CENTER ON BUDGET AND POLICY PRIORITIES

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MORE FISCALLY IRRESPONSIBLE TAX CUTS THIS FALL?

New Corporate Tax Cuts And More Budget Gimmicks Loom On The Horizon

By Joel Friedman

This analysis examines the status of congressional tax-cut legislation in the light of the deteriorating fiscal outlook. It finds that the House of Representatives has already approved additional tax cuts, beyond the tax-cut bill enacted in May, that would add more than $500 billion to deficits over the next ten years, and that further House tax cuts are in the pipeline. The analysis also finds that the Senate has been more cost-conscious and has increasingly moved to include "offsets" in its tax-cut bills. Some of these bills, however, would not yield a fiscally responsible outcome because they rely on budget gimmicks to make the costs of the tax cuts appear smaller than they will actually be over time. As a result of such gimmicks, the costs of the tax cuts in these Senate bills ultimately would exceed the savings from the offsets.

Interest in Tax Cuts Persists, Despite Worsening Budget Outlook

Last month, the Congressional Budget Office issued a report highlighting the sharp deterioration in the nation's fiscal outlook. CBO projected that if three likely actions are taken — extending existing tax cuts, continuing to provide relief from the Alternative Minimum Tax, and establishing a $400 billion Medicare drug benefit — deficits will total $4.4 trillion over the next ten years. Moreover, this $4.4 trillion estimate does not reflect the full cost of the Administration's defense program or the cost of ongoing operations in Iraq and Afghanistan. A joint analysis issued September 29 by the Center on Budget and Policy Priorities, the Committee for Economic Development, and the Concord Coalition projects that with these additional costs, deficits will total $5 trillion over the next ten years.[1] Goldman Sachs puts the figure at $5.5 trillion.[2] In a similar vein, the head of the General Accounting Office, Comptroller General David Walker, warned in a recent speech on the budget that "the picture is not good and it's getting worse" and that with the impending retirement of the baby-boom generation, the long-term fiscal challenges we face are "unprecedented in the history of our nation."[3]

[1] Center on Budget and Policy Priorities, Committee for Economic Development, and Concord Coalition, "Mid-term and Long-term Deficit Projections, " September, 29, 2003.

[2] Goldman Sachs, "The Federal Deficit: A $5.5 Trillion Read Elephant," U.S. Daily Financial Market Comment, September 9, 2003.

[3] David Walker, "Truth and Transparency: The Federal Government's Financial Condition and Fiscal Outlook," speech at the National Press Club, September 17, 2003.

Despite these developments, Congress and the Administration continue to pursue additional tax cuts that would further swell deficits. The House of Representatives passed its latest tax-cut bill on September 17, a measure that expands tax breaks for charitable giving and costs $13 billion through 2013. *The passage of this bill brings to $422 billion the cost over the next ten years of tax cuts the House has passed, beyond the tax-cut package enacted in May*. (See table.) The tax-cut legislation enacted in May itself carries an official cost of $350 billion over the next decade and will actually cost close to $1 trillion if, as expected, its provisions are extended.

Tax Cuts In the House, Beyond the Tax-Cut Package Enacted in May
(In billions of dollars, 2004-2013)

Passed by House:	
Health-related tax cuts	-$174
Estate tax permanent repeal	-162
Child tax credit expansion	-82
Energy-related tax cuts	-17
Charitable giving incentives	-13
Other (net)	+25
Subtotal, passed	-422
Reported by Ways and Means Cmte:	
Pension-related tax cuts	-48
Introduced by Chairman Thomas:	
Corporate tax breaks (net)	-128
Subtotal, pending	-176
Total, tax-cut bills	-598
Interest costs	-149
Total deficit impact	-747

Source: Joint Committee on Taxation, CBO

In addition to the $422 billion in additional tax cuts the House has passed in recent months, the House Ways and Means Committee has approved a package of pension-related tax cuts and is likely to consider in coming weeks a measure introduced by Ways and Means Committee Chairman Bill Thomas to reduce corporate taxes. These two bills would cost another $176 billion through 2013, bringing the overall cost of all approved or pending House tax-cut measures to nearly $600 billion over ten years.

Furthermore, the figures referred to here — $422 billion for the tax-cut measures the full House has passed and another $176 billion for pending tax-cut measures — do *not* include the additional interest costs that would be incurred if these measures become law. These interest costs would amount to $149 billion more over ten years— $84 billion from the tax cuts the House has already passed and $65 billion from the pending House tax-cut measures. This would bring the total impact on the deficit of the approved and pending House tax-cut measures to nearly three-quarters of a trillion dollars over the next ten years.

In contrast to the House, the Senate has generally adopted smaller tax cuts and, in some cases, included revenue-raising provisions that appear to offset the cost of the tax cuts. For instance, the Senate-passed versions of the child tax credit expansion and the charitable giving bill both were offset. Senate Finance Committee Chairman Charles Grassley also has revised his corporate tax bill (“JOBS” bill, S. 1637) to make it deficit neutral over ten years. The Finance Committee is expected to take up this bill on October 1.

Revenue-Raising Offsets and Budget Gimmicks

Requiring sufficient offsets as a condition for getting a tax cut through the Senate may not be sufficient, however, to ensure that such legislation does not "dig the deficit hole deeper." Offsets can be included in tax-cut bills in ways that create an illusion of fiscal responsibility but do not really meet the basic test of deficit neutrality, because over time the savings from the offsets would be greatly exceeded by the cost of the tax cuts.

Tax Cuts That Are "Temporary"

This problem arises when *permanent* revenue-raising provisions are used to pay for tax cuts that are officially *temporary* but, once in place, are very likely to be routinely extended. This is a likely scenario for most "temporary" tax cuts, since pressure to extend tax cuts is usually intense, and those who oppose extension risk being attacked for raising taxes and even for harming the economy.

- To understand this type of gimmick better, assume that a tax cut costs $10 billion each year, or $100 billion over ten years. If it is designed so it would initially be enacted just for two years, its official cost would be only $20 billion. This $20 billion cost could then be offset by a permanent revenue-raising provision that produces $20 billion in revenue over ten years.

- The bill would have the appearance of deficit neutrality — a $20 billion revenue loss offset by a $20 billion revenue increase. But once the tax cut was extended beyond the initial two years, its cost would add to the deficit. If the tax cut in the original bill had been an ongoing tax cut rather than one slated to expire after two years, the bill's true cost of $80 billion would been seen — a $100 billion ten-year revenue loss offset by a $20 billion ten-year revenue increase.

The Senate employed precisely this approach in its charitable giving bill, which meets the test of deficit neutrality over ten years only because the largest tax cut in the bill — which would allow tax filers who do not itemize their deductions to deduct a portion of their charitable donations — is set to expire after two years. After two years, there unquestionably will be substantial pressure to extend this provision. All of the revenue-raising provisions in the bill, by contrast, are permanent.

A variation of the gimmick of enacting tax cuts that expire artificially was used earlier this year to circumvent the $350 billion cost limit imposed by the Senate on the "economic growth" package. There is little reason to think this gimmick will not be used again in future tax-cut bills in order to allow costly tax cuts to gain a foothold. Indeed, Ways and Means Chairman Thomas recently stated that with regard to tax cuts, "If my choice was, 'Don't get them if you have to make them permanent, or get them even though they're not permanent,' getting them is probably more important."[4]

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[4] Martin Vaughan, *Congress Daily*, September 8, 2003.

Tax Cuts That Do Not Become Fully Effective For Several Years

Another gimmick that can be used to lower the official ten-year cost of a tax cut is to have a tax cut phase in over time or not take effect for a few years. If, for instance, a tax cut first takes effect in 2009, the ten-year cost estimate that covers the period through 2013 will reflect only five years of costs, understating the measure's full ten-year cost by half. This appears to be the approach that Senator Grassley is using in the corporate tax bill (the "JOBS" bill) that the Finance Committee is scheduled to take up on October 1.

- The bill includes one costly provision that does not take effect until 2010 and another that only becomes fully effective in 2013.

- As a result, according to the Joint Committee on Taxation, the tax cuts in the bill will cost $1.6 billion over the first five years (2004-2008) but $23.6 billion — nearly 15 times as much — in the second five years (2009-2013). Indeed, one-third of the bill's $25 billion ten-year cost occurs in 2013 alone.

- In contrast, all of the provisions in the JOBS bill that raise revenue and serve as offsets go into effect immediately and raise $25 billion in revenue fairly steadily over the decade. As a consequence, even though the offsets cover the cost of the tax cuts over the ten years as a whole, they fall well short of offsetting these costs over a longer period.

- This can be seen in the Joint Tax Committee cost estimate of the bill. It shows that the cost of the tax cuts exceeds the savings from the offsets by $8.8 billion over the last five years (2009-2013) and by $4.8 billion in 2013 alone. Over the long run, a significant mismatch would result, with the cost of the tax cuts far outstripping the revenue raised by the offsets.

House Tax Cuts

Congress enacted a $350 billion economic stimulus package in May. Of the revenue provisions in the bill, all but one (the acceleration of the income tax rate reductions for the top four income-tax brackets) were designed so that they expire at the end of 2004 or within a few years after that. The Joint Committee on Taxation has estimated that if these "temporary" provisions are made permanent, the measure would actually cost close to $1 trillion over the decade.[5] As noted above, despite the enactment of this costly tax-cut package and the deteriorating fiscal outlook, the House has passed other bills that would reduce revenues by an additional $422 billion through 2013. These include:

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[5] According to the Joint Tax Committee, if all of the provisions in the tax-cut legislation enacted in May were in effect through 2013, the additional cost would be $785 billion, bringing the total cost of the measure to $1.1 trillion. This total reflects $466 billion for extending the business incentives, $159 billion for extending the dividend and capital gains rate cuts, and $160 billion for extending the $1,000 child tax credit and tax cuts for married couples (of which $75 billion represents the cost of extending these two provisions through 2010, when they would have expired under the 2001 tax-cut law, and $85 billion reflects the cost of extending them after 2010 through 2013). A portion of these costs are reflected in House bills that propose to extend some of these expiring provisions.

- $174 billion in health-related tax breaks that are part of the Medicare drug bill (the major provision would establish Health Savings Security Accounts, which are designed to encourage the use of high-deductible health insurance policies in lieu of lower-deductible, comprehensive employer-based coverage[6]);

- $162 billion to repeal the estate tax permanently; and

- $82 billion to extend the child tax credit and expand it to higher-income families.[7]

Further tax cuts are in the pipeline. The House Ways and Means Committee has approved a package of pension-related tax cuts that would reduce revenues by $48 billion. In addition, Ways and Means Committee Chairman Bill Thomas has introduced a package of corporate tax cuts that would cost $128 billion. (This total reflects $200 billion of tax cuts for corporations, partially offset by $72 billion of revenue-raising provisions, including the repeal of export subsidies that the World Trade Organization has ruled violate trade agreements. There is considerable urgency around addressing these export subsidies, since the WTO has authorized our European trading partners to impose trade sanctions on U.S. exports of $4 billion a year if these subsidies are not repealed.)

Moreover, while measures that have passed the House or that the House is likely to consider this fall total nearly $600 billion over ten years (before counting the added interest costs), these estimates *understate* the true cost of these bills, because a number of the provisions in these bills artificially expire. The package of corporate tax breaks that Chairman Thomas has introduced, the House-passed energy bill, and the House-passed charitable giving bill all include such "temporary" provisions. If these provisions were enacted and then extended, the cost of these measures would increase by about another $100 billion through 2013.[8]

Conclusion

The Administration's request for an additional $87 billion for operations in Iraq and Afghanistan has added to growing concerns about the spiraling budget deficit, which will top $500 billion next year if the Administration's request is approved. Furthermore, new Congressional Budget Office estimates show that sizeable deficits are likely to persist over the decade. Despite these concerns, the Administration and Congress continue to pursue more tax

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[6] For a full discussion of these proposals, see Edwin Park, Joel Friedman, and Andrew Lee, "Health Savings Security Accounts: A Costly Tax Cut That Could Weaken Employer-Based Health Insurance," Center on Budget and Policy Priorities, July 8, 2003.

[7] This bill was developed in response to widespread pressure on Congress to approve $3.5 billion in accelerated child credit benefits for low-income working families but became a vehicle for extending the entire child credit and expanding it to upper-income families. For more details, see Robert Greenstein, "House Child Credit Legislation Not Fiscally Responsible: Bill More Likely To Harm Children Than To Assist Them," Center on Budget and Policy Priorities, June 23, 2003.

[8] The Thomas bill proposes to extend temporarily the business tax cuts that were part of the tax-cut package enacted in May. The cost of permanently extending these provisions is not included in the $100 billion estimate above.

Revenue-Raising Offsets

The largest revenue-raising provision under consideration is the repeal of a tax subsidy provided to U.S. exporters that the World Trade Organization has ruled violates existing trade agreements. Both House Ways and Means Chairman Thomas and Senate Finance Committee Chairman Grassley have introduced bills that would repeal this export subsidy, raising approximately $50 billion over ten years. Both bills then propose tax cuts in excess of this amount for U.S.-based manufacturers and multinational corporations.

Senator Grassley's bill includes $25 billion in revenue-raising offsets (beyond the savings from repeal of the export subsidy) to cover the cost of the additional corporate tax cuts in his measure, so that the bill is deficit neutral over ten years. For example, the Grassley bill includes provisions that would clarify requirements intended to ensure that taxpayer transactions have legitimate business and economic reasons and are not being undertaken simply to avoid taxes, would impose various penalties on users and promoters of abusive tax shelters, and would address revenue losses associated with the expatriation of both corporations and individuals.

Similarly, the corporate tax bill that Chairman Thomas has introduced includes $22 billion in offsets beyond the savings from repealing the export subsidy. In addition to extending Customs Service user fees that expire at the end of fiscal 2003, the Thomas bill includes a variety of small provisions aimed at addressing tax shelters, including to reduce the ability of U.S. companies to structure transactions with foreign subsidiaries to avoid U.S. taxes (so-called "earnings stripping" transactions). Some of these shelter provisions also appear in Senate tax-cut measures. Even after these offsets, however, the Thomas bill still has a net cost of $128 billion over ten years.

The universe of potential revenue-raising offsets is much broader, of course, than the provisions that have been included in the new Grassley and Thomas corporate tax-cut bills. Other steps could be taken that would raise more revenue, particularly in the area of closing corporate tax shelters and unproductive tax breaks. It also bears noting that revenue-raising provisions need not be used solely to pay for tax cuts. They could be used to reduce the deficit. They also could be used to finance other policies such as a prescription drug benefit, so that passage of those policies does not add to the deficit. (The current Congressional budget resolution bars using revenue-raising provisions to offset the cost of program expansions, but the "pay-as-you-go" rules that worked so well during the 1990s — and the budget resolutions that helped to enforce those rules — allowed both entitlement cuts and revenue-raising provisions to be used to finance either tax cuts or entitlement expansions.)

cuts. The House has already passed, or is likely to consider this fall, tax cuts totaling nearly $600 billion over ten years, a revenue loss that would be on top of the cost of the tax-cut package enacted in May.

The Senate has been more cost-conscious, pursuing less expensive tax cuts and including revenue-raising offsets in some of its bills. Yet the Senate approach does not guarantee tax-cut bills that are fiscally responsible. There are a range of gimmicks — from "temporary" tax cuts that will subsequently be extended to tax cuts that only become fully effective late in the ten-year period the cost estimates cover — that reduce the *official* cost of tax cuts. When only these artificially low *official* costs are offset, the result is tax cuts whose costs significantly exceed the savings from the offsets in later years. Thus tax cuts with offsets that make use of these gimmicks may have a veneer of fiscal responsibility, but they would, in fact, impose significant costs over time on an already misshapen budget.