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WHO WOULD PAY FOR THE HOUSE'S "FREE LUNCH" TAX CUTS?

In Assessing Whether to Make Any Tax Cuts Permanent, How to Pay for Them and How to Address the Long-Term AMT Problem Needs to be Considered

by Joel Friedman and Isaac Shapiro

The House of Representatives has adopted three tax-cut bills over the past three weeks, and it is expected to pass another this week. These four bills largely involve provisions that were first enacted in 2001 and then accelerated in 2003. The bills would make permanent the creation of the 10 percent bracket and tax reductions for married couples enacted in 2001 and make permanent a version of the child tax credit that benefits many more upper-income families than the original 2001 measure. The House would also extend relief from the Alternative Minimum Tax for one year.

A fundamental problem with these four bills is that they do not include offsets to pay for their tax cuts. Given the specter of persistent deficits for years to come, it is unwise to be considering tax cuts without paying for them. Nor is it responsible to consider making tax cuts permanent without first enacting long-term AMT relief, because of the distorting effects that the AMT, and its spread to tens of millions of taxpayers, has on cost estimates for other tax cuts. The House bills simply ignore these issues, leaving it to future Congresses and future generations to pick up the tab and grapple with the fiscal challenges that will confront the nation when the baby-boom generation begins to retire.

In short, the House would have this Congress pass four more tax cuts that it would not pay for. But "free lunches" for this Congress ultimately would cost the nation dearly.

- **The combined cost of the three bills making various tax cuts permanent would be more than one-half trillion dollars over the next ten years.** The measures that make permanent the 10 percent bracket, relief for married couples, and the expanded child tax credit have a combined ten-year cost of $507 billion, according to estimates from the Urban Institute-Brookings Institution Tax Policy Center.[1] With the associated interest costs, the total impact on the deficit of these three bills would be approximately $601 billion through 2014.

[1] Although the Joint Committee on Taxation has released individual estimates of the House bills, it has not released an estimate that reflects the combined cost of the measures and the interactions between the tax cuts. As a result, this analysis relies on Tax Policy Center estimates of the combined cost of the bills that take into account these interaction effects.

- **Ultimately, AMT relief could also cost more than one-half trillion dollars over the next ten years.** The House's extension of AMT relief for one year would cost $24 billion, assuming enactment of the other three bills, according to Tax Policy Center estimates. But the Tax Policy Center also estimates that if the House AMT proposal were made permanent, it would cost $475 billion over ten years. With the associated interest costs, the ten-year total rises to $579 billion.

- **By not paying for the tax cuts, the net effects of the House bills are not considered.** Although the tax cuts in the House bills provide significant benefits to middle-class families (as well as upper-income families), the bills present an incomplete picture by failing to indicate who will pay for them. The tax cuts must eventually be paid for, and unless these tax cuts are ultimately paid for solely by tax increases, they will have to be paid for at least in part by cuts in various federal programs, of which low- and middle-income households generally are the primary beneficiaries. At issue, therefore, is whether these families would prefer to have a modest tax cut in exchange for subsequent cuts in important public programs and services, possibly ranging from health care to environmental protection, or to retain these policies and forego the tax cut. The House bills ignore these inherent trade-offs, choosing to exclude offsets and thereby dodge the issue.

- **The House bills lay bare the gimmickry employed by the 2001 and 2003 tax bills.** The House bills would make permanent tax cuts originally enacted as temporary measures in order to fit within the dollar limits imposed on the 2001 and 2003 tax-cut bills. Even though the deficit outlook is now worse than it was when these tax-cut measures were enacted in 2001 and 2003, the House is calling for full implementation (and expansion, in the case of the child tax credit) of these provisions, effectively raising the costs of the original tax-cut measures. This makes clear that House Leaders had no intention of scaling tax cuts to fit within the constraints of the budget resolutions in effect in 2001 and 2003.

- **House bills employ further gimmickry when it comes to the AMT.** The one provision that the House would not make permanent is AMT relief, which is extended for only one year. This one-year extension, however, is not a sign of fiscal prudence; rather it represents an example of cloaking the costs of tax cuts. Virtually all observers agree that the problems surrounding the AMT require a permanent solution. A one-year extension of relief only serves to hide the long-term cost of addressing this problem. Furthermore, in the absence of AMT relief, the AMT serves to cancel out — on paper — future tax cuts for tens of millions of taxpayers. This has the perverse effect of making other tax-cut bills appear to be far less costly — and more affordable without offsets — than they actually are.

The 2001 and 2003 Tax-Cut Measures: Where the Gimmicks Began

The tax-cut measures the House is now considering make clear that steps taken in 2001 and 2003 to restrain the cost of the tax cuts enacted in those years were largely budget gimmicks designed to facilitate their passage. The 2001 package was scaled back from the President's request of $1.6 trillion over ten years to the $1.35 trillion allowed under the Congressional budget resolution. Similarly, the 2003 package was reduced from the President's request of $726 billion over ten years to $350 billion. In both cases, the dollar amount of the tax cuts was scaled back to address concerns, raised most vigorously in the Senate, that the original measures were too costly and exceeded what was affordable. Only by scaling back the cost of these tax cuts were Congressional leaders able to garner sufficient votes to pass the budget resolutions those years and subsequently to pass the tax-cut bills.

Yet Congressional leaders met these dollar targets not by proposing smaller, less costly tax cuts, but primarily by employing gimmicks — such as slow phase-ins and artificial sunsets — that reduced the cost of these tax cuts on paper. All of the major income-tax reductions enacted in 2001 phased in slowly, and then all were abruptly terminated by 2010 to lower their cost in the official estimates covering the period 2001 through 2011.[2]

An essential part of this strategy was for Congress to revisit these tax cuts after they had been enacted to undo the phase-ins and the artificial sunsets. In 2003, Congress took the first step. It sped up implementation of most of the income-tax changes enacted in 2001, so that they would become fully effective immediately, rather than phase in slowly. The deficit outlook, however, was significantly worse by 2003 than it had been in 2001 — the ten-year forecast for 2002-2011 had deteriorated by $6.0 trillion according to CBO — and this created pressure to reduce the size of the 2003 tax-cut package.[3] To meet the $350 billion limit the Senate had imposed on the 2003 package, Congress could not keep all of these accelerations in effect beyond the first few years. So the accelerations of the widening of the 10 percent bracket, the expansion of the child tax credit, and relief for married couples were put in place for two years only, expiring at the end of 2004.

From the perspective of tax-cut proponents attempting to preserve all of the tax cuts enacted in 2001 and 2003, these particular tax cuts were perfect candidates to make temporary, as their benefits are more evenly distributed across the population than other tax cuts enacted in

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[2] Contrary to what some have claimed, the expiration of the entire 2001 tax-cut bill at the end of 2010 was not a direct result of a Senate rule. The Senate rule in question only came into play because the tax cuts increased the deficit after 2011; had the costs of the tax cuts been offset, they would not have had to expire. Moreover, the tax cuts in the legislation did not have to expire at the end of 2010 to comply with the Senate rule; rather, some or all of the tax cuts could have expired at the end of 2011. The tax cuts in the bill sunset *one year earlier than necessary* to reduce the 2001-2011 costs of those tax-cut provisions. This gimmick allowed more tax-cut provisions to be packed into the bill without breaching the amount allocated for the tax-cut legislation through 2011 under the budget plan Congress adopted in the spring of 2001. In the words of House Ways and Means Chairman Bill Thomas, the gimmick allowed Congress to put "a pound and a half of sugar into a one-pound bag."

[3] Despite the worsening budget outlook, there was a general consensus that continuing weakness in the economy warranted some economic stimulus that would increase the deficit in the short term. While there were calls to restrain the cost of the 2003 measure in response to projected deficits, few argued that the entire cost of the package should be offset in the short term.

House Tax-Cut Bills, 2004-2014 (including interaction effects)	In billions
Permanent provisions:	
10 percent bracket (H.R. 4275)	$205.3
Child tax credit (H.R. 4359)	219.9
Relief for married couples (H.R. 4181)	81.5
Total	506.7
Associated interest costs	93.8
Total, including interest	600.6
AMT relief:	
One-year extension (H.R. 4227)	23.8
Additional cost of making H.R. 4227 permanent	451.5
Total	475.3
Associated interest costs	104.0
Total, including interest	579.3
Total cost if all provisions are made permanent	982.1
Total cost if all provisions permanent, including interest	1,179.9

Source: Urban-Brookings Tax Policy Center for the cost of tax cuts. CBPP calculations, using CBO assumptions, for interest costs.

2001 and they enjoyed more bipartisan support. As a result, it was logical to assume that there would be broad support to continue full implementation of the three provisions after 2004 rather than let them expire. The acceleration of the more controversial upper-bracket rate reductions, in contrast, was not made temporary.

With the expiration of the acceleration of the three so-called "middle-class" provisions looming at the end of 2004, this strategy continues. First, the House Leadership asserts that allowing these provisions to expire is a tax increase. Second, the House Leadership is using the urgency created around the schedule expiration of the accelerations at the end of this year as an opportunity to push for making these measures permanent, even though that affects only years after 2010.

It may be noted that since the 2003 package was enacted — with its decision to make these tax cuts temporary, ostensibly in recognition of fiscal realities — the deficit outlook has deteriorated further. CBO's projection of the cumulative deficit for the period from 2004-2013 is now $3.4 trillion larger than it was when the 2003 tax cut was enacted a year ago.

The House bills ignore this deteriorating fiscal situation. The cost of making the three bills permanent — plus the added cost of expanding the child tax credit to upper-income families — would total $507 billion through 2014, according to Tax Policy Center estimates. (Note that these Tax Policy Center estimates incorporate "interaction effects" between the different tax cuts that are not included in the available Joint Committee on Taxation estimates of the individual

House bills.[4]) When the associated interest costs are included, the total impact on the deficit rises to $601 billion through 2014.

Expansion of the Child Tax Credit to Upper-Income Families

The House bill would not only make permanent the child tax credit provisions that were enacted in 2001 and 2003, but would also provide for a substantial expansion of the credit to upper-income families with children. According to Tax Policy Center estimates, this expansion would cost $69 billion through 2014 — or nearly one-third of the cost of the child tax credit provision. The ten-year cost rises to $87 billion when the associated interest costs are included.[5] The benefits of this expansion would flow to families with incomes between $110,000 and about $300,000. This is one of the reasons that the benefits of the House tax-cut bills are tilted more toward upper-income families than is generally understood (see box on page 6).

Extending the AMT Gimmick, One Year at a Time

With regard to the Alternative Minimum Tax, the House Leadership is *not* proposing to make permanent the relief that is scheduled to expire at the end of 2004, but rather is proposing only a one-year extension, in part to continue the usefulness of AMT as a budget device that masks the cost of other tax cuts. If AMT relief were made permanent, the House Leadership would not only have to own up to the high cost of addressing the AMT problem, but would have to show much higher costs for its other tax-cut proposals, including proposals to make the 2001 tax cuts permanent.

The AMT is a parallel tax system, and a household pays the higher of its AMT liability or its regular income tax liability. Unlike the regular income tax code, however, the key parameters of the AMT are not indexed for inflation. Over time, therefore, more and more households will see their AMT liability exceed their regular income-tax liability and become subject to the AMT, unless AMT relief is continued. In the absence of an extension of AMT relief, for instance, the number of taxpayers subject to the AMT will explode to about 29 million in 2010, according to the Tax Policy Center, up from about 3 million today.

In its cost estimates, the Joint Committee on Taxation must assume current law, under which AMT relief is slated to expire at the end of 2004. This is significant because once a household is subject to the AMT, it derives no benefit from further reductions in the regular income tax. The official Joint Tax Committee cost estimates, therefore, are required to assume

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[4]. Currently available estimates of the four House bills by the Joint Tax Committee reflect the cost of the individual bills taken separately and therefore ignore any "interaction effects" between the measures. In contrast, the Tax Policy Center estimates reflect the cost of the bills taken together and thus capture the relevant interaction effects. Thus for assessing the combined cost of the bills, the Tax Policy Center estimates are more appropriate. In addition, cost estimates by the Tax Policy Center and the Joint Tax Committee typically differ from each other because they rely on somewhat different estimating assumptions.

[5] Robert Greenstein, "House Bill Adds $69 Billion in Deficit-Financed Tax Cuts by Extending Child Tax Credit to Families With Incomes Up to About $300,000," Center on Budget and Policy Priorities, May 18, 2004.

More Than the "Middle Class" Benefit from the House Tax-Cut Bills

The three tax cuts that the House bills would make permanent — the 10 percent bracket, the relief for married couples, and an expanded version of the child tax credit — are frequently described as benefiting primarily middle-class families. Even the relief from the Alternative Minimum Tax is sometimes described as needed to ensure that middle-class taxpayers are not inadvertently snared by the AMT. Although the broad middle class would benefit from these provisions — and certainly will benefit far more from these provisions than from the other tax cuts enacted since 2001, such as the reductions in upper-bracket tax rates, capital gains and dividend taxes, and the estate tax — higher-income households would also gain significantly from the House tax cuts. This is particularly true in the short run, according to Urban Institute-Brookings Institution Tax Policy Center estimates. These Tax Policy Center estimates show that:

- Households in the top 20 percent of the income spectrum would receive nearly 73 percent of the tax-cut benefits in 2005 from the four House bills. The top 10 percent of households would receive about half of the tax-cut benefits, while the top 5 percent would receive 30 percent of the tax cuts.

- In contrast, those in the middle of the income spectrum — the middle 20 percent — would receive only 8 percent of the benefits from these four bills in 2005.

- Further, the top fifth of households would receive an average tax cut of $1,380 in 2005 from these bills, as compared to an average tax cut of $155 for those in the middle fifth of the income spectrum.

The distribution of the tax-cut benefits in the House bills over the long run, assuming all of the provisions are made permanent, would likely be less skewed than the distribution in 2005. Nevertheless, even when the tax cuts are in their long-run steady state after 2010, it is likely that more than half of the benefits of these provisions would still flow to the top 20 percent of households.

that a swollen AMT will cancel out a sizeable share of proposed tax-cut benefits and thereby lower the projected cost of various tax cuts.

Using the AMT to cancel out tax-cut benefits and lower cost estimates is a gimmick because virtually all knowledgeable observers are convinced that AMT relief will be provided on an ongoing basis and that nowhere close to 29 million households will be subject to the AMT in 2010. The Administration itself has clearly stated on a number of occasions that it plans to propose ongoing AMT relief legislation in the future, probably in 2005. Nevertheless, as long as Congress continues to enact AMT relief that is only temporary, the official cost estimates must assume that this relief will expire, that the AMT will explode into the middle class, and that the AMT will cancel out a significant portion of the cost of future tax cuts, thereby lowering their costs.

The effectiveness of the AMT in artificially reducing the cost of tax cuts was vividly illustrated when the House adopted a measure a few weeks ago to extend and make permanent the tax cuts for married couples enacted in 2001. The official cost of that bill is $105 billion through 2014, according to the Joint Committee on Taxation. But the Joint Tax Committee's

official estimate assumes that the AMT will partially or entirely eliminate the bill's tax reductions for millions of couples. If the AMT does *not* cancel out the tax cuts for married couples — a more plausible assumption — other Joint Tax Committee data show that the measure would cost $204 billion over ten years, or nearly twice as much.

The impact of the AMT on other tax cuts enacted in 2001 and 2003 that the President is now proposing to make permanent also is quite substantial. In total, the cost with interest of extending the Bush tax cuts is not $1.3 trillion between 2005 and 2014, as reflected by the official estimates, but $1.7 trillion when the anticipated extension of AMT relief is taken into account.[6]

The House bill, by calling for only a one-year extension of AMT relief, not only ensures that the AMT's retention artificially lowers the cost of other tax-cut proposals, but also that the full cost of providing long-term AMT relief is hidden from the public. The one year of AMT relief in the House bill will reduce revenues by $24 billion through 2006, according to Tax Policy Center estimates that assume enactment of the three other tax cuts considered by the House. In contrast, making the AMT relief in the House bill permanent would reduce revenues by $475 billion over the next ten years, according to Tax Policy Center (and this estimate may understate the full cost of permanent AMT relief).[7] The added interest costs on the debt would amount to another $104 billion, bringing the overall impact of AMT relief on the deficit to $579 billion over the coming decade.

Paying For the Tax Cuts

Since the tax cuts were first enacted in 2001, the fiscal outlook has deteriorated dramatically. The long-term outlook shows deficits growing to economically unsustainable levels.

Rather than taking stock of these developments and considering a mid-course correction, the House proposals reflect further steps down the same path. Ongoing efforts to make tax cuts permanent and add new tax cuts on top, without considering how they would be paid for, is disconcerting. To the degree that little is done to address the effects of the tax cuts on the deficit:

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[6] See Isaac Shapiro and Joel Friedman, "Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts," Center on Budget and Policy Priorities, April 2004.

[7] This Tax Policy Center estimate likely understates the cost of full AMT relief for at least two reasons. First, the estimates assume that no other tax cuts are made permanent after 2010 other than the three House provisions. If other tax cuts enacted in 2001, such as the upper-bracket rate reductions, are also made permanent, the cost of AMT relief would increase. Second, the estimates only reflect the cost of indexing the AMT exemption levels. It is likely that AMT relief will also include indexing other AMT parameters (such as the income levels of the AMT brackets) and allowing certain tax credits to count for AMT purposes (a provision that has been routinely extended in the past, typically as part of a package of expiring tax breaks known as "extenders"). If these provisions are continually extended, along with indexing of the AMT exemption amount, and if all of the tax cuts enacted since 2001 are made permanent, then the total cost of AMT relief rises to $591 billion between 2005 and 2014, according to Congressional Budget Office estimates. When the associated interest costs are included, the ten-year total would be $708 billion.

- Federal deficits will remain large, reducing national saving and eventually slowing economic growth;
- More of the task of shoring up the nation's fiscal position will be passed on to future generations; and
- Interest payments will mount. In 2014 alone, assuming the Bush Administration's full-tax cut agenda is put into place, the increased interest payments that result from the tax cuts will total $218 billion, or 1.2 percent of the economy.

Passing problems on to future generations is generally an undesirable and irresponsible choice. This is especially true today. In just a few years, the baby-boom generation will begin to retire, and that will inevitably result in programs for the elderly such as Medicare and Social Security consuming a larger share of national resources. Only a few years ago there was a consensus that the nation should use the first decade of this century to prepare for this eventuality by paying down the debt and placing annual Social Security surpluses off limits so they would not be used to finance other programs. Such an approach would diminish interest costs and other burdens down the road. The House bills continue the pattern of the past three years of deviating sharply from this course.

Proposals to reduce deficits swollen by tax cuts entirely through budget cuts in domestic programs now are being advanced. The President's budget and Senate and House budget resolutions concentrate primarily on reducing domestic discretionary programs outside of homeland security. Yet recent increases in these programs pale in comparison with the effects of the tax cuts.[8] Moreover, as a share of the economy, total spending on this part of the budget — which includes programs such as education, child care, environmental protection, veterans' health, housing, and many other areas — already is slightly below its average level since 1970.

In addition, the savings that can (or should) be achieved through targeting this category of the budget can make only a small dent in the deficit problem; domestic discretionary programs outside homeland security constitute only about one-sixth of the federal budget. Indeed, the President's budget and the budgets that both the House and Senate have passed would *increase* the deficit above the level at which it otherwise would be, not reduce it. This outcome reflects the fact that the size of the tax-cut proposals in these budgets substantially exceeds the domestic discretionary spending reductions and other savings in the budgets.

To the degree that the tax cuts are ultimately "paid for" primarily by program reductions, it is middle- and low-income households that are likely to be hit hardest by these cutbacks. If the tax cuts eventually are fully offset through program cuts, many if not most low- and middle-income families are likely to lose significantly more from the program reductions than they gain from the tax cuts.

[8] In 2004, tax cuts will account for 59 percent of the cost of legislation that has been that has been enacted since January 2001. Increases in domestic discretionary spending (outside of homeland security) will account for just three percent of the cost of legislation enacted during this period.