclusion.

## **II. The Budget Outlook**

### **A. The Baseline Forecast**

The most recent Congressional Budget Office baseline forecast, released in January 2001, projects cumulative unified budget surpluses of \$5.6 trillion between 2002 and 2011, including \$2.5 trillion in the Social Security trust fund (the “off budget” surplus) and \$3.1 trillion in the rest of the budget (the “on-budget” surplus). The projected surpluses rise significantly over time (see Appendix Table 1).

While the CBO baseline provides a common and visible benchmark, it is limited in several crucial ways and, by itself, does not provide sufficient information to assess various policy options. First, the baseline includes trust fund accumulations for Social Security, Medicare and government pensions, but ignores their accruing liabilities. Second, the baseline is based on conventions about spending and taxes that are inconsistent with likely outcomes. Third, as a point estimate, the baseline does not reflect the uncertainty of fiscal projections. Finally, the ten-year baseline is seriously misleading with respect to the long-term fiscal picture, which is dominated by the rapid projected growth of Medicare and Social Security.

Before turning to these issues, we briefly examine changes in the baseline forecast in the recent past. In July 2000, CBO (2000a) projected baseline surpluses of \$4.6 trillion overall, and \$2.2 trillion on-budget. At first glance, this suggests that fiscal prospects improved dramatically between July 2000 and January 2001, but this impression is somewhat misleading. To begin with, the two forecasts cover different fiscal years. The January 2001 forecast covers 2002 to 2011; the July 2000 forecast covers 2001 to 2010. Because the projected surpluses rise over time, the removal of 2001 and the addition of 2011 to the forecast period creates an increase in the 10-year surplus of about \$600 billion for purely mechanical reasons. Had the budget period not changed, the cumulative projected surplus in January, 2001 would have been \$5.0 trillion, rather than \$5.6 trillion. Thus, more than half of the increase in the reported 10-year surplus was not due to any change in the underlying fiscal prospects of the country. In addition, comparing changes in the 10-year baseline does not allow for the criticisms noted above, and in particular ignores the longer-term forecast, which has turned for the worse since July 2000.

## B. Adjusting the 10-Year Baseline

Politicians, the media, and citizens often look at the 10-year baseline surplus—the \$5.6 trillion—as money that can be allocated for tax cuts, new spending, or debt reduction. However, the baseline uses cash flow accounting, which is not always consistent with responsible budgeting practices, and it employs a series of unrealistic assumptions regarding future taxes and spending. Our goal in adjusting the 10-year surplus figures is to derive an estimate of the resources that policymakers may reasonably choose to allocate, having incorporated responsible budget practices and realistic assumptions.

### *i. Retirement trust funds*

As noted above, a substantial portion of currently projected budget surpluses over the next 10 years occurs because the Social Security trust fund will take in about \$2.5 trillion more in payroll tax revenues and interest received on its assets than it will pay out in benefits and administrative costs. In the past, President Clinton and Congressional leaders of both political parties agreed that accruing Social Security trust fund balances should contribute to improving that program's long-term financial viability, and should not be used to finance tax cuts or other spending programs. Indeed, as discussed below, the current Social Security trust fund accumulations are far outstripped by the accruing liabilities that they are meant to help offset. A full accounting of the Social Security system would show it substantially in deficit. At the very least, though, if the budget ignores the liabilities, it should certainly not count the assets as available for other purposes. Though this logic is codified in Social Security's off-budget status, it applies to other trust funds as well.

Medicare pays for health care for the elderly, and is divided into two parts. Part A, hospital insurance, covers hospital costs and is financed by payroll taxes. Part A is very similar

in structure to Social Security. Workers contribute payroll taxes to a trust fund while working and receive promised benefits when they are elderly. Part B, supplementary medical insurance, is financed by a combination of user fees and general revenues.

Over the next 10 years, the Medicare trust fund, which covers Part A, is projected to run surpluses totaling \$392 billion (CBO 2001, p. 19). Although Medicare is officially part of the on-budget surplus, both Houses of Congress voted last year to support measures that protected the Medicare trust fund from being used to finance other programs or tax cuts. The House of Representatives approved the measure by a vote of 420-2. The Senate passed two separate measures; 98 Senators voted in favor of one or both. The House also passed a similar resolution earlier this year by 407-2. The strong votes demonstrated overwhelming Congressional support for preserving the Medicare trust fund.

While the Social Security and Medicare trust funds have received significant attention in the budget debate, a third set of retirement funds has not. Trust funds holding pension reserves for federal military and civilian employees are projected to accrue surpluses of \$419 billion over the next 10 years (CBO 2001, p. 19). Under current budget procedures, these surpluses are a component of the on-budget surplus. Like Social Security and Medicare, however, these trust funds represent current accumulations intended to provide retirement benefits to future workers. Thus, the same economic logic that has led fiscally responsible leaders to protect Social Security and Medicare balances implies that government pension reserves should be protected as well. Many states, in fact, already separate their pension reserves from funds available for tax cuts and other spending. A recent proposal (H. RES. 23) by Representatives Baron Hill (D-Indiana) and Gene Taylor (D-Mississippi) would protect the pension reserves owed to military workers. Fiscal responsibility requires that the same protections be accorded to civilian pensions as well.

*ii. The definition of current policy*

In order to project future spending and tax revenues, assumptions must be made about how tax and spending programs will evolve. The CBO's baseline forecast is intended only to measure the implications of maintaining "current policy." But how one should project current policy into the future is not always obvious. The baseline forecasts project current policy subject to a variety of statutory requirements, which limit the scope of the forecast's underlying assumptions and time horizons and can be at variance with reasonable expectations. Thus, one should not confuse the CBO baseline with a forecast of what is most likely to occur.

Mandatory spending—e.g., entitlements, such as Social Security—is generally assumed to continue as it is currently structured in the law. Discretionary spending, however, poses problems with regard to defining "current policy." Unlike mandatory spending, discretionary programs—e.g., defense, education, the environment, or infrastructure—are not automatically included in the annual budget and thus require annual appropriations from Congress. As a result, no consensus exists about how to project current policy for discretionary programs. In light of this quandary, CBO simply assumes that real discretionary spending authority will remain constant at fiscal year 2001 levels (CBO 2001, p. 76).

This assumption is clear, but may not be very reasonable. Discretionary spending totaled 6.3 percent of GDP in 1999 and 2000, the lowest share since at least 1962. Under CBO's ten-year baseline forecast, discretionary spending would fall to 5.1 percent of GDP. That is, it would fall by 20 percent relative to the size of the economy. It would also fall by over 10 percent in per capita terms. In a growing economy with growing defense needs and other concerns, this seems to be a particularly unrealistic projection.



At the very least, it would be more reasonable to have real discretionary spending grow at the same rate as the population (about 1 percent per year). Indeed, George W. Bush has made precisely the same point, arguing during the campaign that an “honest comparison” of spending growth should take inflation and population growth into account (Slater 1999).<sup>1</sup> Adjusting for population growth and inflation would still allow discretionary spending to fall to 5.6 percent of GDP by 2011. Incorporating this baseline would raise discretionary spending by \$359 billion (CBO 2001, Table 4-4) and, counting the added interest payments on federal debt that would be required, would reduce available surpluses by about \$418 billion.<sup>2</sup>

To put these figures in perspectives, note that in the campaign President Bush proposed new spending programs totaling \$475 billion, along with cuts in government spending of \$196 billion, for a net spending increase of \$279 billion between 2001 and 2010 (Bush-Cheney 2000a). This is virtually identical to the cost of having real discretionary spending grow by 1 percent over the same period (rather than over 2002-2011, see CBO Table 4-4). Thus, this suggests that having real discretionary spending grow by 1 percent is a lower bound for the likely path of discretionary spending, because Congressional Democrats and Republicans may have proposals of their own sometime over the next 10 years, because President Bush may have more proposals for spending—especially on defense—after his initial round of proposals, and because emergencies or other contingencies will inevitably arise.

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<sup>1</sup> Indeed, the Bush campaign web site included the statement that “When adjusted for inflation and population, state spending [in Texas] will increase by only 3.6 percent between 1994-1995 and the end of the 2000-2001 biennium.” [www.georgewbush.com/issues/budget.html](http://www.georgewbush.com/issues/budget.html).

<sup>2</sup> Interest payments are estimated by assuming the federal government pays an average of the 3-month rate and the ten-year rate on outstanding debt (CBO 2001, table E-2), that half of the increased expenditures in a given year accrue interest costs during that year, and all of the increased expenditures in a given year accrue interest costs in future years.

An alternative, perhaps even more realistic, baseline would have discretionary spending grow at the same rate as nominal GDP, thus keeping the ratio of discretionary spending to GDP constant. Relative to the baseline forecast, this would raise spending by \$905 billion (CBO 2001, Table 4-4) and reduce the available surplus by \$1,055 billion between 2002 and 2011.

At least two aspects of current policy toward taxation merit consideration. The first regards the alternative minimum tax (AMT), one of the most complex areas of individual tax law. The AMT was implemented as a sort of backstop confronting the small number of taxpayers who are considered to be too aggressive in creating shelters and claiming deductions to avoid paying taxes.

In practice, the AMT has affected few taxpayers. In 2000, for example, only 1.3 percent of taxpayers faced the levy. Under current law, however, the Joint Committee on Taxation projects that the number of taxpayers facing the AMT will rise from 3.5 million in 2002 to 20.7 million in 2011. The main reason is that the AMT exemption is not indexed for inflation. CBO's surplus forecasts assume that the dramatic rise in AMT taxpayers will occur. However, the increase would be fought fiercely by the affected groups. Indeed, the problem has already received significant attention, even though only a small portion of taxpayers currently face the tax.

“Current policy” would be better represented by indexing the AMT for inflation. This would keep the number of taxpayers on the AMT limited to about 1.9 percent by 2010. The lost tax revenue from this policy would total \$113 billion over the next 10 years. Counting the added interest, the net cost would be \$130 billion.<sup>3</sup>

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<sup>3</sup> Estimates of the revenue loss from indexing the AMT from 2002 to 2010 are taken from Rebelein and Tempalski (2000). The estimates rise steadily and reach \$18 billion by 2009, and \$24 billion by 2010. We extrapolate the 2011 revenue loss to be \$30 billion. These figures probably understate the true costs because recent estimates (e.g., JCT 2001) have revised upward the number of people expected to be on the AMT in future years.

A second tax issue relates to temporary tax provisions, a number of which are scheduled to expire over the next decade. For all taxes other than excise taxes dedicated to trust funds, CBO assumes that legislated expirations occur as scheduled. In the past, however, the temporary provisions have typically been extended another few years each time the expiration dates approached. In light of this practice, current policy is more aptly viewed as assuming that these so-called “extenders” will be granted a continuance. Extending the provisions—except the one relating to AMT, which is addressed above—through the ten-year horizon would cost a net of \$69 billion in lost revenues (CBO 2001, Table 3-12), plus an estimated additional \$13 billion in interest costs.

*iii. Implications for the available surplus over the next 10 years*

Table 1 shows that adjustments for responsible budgeting practices and realistic policy assessments have a profound effect on the amount that should be considered to be available for tax cuts or new spending. (Appendix Table 1 provides year-by-year estimates of the alternative surplus measures.) The total ten-year projected surplus of \$5.6 trillion is shown in the first line. Removing the Social Security trust fund surplus generates an “on-budget” surplus of \$3.1 trillion. Removing Medicare trust funds reduces the surplus to \$2.7 trillion. Protecting government pension funds from invasion for other purposes reduces the available surpluses to \$2.3 trillion. That is, almost 60 percent of the projected ten-year surpluses are due to the retirement trust funds.

Adjusting for the AMT and expiring tax provisions reduces the available surplus to \$2.1 trillion. If real discretionary spending were held constant on a per capita basis—for example, if President Bush’s campaign spending plans were implemented, but no other new spending was implemented over the entire decade—the net available surplus for other programs would be just

under \$1.7 trillion. In contrast, if discretionary spending were held constant as a share of GDP, the remaining available surplus would be about \$1 trillion.

Thus, depending on what is considered the most reasonable assumption regarding current policy toward discretionary spending, the available surplus is between \$1.0 trillion and \$1.7 trillion. This represents between 18 and 30 percent of the total surplus, and roughly one-third to one-half of the on-budget surplus over the ten-year period.<sup>4</sup>

### C. Looking Beyond the Ten-Year Horizon

As indicated, the Social Security and Medicare trust fund balances fall far short of what would be needed to meet liabilities under current policy for those programs. This imbalance is masked by the asymmetry in unified budget accounting practice that counts assets for these programs but not liabilities, a practice only slightly improved on by placing the assets off-budget. Were this problem corrected, the ten-year surpluses just reported would be negative. An alternative way of recognizing these large entitlement liabilities is to extend the planning horizon, to include the future years in which these liabilities come due and thus can no longer be ignored, even under the cash accounting method.

The use of long-term planning horizons is now standard for Social Security and Medicare. In the context of an aging population and rapidly rising medical care expenditures, this is the only way to get an accurate picture of the fiscal balance of these programs – and hence the government’s budget as a whole.

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<sup>4</sup> The Center on Budget and Policy Priorities (CBPP) has made a similar set of adjustments and estimated an available surplus of about \$2 trillion over the next 10 years (Greenstein and Kogan 2001). The CBPP estimates differ from ours in a number of ways. CBPP focuses on holding discretionary spending per capita constant, does not adjust for government pension reserves, and includes adjustments for some other programs, such as farm spending. The differences between the CBPP estimates and the ones presented above, however, are small relative to their similarities: both studies make the case that the surplus available for new spending programs or tax cuts is much less than it appears to be, based on the baseline forecast.

To take these and other factors into account, previous research (Auerbach 1994 and 1997, Auerbach and Gale 1999a, 1999b, 2000) estimates the long-term “fiscal gap” under different policies. The fiscal gap is the size of the permanent increase in taxes or reductions in non-interest expenditures (as a constant share of GDP) that would be required *now* to keep the long-run ratio of government debt to GDP at its current level. Over an infinite planning horizon, this requirement is equivalent to assuming that the debt-GDP ratio not explode. The fiscal gap gives a sense of the *current* budgetary status of the government, taking into account long-term influences. To calculate the fiscal gap, we use the most recent CBO 10-year and long-term forecasts. Details of the methodology are described in Auerbach (1994, 1997), and Auerbach and Gale (1999a, 1999b, 2000).<sup>5</sup>

Our current estimates of the long-term gap for different assumptions about discretionary spending and for different planning horizons are shown in line 3 of Table 2. Under the CBO baseline assumptions about discretionary spending – constant in real terms until 2011 and constant as a share of GDP thereafter – the fiscal gap through 2070 is projected to be 0.67 percent. That implies that a permanent tax increase or spending cut of 0.67 percent of GDP, which would currently be about \$67 billion per year, would be required to achieve the same national debt-GDP ratio in 2070 as currently exists.

However, the picture between now and 2070 understates the magnitude of the long-term problem. The fiscal gap on a permanent basis – what would be needed to prevent the national debt from exploding in the long run – is currently 3.33 percent of GDP. The permanent gap is so

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<sup>5</sup> If the ten-year forecast has been updated more recently than the long-term forecast—as is currently the case—we adjust the long-term forecast for these changes. To do so, we incorporate the projected changes in revenues and outlays (excluding debt service) through the 10-year budget period and assume that changes in revenue and non-interest outlays in subsequent years are equal as a share of GDP to the changes projected for the last year of the budget period.

much larger because the budget is projected to be substantially in deficit during the years approaching 2070 (and those that follow).

Estimates of the fiscal gap are also sensitive to assumptions about the baseline for discretionary spending. Allowing discretionary spending outlays to remain constant as a share of GDP from now on, rather than beginning only in 2011, raises the fiscal gap further, to 1.45 percent of GDP over the next 70 years and 4.14 percent on a permanent basis.

These projections are far more pessimistic than the ones we reported just months ago (Auerbach and Gale 2000). The previous estimates are reproduced in line 1 of Table 2. This change may be puzzling in light of the improved short-term fiscal picture over the last six months, but the reconciliation is straightforward. Our prior estimates were based on CBO's July 2000 10-year forecast and CBO's fall, 1999, long-term projections. Since then, both the 10-year and the long-term projections have been updated, and the pessimistic changes in the new long-term forecast dominate the optimistic changes in the new short-term forecast.

The new long-term forecast (CBO 2000b) significantly raises the estimated fiscal gaps, as shown in line 2 of Table 2. The main reason is a change in an assumption about the growth rate of Medicare and Medicaid spending. Whereas CBO previously assumed that health costs per enrollee would cease rising faster than wages over the next two decades, they now assume that the growth in excess of wages will fall from its current rate of 2.1 percent to 1.1 percent but no further. This new assumption reflects the growing consensus that the previous one was far too optimistic in light of history. Indeed, it simply reflects the recent recommendation of the Technical Review Panel on the Medicare Trustees Reports issued in December 2000. Comparing lines 2 and 3 of Table 2 shows that incorporating the most recent 10-year forecast

reduces the long-term fiscal gap, as expected. But the net effect of the new 10-year and long-term forecasts is to significantly raise the estimated fiscal gaps.

#### D. Uncertainty

It is difficult to predict the course of the economy over a period as short as 6 to 9 months. Thus, it should not be surprising that all of the estimates above are subject to a considerable amount of uncertainty. A few comments on the uncertainty of the forecasts are warranted.

First, CBO's underlying economic assumptions do not appear to be unreasonable. Their forecast for GDP growth over the next two years—2.4 percent in 2001 and 3.4 percent in 2002—is in the middle of the Blue Chip forecasters. Notably, CBO does not foresee a recession in 2001, just a slowdown. Just as notably, CBO projects that the economy will turn around and growth will accelerate in 2002, even without any changes in tax or spending policy. CBO predicts a growth rate of about 3.1 percent for the rest of the decade, which does not seem out of line with reasonable expectations. CBO (2001, p. 60) points out that its forecast does not depend on a continuation of high capital gains revenues or high stock market values and in fact projects a decline in the share of revenues from capital gains.

Second, there is simply a huge amount of uncertainty regarding the evolution of the economy and the surplus. CBO (2001, p. 99) reports optimistic and pessimistic scenarios for the economy, where the ten-year surpluses range from \$8.8 trillion to \$1.6 trillion. In the latter case, there is an on-budget deficit of about \$525 billion over the 10 years. CBO (2001, p. 96) also notes that on average their revenue forecast has been off by 11 percent of revenues after 4 years. If revenues were consistently 11 percent higher or lower than forecast over the next 10 years, the surplus would differ from baseline by about \$3.9 trillion. Interestingly, CBO (2001, p. 102) estimates that a mild recession followed by higher-than-trend growth would have little effect on

the ten-year surplus, but that does not preclude a deeper, longer recession or a change in the long-term growth rate from having a significant impact.

Third, an important source of uncertainty stems from the fact that the surpluses are expected to rise over time. Only 12 percent of the projected total surplus and 10 percent of the projected on-budget surplus occurs in the first two years. Likewise, only 36 percent of the projected total surplus and 32 percent of the projected on-budget surplus occur in the first five years.

Fourth, other things equal, long-term estimates are inherently more uncertain than short-term estimates. But the added uncertainty should not lead us to ignore long-term issues, for at least two reasons. First, the serious consequences of a relatively bad long-term outcome should spur a precautionary response from policymakers now (Auerbach and Hassett 2001). Second, over the next 10 years, the primary factor affecting surpluses will be the course of the economy, which as noted above, is uncertain. In contrast, in the longer-term, the demographic pressures that are due to an aging population are far more certain to occur.

#### E. Implications for the Tax Policy Debate

These findings suggest some useful lessons for the current debate about how to allocate the surplus. The virtually exclusive emphasis given to baseline ten-year budget projections in current fiscal policy debates is inappropriate. The baseline forecast suggests the availability of trillions of dollars for tax cuts or new spending, but is based on a particular set of views of what constitutes current policy and a particularly strange set of assumptions regarding retirement trust fund accumulations. Basic corrections to incorporate responsible approaches to budgeting and plausible notions of current policy reduce the available ten-year surplus to between \$1.0 and \$1.7



trillion, while a full recognition of the growth of unfunded entitlement program liabilities makes the surplus vanish entirely.

Despite the recent strong improvement in the government's fiscal position, there is still a long-term imbalance. This imbalance is a "future" problem only insofar as our budget accounting rules ignore the existence of liabilities already accrued. Thus, a large tax cut is not simply a matter of giving unneeded funds back to taxpayers. It reflects a decision to require other, future taxpayers to cover the existing long-term fiscal gap, made larger by the tax cut. While government might spend additional funds unwisely, it already is committed to very large social programs that the American public has no apparent desire to curtail.

Given this long-term imbalance, the fiscal climate may be more troubling now than in previous years. The short-term surplus is no doubt an improvement, but fiscal discipline may be especially difficult to impose under current conditions. In the 1980s and early 1990s, when the country faced both short-term and long-term deficits, the short-term deficits helped focus attention in a way that also helped reduce long-term gaps. Today, the United States faces the same trade-off between current and future generations as in earlier decades, and it is still confronting a long-term shortfall. But the current policy discussion focuses on ways to use the surplus that would likely exacerbate the long-term situation.

### **III. President Bush's Budget and Tax Proposals**

The Administration's underlying baseline forecast is quite similar to CBO's in many respects. The Administration baseline forecasts a 10-year surplus of \$5.6 trillion, a Social Security trust fund surplus of about \$2.6 trillion, and a Medicare part A trust fund surplus of \$526 billion (OMB 2001, Table S-1). Thus, the projected non-Medicare, non-Social Security surplus is \$2.5 trillion. The comparable CBO projection is \$2.7 trillion. The Administration's

budget forecast could be adjusted further in the same way as the CBO forecast was above, but since the overall numbers are so similar, we omit the calculations. However, it is important to note that the administration's budget does not provide for resources for fixing the AMT or granting permanent continuances to expiring tax credits. It allows for \$173 billion of net new spending over baseline over the decade, but gross new spending is substantially higher and most of the required cuts are not yet specified.

The Administration proposes significant, but subtle changes with respect to the budgetary treatment of Social Security and Medicare. The Administration would not devote the entire Social Security surplus to paying down the debt. Rather, the Administration claims that only \$2 trillion of debt can be repaid during the budget period, so that about \$600 billion of the Social Security surplus is left over. The Administration would not invest these funds in private assets. Thus, by definition, the funds must be used to finance tax cuts above those already proposed or other spending above amounts called for in the budget. The latter possibly includes Social Security privatization, as hinted in the budget. Of course, if the funds are eventually used for anything other than Social Security benefits under the existing program, government investment in private assets that serve as a reserve from which to pay future Social Security benefits under the existing system, or debt reduction, the Administration will have effectively siphoned off funds from the Social Security trust fund to use for other purposes.

A similar policy is proposed explicitly for Medicare. The part A trust fund is projected to run a surplus of \$526 billion over the decade. Part B—supplemental medical insurance—is *stipulated by statute* to be funded from general revenues and from medical insurance premia. Typically, general revenues cover three quarters of these expenses. The Administration, however, has claimed that Medicare taken as a whole is running a deficit over the next 10 years,

because the general revenue financing requirements of part B exceed the trust fund accumulations of part A. Thus, the administration proposes to wipe out the \$526 billion part A cash flow surplus by spending it on part B. There are numerous problems with this policy. First, the taxes paid into Medicare part A, and hence the surpluses there, are intended to finance future hospital insurance, not current SMI. Second, the part A trust fund faces a long-term deficit, as described above, so removing the funds from part A exacerbates that situation. Third, the administration is in effect trying to use the part A surplus to relieve burdens on general revenues, and free up funds for a tax cut.

Taken together, these changes would strip more than \$1 trillion from the Social Security and Medicare trust funds, would threaten the fiscal accomplishments of the recent years, and would undermine the bipartisan consensus discussed above to protect the Social Security and Medicare trust funds.

The President's tax cut is the centerpiece of his budget. The plan contains several major elements, and is phased in gradually over time (Bush-Cheney 2000b, JCT 2000a, OMB 2001). It is important to note that the plan itself has changed somewhat over time. On February 8, 2001, the President submitted a plan to Congress with the following major structural elements, listed in order of their revenue cost when fully phased in:

- Reduce the highest income tax rates

By 2006, tax rates in the 39.6 and 36 percent brackets would fall to 33 percent, and rates in the 31 and 28 percent brackets would fall to 25 percent.

- Abolish the estate tax

The estate tax would be reduced gradually and then abolished in 2009. It is unclear whether any changes in the taxation of capital gains at death would occur.

- Create a new 10 percent tax bracket

The first \$6,000 of taxable income for singles and \$12,000 for married couples would be taxed at 10 percent rather than 15 percent.

- Expand the child credit to high-income households, reduce the phase-out rate, and double the credit amount.

Eligibility for the full credit would be extended to all taxpayers with income below \$200,000 (up from \$110,000 for married couples and \$75,000 for singles, currently), the phaseout rate would fall from 5 percent to 2 percent, and credit would double to \$1,000. The credit would remain non-refundable.

- Allow a two-earner deduction

Allow a 10 percent deduction for the earnings of the lower-earning spouse in a two-earner family. The maximum deduction would start at \$12,000 in 2002 and rise to \$30,000 in 2005.

Other components of the plan submitted to Congress on February 8, 2001, include allowing a charitable contributions deduction for households that do not itemize, allowing individuals aged 55 and over to make penalty-free withdrawals from their IRAs to make charitable contributions, raising the cap on corporate charitable contributions from 10 percent to 15 percent of taxable income, expanding the limits and uses of educational IRAs, and permanently extending the credit for research and development.

In his budget submission of February 28, the President included a variety of additional features. These include: a one-year extension of expiring tax provisions, a tax credit for individuals to buy health insurance, extension of medical saving accounts, subsidies for long-term care costs, tax credits for individual development accounts, a tax deduction of \$400 for

teachers' out-of-pocket expenses for classroom items, a tax credit for the installation of rooftop solar equipment, an extension of the tax credit for fuel produced from renewable resources, capital gains exclusions on land sold for conservation purposes, raising and making permanent the adoption tax credit, and numerous other items.

#### **IV. Issues in the Tax Cut Debate**

Our previous work evaluated several arguments in favor of a large tax cut and found them wanting. With respect to some of these arguments, there is little new to be said, so we review our previous conclusions and refer the reader to our earlier work for elaboration.

One argument cites the historically high share of GDP being absorbed by federal taxes as an argument that tax burdens have risen too high and need to be reduced. Aside from the issue of whether such a move would be fiscally responsible, this argument ignores the fact that tax burdens on most families, as a share of income, actually have fallen during the past several years (Auerbach and Gale 1999a). The increase in taxes as a share of GDP is attributable to a rise in effective tax rates at the upper end of the income distribution and, more importantly, the increasing share of income going to these individuals, and therefore subject to higher marginal tax rates.

A second argument, that the surplus is the American people's money and should be given back to them, simply ignores the fact that, with a long-term fiscal imbalance, giving money to some individuals amounts to taking even more from others.

An entire debate revolves around both the actual distributional effects of various tax plans and the desired distributional effects. We do not enter that debate here. However, see Gale (2001) for further discussion.

Now that the President has provided a specific proposal, however, it is appropriate to consider its revenue cost in relation to current estimates of the ten-year and long-term budget projections. Also, we can evaluate arguments made recently in its favor, notably its potential as a Keynesian stimulus package, an antidote to the disappearance of the government debt market, and a way to prevent wasteful government spending.

#### A. Size of the Tax Cut

Considering the size of the President's tax cut is more complicated than it might at first appear. Recently, HR 3—which was passed by the House on March 8—included the creation of a new 10 percent bracket and the reduction in the marginal tax rates, with the former accelerated one year. The Joint Committee on Taxation has estimated that if HR 3 were enacted, approximately 36 million taxpayers would face, or be affected by, the AMT by 2011. This is 15 million more than the 21 million that would be placed under the AMT under current law. The Bush administration has acknowledged that the AMT creates a problem for the proposed tax cut. Indeed, the tax program on the Bush campaign web site (where voters could calculate how much of a tax cut they would receive under Bush's plan) did not allow for the AMT to reduce anyone's tax cut, and thus implicitly assumed that an AMT offset was *de facto* a part of the Bush plan. For all of these reasons, it is arguable that the necessary AMT adjustments should be considered part of the Bush plan. But that argument is semantic. Even if they are not considered a part of the plan *per se*, the required AMT adjustments are a problem created by the plan that will need to be addressed. To be clear, the adjustments would merely undo the increase in AMT taxpayers due to the Bush plan. They would not address the increase in AMT taxpayers that is expected to occur under current law even in the absence of tax changes.

Table 3 breaks down the revenue costs into several components. (Year-by-year and provision-by-provision estimates are provided in Appendix Table 2). The provisions of HR 3 would reduce taxes by \$958 billion over the next 10 years. Other components of the plan the President submitted to the Congress on February 8 would cost \$717 billion. Additions to the plan that were in the President's budget, but not in the earlier submission to Congress cost another \$127 billion, by the Administration's estimates. The adjustments required to avoid having taxpayers bear the burden of the AMT because of Bush's tax cuts would total \$292 billion. The added interest payments on the federal debt caused by the reduction in federal revenues would cost another \$418 billion. Thus, although the proposal is often referred to as a \$1.6 trillion tax cut, the real cost of the proposal now comes to an astonishing \$2.5 trillion over the next 10 years. Even if the both the tax cut and interest costs associated with AMT adjustments are ignored, the plan would cost almost \$2.2 trillion over the next decade.

Ultimately, assessments of whether Bush's proposed tax cut is too large are in "the eyes of the beholder." Several analytic perspectives, however, suggest the tax cut is excessive. First, the magnitude of the tax cut exceeds the "available surplus" listed in Table 1 by between \$500 billion and \$1.5 trillion. Second, recall that the surplus excluding retirement trust funds equaled \$2.3 trillion. Thus, enacting Bush's tax cut (even without the AMT adjustment) would imply that virtually no other important policy priorities could be met unless Congress were willing to finance the programs with balances in the retirement trust funds. Third, the Bush tax cut with AMT adjustment is exactly equal in size to the Administration's projected non-Medicare, non-Social Security surplus.

Some have argued that official revenue estimates, in omitting potentially important behavioral responses, overstate the revenue cost of the tax cut, and that incorporating such

responses could reduce the costs by one-quarter (Feldstein 2001a, 2001b). While there is no doubt that official revenue estimates omit some types of behavioral responses, there is significant controversy over how large those responses are. Moreover, analyses of the economic responses typically do not consider the further effects on revenue of the reduction in national saving that would occur along with the cut in taxes. The reduction in national saving would reduce productivity growth and place a drag on economic growth.<sup>6</sup>

A fourth perspective on the size of the cut can be gleaned from Table 2: the proposed tax cut would substantially increase the long-term fiscal gap. Even if discretionary spending were held constant in real terms through 2011, so that it fell continuously as a share of GDP, Bush's tax cut would triple the long-term fiscal gap through 2070 and raise it by 150 percent on a permanent basis. This would significantly worsen the long-term fiscal problem the government faces. This should not be surprising. By 2011, the Bush tax cut, including the AMT adjustment, would reduce income tax revenues by almost 19 percent on a permanent basis.

Fifth, to respond to the criticism that the Bush proposals are irresponsibly large, some tax cut advocates have argued that Bush's proposals are much smaller relative to the economy than the 1981 tax cut signed by President Reagan. Indeed, Reagan's tax cut has been estimated by the CBO (1983) and the Treasury (Tempalski 1998) to have reduced revenues by between 4.2 percent and 5.6 percent of GDP, much larger than the estimates for the Bush plan. However, recall that the tax system was not indexed for inflation in 1981. CBO (1983) estimates that at least 40 percent of the Reagan tax cut was simply an elimination of tax increases that would have occurred because of inflation, suggesting a real tax cut of between 2.4 and 3.3 percent of GDP. Bush's proposed tax cut, on the other hand, may appear smaller than it actually is because it

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<sup>6</sup> Orszag (2001), for example, estimates that the decline in national saving would reduce revenue by about as much as the improved incentives have been claimed to raise revenue.



would be phased in slowly over time. About three-quarters of the costs occur in the second five years of the forecast period (Appendix Table 2). Thus, estimates of the cost of the plan relative to GDP averaged over the whole 10-year period are misleading. In 2011, the cost of the tax cut and the accompanying AMT adjustments would be about estimated at 1.95 percent of GDP. In addition, it is useful to recall that the 1981 tax act was immediately eroded by income tax increases in 1982 and 1984, with further increases in 1990 and 1993, reflecting a realization of how damaging the original plan had been to the government's fiscal balance. Using the 1981 tax cut as a benchmark for responsibility, then, is somewhat problematic.

## B. Tax Cuts and Recession

The Bush Administration has argued that the case for its tax cut is strengthened by the possibility that the economy is entering a recession. If there is a recession, and if tax cuts could in general fight recessions effectively – both problematic assumptions – the President's tax proposal is poorly designed to fight a recession that is happening currently. First, in the President's original proposal, there is no tax cut proposed for fiscal 2001 (which ends on September 30, 2001). It is hard to see how a tax cut could boost the economy now if it is not providing any tax cuts now. In addition, the President's plan would only provide tax cuts of \$21 billion (about \$75 per person or 0.2 percent of GDP) in fiscal 2002. Thus, in the next 18 months, the plan would provide virtually no stimulus at all. HR 3 would provide about \$6 billion in tax cuts in 2001, but in a \$10 trillion economy, this adjustment is trivial.

In addition, an anti-recession plan would be aimed at increasing current spending by government, business, or households. The President's plan is aimed at the private sector, and provides no incentives for business investment. This leaves consumption as the main vehicle for increasing aggregate demand. But the plan targets the bulk of individual tax reductions at high-

income households, who are less likely to be the short-horizon consumers who would spend a significant share of increases in after-tax income (Dynan, Skinner, and Zeldes 2000).

To affect the economy sooner, the President's tax reduction could be accelerated, but this would raise its revenue cost, too. Our estimates suggest that accelerating the entire plan by a year would add about \$400 billion to the cost.<sup>7</sup> This would further crowd out other spending priorities and would likely put increased pressure on interest rates.

### C. Are Tax Cuts Needed Because Government Would Waste any Surplus Funds?

Another argument claims that we need tax cuts because surpluses lead to bloated government spending. There is an element of truth to this characterization of the problem. For example, Congress exceeded the caps on discretionary spending by increasing amounts in each of the past three years, and it may well be that the pressure of large deficits helps restrain spending. But there are several flaws to the argument as well.

First, before concluding that government will spend all available funds, it is important to note that the vast portion of recent surpluses have been allowed to accrue, and as noted above, discretionary spending is currently at its lowest level relative to GDP in almost 40 years.

Second, the logic of the argument suggests that the current level of government spending is too high, as distinct from some government spending being wasteful. If some but not all government spending is worthwhile, it would, of course, be desirable to eliminate the wasteful government spending. But cutting only waste is not a straightforward task. Reforming the incentives that lead to government waste is a laudable objective, but absent such reform one must accept the reality that some government spending will be wasteful. This reality likely would

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<sup>7</sup> Greenstein (2001) obtains a similar result.

reduce the desired level of spending, but it does not imply that the optimal level of spending is zero or, for that matter, lower than the current level.

Finally, even if large surpluses do encourage spending that is undesirable, there is a much simpler and less disruptive way to accomplish this objective, namely, to reform the current method of government accounting that counts trust fund assets but not liabilities. Admitting that we don't have the money surely is preferable to giving away funds that we don't really have in the first place.

#### D. Is Paying Off the Public Debt a Reason for Tax Cuts?

An argument put forth recently by Alan Greenspan, and quickly repeated by tax cut advocates, is that under current surplus projections, the government will pay off all available government debt by around 2006 or shortly thereafter. At that point, with more surpluses pouring in every year, the government would have to start accumulating private assets. Greenspan and others argue that having the federal government hold such assets would raise the specter of government interference in the operation of private companies, and that to avoid this it would be preferable to cut taxes now, rather than being forced either to cut taxes or raise spending massively at some point in the future.

Before addressing this issue, it is helpful to remind ourselves how a government with a substantial long-term fiscal imbalance can face the prospect of paying off its marketable debt. These two items are reconciled by the fact that paying off the marketable debt would still leave enormous unfunded liabilities to pay future entitlements, liabilities equivalent to large amounts of nonmarketable government debt. Thus, paying off all or most of the marketable national debt does not ensure that a responsible fiscal policy is being followed, for debts of a much larger

magnitude remain. The problem at hand, then, is that marketable government debt is declining, while a broader measure of government debt is not.

President Bush's "solution" to this liquidity problem is simply to increase the level of marketable debt, thereby increasing the broader measure of indebtedness as well. But one can also envision a range of policies that would increase the government's marketable debt without increasing its liabilities overall.

One approach is for government trust funds currently holding marketable government debt to hold other assets instead. Designing mechanisms to protect against the hazards of government involvement in private securities markets is a serious issue that we do not wish to address in any detail here. However, it is worth noting that state and local government pension funds already hold \$3 trillion in assets, including \$2 trillion in equities (Orszag 2001). Evidence suggests that these funds earn competitive returns, and that—even with virtually none of the safeguards that would be imposed on federal investments—only a tiny fraction of the state and local investments are "targeted" (Munnell and Sunden 1999). The governments of Norway and Denmark have also had favorable experiences investing in private funds (Orszag 2001. See also Aaron and Reischauer 1998).

An alternative approach to making more of the government's existing liabilities marketable is to convert implicit liabilities to explicit ones. This is the essence of another of President Bush's campaign proposals, to siphon payroll taxes into private accounts. By transferring tax revenues to private accounts meant to offset reductions in future Social Security benefits, the government would be increasing its marketable debt but reducing its unfunded Social Security liability at the same time.

As these two examples illustrate, the government can increase the level of its marketable public debt without increasing its overall level of indebtedness either by exchanging marketable debt for other assets or by converting nonmarketable debt into marketable debt. But there also exist intermediate steps between private accounts and government investment in equity, for example the establishment of accounts held by the government on behalf of individuals, with individuals making investment choices from a limited set of diversified portfolios.

How government would handle investment in private assets and how the Social Security system should be reformed are important questions that should be addressed. But they do not provide a justification for large tax cuts any more than for large increases in government spending.

## **V. Conclusion**

The current fiscal surpluses are a significant accomplishment, and should not be taken for granted. But the underlying budget situation is bleaker than the official numbers suggest, and proposed tax cuts would cost far more than advertised. Most of the other arguments given in favor of tax cuts are demonstrably weak. Taken together, these factors suggest that tax cuts that consume virtually all of the available surplus over the next 10 years and that significantly worsen the long-term fiscal outlook remain a poor idea.

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**Table 1**  
**How Big is the Available Surplus?**  
**2002-2011**

(\$ Billions)

|   | 2002-2006 | 2007-2011 | 2002-2011 |
|---|-----------|-----------|-----------|
| CBO Baseline  | 2,007     | 3,603     | 5,610     |
| - Adjust for Retirement Funds                               |           |           |           |
| SS  | 1,019     | 1,470     | 2,488     |
| Medicare  | 200       | 192       | 392       |
| Government Pensions   | 198       | 221       | 419       |
| = Surplus, adjusted for retirement funds                    | 590       | 1,720     | 2,311     |
| - Adjust for Current Policy                                 |           |           |           |
| AMT   | 19        | 111       | 130       |
| Expiring Provisions   | 21        | 61        | 82        |
| Real DS/Person constant                                     | 79        | 339       | 418       |
| = Surplus, adjusted for retirement funds and current policy | 471       | 1,209     | 1,681     |
| - Further adjustment if discretionary spending/GDP constant | 126       | 511       | 637       |
| = Surplus, adjusted for retirement funds and current policy | 345       | 698       | 1,044     |

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Sources: Congressional Budget Office (2001); Rebelein and Tempalski (2000); and authors' calculations.

**Table 2**  
**Estimates of the Long-Term Fiscal Gaps**  
(Percent of GDP)

**Spending Assumptions**  
**2002-2011**

|   | <b>CBO Baseline</b> |             | <b>Constant DS/GDP</b> |             |
|---|---------------------|-------------|------------------------|-------------|
|   | Through 2070        | Permanent   | Through 2070           | Permanent   |
| (1) Auerbach-Gale (2000) Estimate                                 | -0.67               | 0.31        | 0.28                   | 1.36        |
| (2) (1), adjusted for 10/2000 CBO long- term forecast             | 1.08                | 3.77        | 2.20                   | 4.93        |
| (3) Current Estimate = (2), adjusted for 1/2001 ten-year baseline | <b>0.67</b>         | <b>3.33</b> | <b>1.45</b>            | <b>4.14</b> |
| <hr/>   |                     |             |                        |             |
| (4) Current Estimate plus Bush tax cut                            | 2.04                | 4.74        | 2.81                   | 5.55        |

Source: Authors' calculations

**Table 3**  
**Revenue Costs of HR 3, the Rest of Bush Tax Plan, and AMT Adjustments**  
(\$ Billions)

|   | 2001-2011 <sup>4</sup> |
|---|------------------------|
| <b>Tax Cuts Introduced in HR 3</b>                                  |                        |
| (1) Marginal rate cuts <sup>1</sup>                                 | -560.0                 |
| (2) New bracket <sup>1</sup>  | -383.1                 |
| (3) AMT offset for refundable tax credits <sup>1</sup>              | -15.3                  |
| subtotal  | -958.4                 |
| <b>Other Components Submitted to Congress on February 8</b>         |                        |
| (4) Eliminate estate tax <sup>2</sup>                               | -295.0                 |
| (5) Child tax credit <sup>2</sup>                                   | -192.2                 |
| (6) Two earner deduction <sup>2</sup>                               | -101.9                 |
| (7) Charitable cont. for non itemizers <sup>2</sup>                 | -91.1                  |
| (8) Penalty-free IRA withdrawal for 55+ <sup>2</sup>                | -2.2                   |
| (9) Corporate charitable cont. <sup>2</sup>                         | -2.0                   |
| (10) Expand IRAs, increase cont. limits <sup>2</sup>                | -4.5                   |
| (11) R&E credit extension <sup>2</sup>                              | -28.9                  |
| subtotal  | -717.8                 |
| <b>Additional Tax Cuts Submitted in the Budget</b>                  |                        |
| (12) Additional tax incentives <sup>3</sup>                         | -123.3                 |
| (13) One-year extension of provisions expiring in 2001 <sup>3</sup> | -3.4                   |
| subtotal  | -126.7                 |
| <b>Reduction in Taxes</b>   |                        |
| (14) Tax Proposals = Sum of (1) - (13)                              | -1,802.9               |
| (15) AMT adjustment to allow tax cuts to flow through to taxpayers  | -292.1                 |
| (16) Tax cut w/ AMT adjustment = (14) + (15)                        | -2,095.0               |
| <b>Interest Costs</b>   |                        |
| (17) Interest on tax cut <sup>4</sup>                               | -373.0                 |
| (18) Interest on AMT adjustment <sup>4</sup>                        | -45.2                  |
| (19) Total interest <sup>4</sup> = (17) + (18)                      | -418.2                 |
| <b>Total Budgetary Costs including Interest</b>                     |                        |
| (20) Total cost of tax cut = (14) + (17)                            | -2,175.9               |
| (21) Total cost of AMT adjustment = (15) + (18)                     | -337.3                 |
| (22) Total cost of cut w/ AMT adjustment = (20) + (21)              | -2,513.2               |

Sources:

<sup>1</sup> JCT #01-1 029, 28-Feb-01

<sup>2</sup> JCT #00-1 075 R, 3-May-00, "Estimated Revenue Effects of Various Provisions Described as the 'George W. Bush Tax Reduction Proposal'"

<sup>3</sup> *A Blueprint for New Beginnings* Table S-9, February 28, 2001

<sup>4</sup> Authors' calculations for interest cost and 2011 revenue loss

**Appendix Table 1**  
**How Big is the Available Surplus?**  
**Year-by-Year Estimates**

|   | Fiscal Years<br>(Billions of Dollars) |      |      |      |      |      |      |      |      |      |      |
|---|---------------------------------------|------|------|------|------|------|------|------|------|------|------|
|   | 2001                                  | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| CBO Baseline  | 281                                   | 313  | 359  | 397  | 433  | 505  | 573  | 635  | 710  | 796  | 889  |
| - Adjust for Retirement Funds                               |                                       |      |      |      |      |      |      |      |      |      |      |
| SS  | 156                                   | 171  | 188  | 201  | 221  | 238  | 257  | 276  | 294  | 312  | 331  |
| Medicare Part A   | 29                                    | 36   | 39   | 41   | 40   | 44   | 41   | 41   | 39   | 37   | 34   |
| Government Pensions   | 39                                    | 38   | 39   | 40   | 40   | 41   | 42   | 43   | 44   | 45   | 47   |
| = Surplus, adjusted for retirement funds                    | 57                                    | 68   | 93   | 115  | 132  | 182  | 233  | 275  | 333  | 402  | 477  |
| - Adjust for Current Policy                                 |                                       |      |      |      |      |      |      |      |      |      |      |
| AMT   | 0                                     | 1    | 2    | 3    | 5    | 8    | 11   | 15   | 21   | 28   | 35   |
| Expiring Provisions   | 0                                     | 1    | 3    | 4    | 6    | 8    | 9    | 11   | 12   | 14   | 16   |
| Real DS/Person constant                                     | 0                                     | 2    | 7    | 14   | 24   | 32   | 43   | 54   | 67   | 80   | 94   |
| = Surplus, adjusted for retirement funds and current policy | 57                                    | 64   | 81   | 94   | 97   | 134  | 170  | 195  | 233  | 280  | 332  |

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Source: Congressional Budget Office (2001); Rebelein and Tempalski (2000); and authors' calculations.

**Appendix Table 2**  
**Revenue Costs of HR 3, the Rest of Bush Tax Plan, and AMT Adjustments**  
**Year-by-Year Estimates**  
(billions of dollars)

| <b>Tax Cuts Introduced in HR 3</b>                                  | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> | <b>2008</b> | <b>2009</b> | <b>2010</b> | <b>2011<sup>4</sup></b> |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------------------|
| (1) Marginal rate cuts <sup>1</sup>                                 | 0.0         | -13.3       | -24.0       | -37.7       | -47.5       | -63.8       | -71.0       | -72.6       | -74.6       | -76.7       | -78.8                   |
| (2) New bracket <sup>1</sup>  | -5.6        | -35.7       | -30.0       | -32.4       | -32.3       | -37.9       | -40.7       | -41.3       | -41.8       | -42.4       | -43.0                   |
| (3) AMT offset for refundable tax credits <sup>1</sup>              | 0.0         | -0.1        | -0.4        | -0.7        | -1.0        | -1.4        | -1.8        | -2.1        | -2.3        | -2.6        | -2.9                    |
| <b>Other Components Submitted to Congress on February 8</b>         |             |             |             |             |             |             |             |             |             |             |                         |
| (4) Eliminate estate tax <sup>2</sup>                               |             |             | -7.8        | -8.3        | -15.9       | -23.4       | -30.7       | -42.8       | -52.0       | -55.3       | -58.8                   |
| (5) Child tax credit <sup>2</sup>                                   |             | -1.1        | -6.7        | -11.3       | -15.9       | -20.8       | -24.9       | -25.9       | -27.2       | -28.5       | -29.9                   |
| (6) Two earner deduction <sup>2</sup>                               |             | -1.1        | -4.5        | -7.3        | -9.6        | -11.6       | -12.9       | -13.2       | -13.6       | -13.9       | -14.2                   |
| (7) Charitable cont. for non itemizers <sup>2</sup>                 |             | -0.2        | -1.7        | -3.6        | -6.3        | -9.5        | -12.7       | -13.3       | -13.9       | -14.6       | -15.3                   |
| (8) Penalty-free IRA withdrawal for 55+ <sup>2</sup>                |             | -0.2        | -0.3        | -0.3        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2                    |
| (9) Corporate charitable cont. <sup>2</sup>                         |             | -0.2        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2        | -0.2                    |
| (10) Expand IRAs, increase cont. limits <sup>2</sup>                |             |             | -0.1        | -0.2        | -0.3        | -0.4        | -0.5        | -0.6        | -0.7        | -0.8        | -0.9                    |
| (11) R&E credit extension <sup>2</sup>                              |             |             |             | -0.4        | -2.5        | -3.2        | -3.8        | -4.3        | -4.7        | -4.9        | -5.1                    |
| <b>Additional Tax Cuts Submitted in the Budget</b>                  |             |             |             |             |             |             |             |             |             |             |                         |
| (12) Additional tax incentives <sup>3</sup>                         | 0.0         | -2.2        | -5.2        | -8.0        | -11.1       | -12.6       | -14.8       | -16.0       | -17.0       | -17.8       | -18.6                   |
| (13) One-year extension of provisions expiring in 2001 <sup>3</sup> |             | -1.6        | -1.4        | -0.2        | -0.1        | -0.1        | 0.0         | 0.0         | 0.0         | 0.0         | 0.0                     |
| <b>Reduction in Taxes</b>   |             |             |             |             |             |             |             |             |             |             |                         |
| (14) Tax Proposals = Sum of (1) - (13)                              | -5.6        | -55.8       | -82.2       | -110.6      | -142.9      | -185.0      | -214.2      | -232.5      | -248.2      | -258.0      | -267.9                  |
| (15) AMT adjustment to allow tax cuts to flow through               | -0.1        | -1.0        | -3.7        | -7.0        | -13.3       | -20.9       | -36.6       | -42.5       | -48.8       | -55.5       | -62.7                   |
| (16) Tax cut w/ AMT adjustment = (14) + (15)                        | -5.7        | -56.8       | -85.9       | -117.6      | -156.2      | -205.9      | -250.8      | -275.0      | -297.0      | -313.5      | -330.6                  |
| <b>Interest Costs</b>   |             |             |             |             |             |             |             |             |             |             |                         |
| (17) Interest on tax cut <sup>4</sup>                               | -0.1        | -1.7        | -5.4        | -10.4       | -17.3       | -26.2       | -36.9       | -48.8       | -61.7       | -75.2       | -89.3                   |
| (18) Interest on AMT adjustment <sup>4</sup>                        | 0.0         | 0.0         | -0.2        | -0.4        | -1.0        | -1.9        | -3.4        | -5.6        | -8.0        | -10.8       | -14.0                   |
| (19) Total interest <sup>4</sup> = (17) + (18)                      | -0.1        | -1.7        | -5.5        | -10.9       | -18.2       | -28.1       | -40.3       | -54.4       | -69.7       | -86.0       | -103.2                  |
| <b>Total Budgetary Costs including Interest</b>                     |             |             |             |             |             |             |             |             |             |             |                         |
| (20) Total cost of tax cut = (14) + (17)                            | -5.8        | -57.5       | -87.6       | -121.0      | -160.2      | -211.2      | -251.1      | -281.3      | -309.9      | -333.2      | -357.2                  |
| (21) Total cost of AMT adjustment = (15) + (18)                     | -0.1        | -1.0        | -3.9        | -7.4        | -14.3       | -22.8       | -40.0       | -48.1       | -56.8       | -66.3       | -76.7                   |
| (22) Total cost of cut w/ AMT adjustment = (20) + (21)              | -5.9        | -58.5       | -91.5       | -128.4      | -174.4      | -234.0      | -291.1      | -329.4      | -366.7      | -399.5      | -433.9                  |

Sources:

<sup>1</sup> JCT #01-1 029, 28-Feb-01

<sup>2</sup> JCT #00-1 075 R, 3-May-00

“Estimated Revenue Effects of Various Provisions Described as the ‘George W. Bush Tax Reduction Proposal’”

<sup>3</sup> A *Blueprint for New Beginnings* Table S-9, February 28, 2001

<sup>4</sup> Authors’ calculations for interest cost and 2011 revenue loss.