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ARE TAX CUTS A MINOR OR MAJOR FACTOR IN THE RETURN OF DEFICITS? WHAT THE CBO DATA SHOW

by Richard Kogan

Summary

Over the last two years, the federal budget has gone from surplus to deficit. At the same time, Congress enacted major tax cuts. What role did those tax cuts play? Mitchell Daniels, the Director of the President's Office of Management and Budget, has characterized the role of the tax cuts as "minor" and said that the budget would be in deficit even without them. The three short analyses that constitute this paper examine this question, based on the extensive data that the Congressional Budget Office issued in late January. The analyses find the following:

- The CBO data show that *one-third* of the deterioration in the budget since 2000 has been caused by tax cuts enacted in the last two years. This makes the tax cuts one of the principal factors in the deterioration, rather than a minor element. Moreover, the share of the budget deterioration that is attributable to the tax cuts grows larger each year over the course of the decade.

- According to the CBO data, the recession, along with defense, homeland security, and other spending increases, would have driven the budget into deficit in 2002 and 2003 even without the tax cuts. But the budget would be back in surplus in 2004 and every succeeding year for the rest of the decade were it not for the tax cuts. (This CBO projection excludes the cost of policies not yet enacted, such as further defense increases, a war, or further tax cuts.)

- The CBO estimates do not reflect any impacts that tax cuts and spending measures enacted in 2001 and 2002 may have had on the economy. The President's Council of Economic Advisers argues that the tax cuts have stimulated economic growth and that the recession would have been worse without them. The CEA has issued specific estimates of how much worse it would have been. Yet if one uses the CEA estimates on this matter — which are favorable to the Administration and portray the tax cuts as having had larger economic effects than some studies indicate — the tax cuts still would have been responsible for almost 30 percent of the budget deterioration since 2000. There is no escaping the fact that the tax cuts are one of the primary factors behind the deterioration.

- One also can examine the extent to which various types of federal legislation have contributed to the budget deterioration. The CBO data show that over the last two years, Congress enacted legislation that cost an average of $260 billion a year in 2003 and 2004. The CBO data also show that $150 billion — or 58 percent — of this $260

billion annual cost resulted from the tax cuts. These data demonstrate that the cost of the tax cuts substantially exceeded the combined costs of increases for the military, homeland security, foreign aid, the farm bill, and all other legislation. (Even if one uses the CEA assumptions regarding the effect of the tax cuts on economic growth, the tax cuts still account for 54 percent of the cost of the legislation enacted over the past two years.)

- Finally, under the Administration's new budget — which would make the 2001 tax cut permanent, add further tax cuts on top, and institute some program expansions such as a prescription drug benefit — the federal budget would remain in deficit *forever*. The projections of permanent deficits come from the Administration itself. They are shown in a 75-year table in the OMB budget volume entitled *Analytical Perspectives*.

Structure of This Analysis

This analysis takes the form of three short papers that examine the role of tax cuts in three ways.

Part 1 uses new estimates issued by CBO to compare the estimated deficits in 2003 and 2004 with the actual surplus in 2000.[1] It addresses the question, "How much of the budget deterioration from the actual surplus in 2000 to the estimated deficits in 2003 and 2004 has been caused by enacted tax cuts?"

Part 2 uses new CBO estimates to compare the estimated deficits in 2003 and 2004 with *projections* for 2003 and 2004 that CBO issued in January 2001. It addresses the question, "How much of the deterioration in the *projected* budget is attributable to the tax cuts?" In other words, Part 2 compares two-year-old projected budget figures for 2003 and 2004 with the most up-to-date CBO projections for 2003 and 2004.

Part 3 examines the claim that the economy would have been even worse without the 2001 tax cuts. If the tax cuts stimulated the economy (and therefore generated some extra revenue), the net cost of the tax cuts would be less than CBO reported. Using an analysis by the President's Council of Economic Advisers that is favorable to the Administration, we translate the positive "economic feedback" assumed by the CEA into a favorable estimate of "revenue feedback." Part 3 then compares the results found in Part 1 and Part 2, using CBO estimates, with the more favorable view of the net cost of the enacted tax cuts implied by the CEA estimates.

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[1] All estimates of the cost of the tax cuts enacted in 2001 and 2002 come from a publicly available table that CBO issued as backup to its recent annual report, *The Budget and Economic Outlook: Fiscal Years 2004-2013*, January 29, 2003. In this table, CBO shows the cost through 2011 of all legislation enacted since 2001. The table also shows the amount by which projected payments of interest on the debt have increased because legislation causes the debt to be higher than projected in 2001. The figures we use in this analysis for the cost of legislation cover both the direct costs of such legislation (e.g., the revenue losses from a tax cut) and the interest costs.

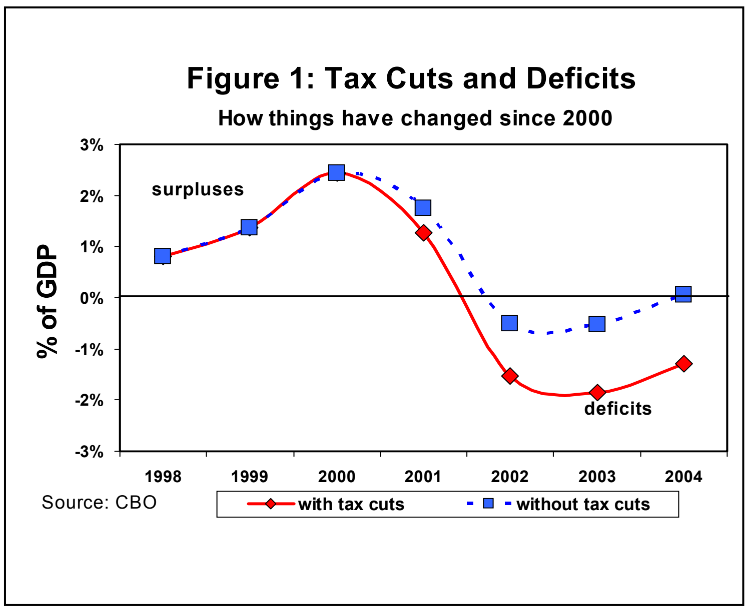
In addition, the CBO table shows the amount by which surpluses projected in 2001 have decreased for reasons other than legislation and interest on it, i.e., because the 2001 projections were based on economic and related assumptions that are now recognized as having been overly optimistic.

THE RECORD ON TAX CUTS AND DEFICITS
Part 1: How Much of the Budget Deterioration Did the Tax Cuts Cause?

Some policymakers have asserted that the tax cuts enacted in 2001 and 2002 were only a "minor factor" in the deterioration of the budget outlook. For example, a December *New York Times* article on the growing federal budget deficit reported that, "Mr. Daniels [the OMB director] declined to specify the amount of a likely deficit for fiscal 2004, but he described the tax cuts scheduled to take place that year as only a 'minor factor' in the red ink. He laid blame for the deficit on the sluggish economy and the slump on Wall Street and said there would be deficits without the administration's tax cuts."[2] More recently, Daniels dismissed as "bunk" a statement at a Congressional hearing by Senator Kent Conrad that tax cuts have played a substantial role in the disappearance of the surplus.

- CBO data issued in late January show that tax cuts are responsible for one-third of the short-run deterioration in the budget since 2000, making them one of the most important factors behind the re-emergence of deficits.[3] The recession and related revenue shortfalls, along with budget increases (principally for defense and homeland security), are responsible for the remainder of the budget deterioration.

- The tax cuts are responsible for an even larger share of the deterioration of the budget outlook over a ten-year period. The economy is expected to improve as time passes, making economic factors a smaller share of the deterioration of the long-term budget picture. The CBO data show that over the ten-year period from 2001 to 2010, the 2001 and 2002 tax cuts account for 51 percent of the deterioration in the budget, relative to the surplus in 2000.



The President has now proposed a costly round of additional tax cuts. If enacted, these measures would enlarge the deficits currently projected. The newly proposed tax cuts are not a part of this analysis, which examines the effects only of tax cuts that already have become law.

Background and Analysis

In June 2001, Congress enacted a large tax cut. In March 2002, Congress enacted a "stimulus" bill providing major, temporary tax reductions for profitable corporations that purchase new capital assets.

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[2] Elizabeth Bumiller, "Threats And Responses: The Cost; White House Cuts Estimate of Cost of War With Iraq," *New York Times,* December 31, 2002, page A1.

[3] As explained in footnote 1, all costs discussed in this analysis include both direct costs and the related costs of increased interest payments on the debt.

CBO estimates show that these tax cuts together will cost $142 billion in 2003 and $158 billion in 2004, and a growing amount in subsequent years through 2010. Estimates by the President's Office of Management and Budget are nearly identical. These CBO and OMB estimates include both the direct costs of the legislation and the cost of the increased interest payments on the debt that result from the tax cuts.

In Figure 1, on page 3, the lower line (the solid line) represents actual surpluses and deficits through fiscal year 2002, along with CBO's projection for fiscal years 2003 and 2004. The upper line (the dashed line) shows what the surplus or deficit would have been if the two tax cuts had not been enacted, using CBO estimates of the costs of these tax cuts. All figures are expressed as a share of the Gross Domestic Product (i.e., as a share of the economy).

- The upper, dashed line shows that without the tax cuts, the deficits would have been relatively small in 2002 and 2003 and the budget would be in surplus in 2004.

- These data show that tax cuts contributed significantly to turning surpluses to deficits. The surplus in 2000 reached 2.4 percent of GDP. In contrast, the projected 2003 deficit is now 1.9 percent of GDP and the projected 2004 deficit is 1.3 percent of GDP. (These figures are CBO's baseline projections, which do not include the costs of new proposals for additional tax cuts, defense funding increases, prescription drugs, and so on.)

  Over the two years 2003 and 2004, CBO's projected baseline deficit thus averages 1.6 percent of GDP. Comparing the 2000 surplus of 2.4 percent of GDP with the 2003/2004 average deficit of 1.6 percent of GDP shows that that the fiscal picture has deteriorated by 4.0 percent of GDP since 2000. Of that 4.0-percent deterioration, the cost of the tax cuts equals 1.3 percent of GDP in 2003 and 2004. Thus, the tax cuts caused an average of one-third (33 percent) of the budget deterioration that has occurred since 2000, making the tax cuts one of the principal causes of the budget deterioration.

- The upper line in Figure 1, which shows the level of the budget surplus in 2000 and the surplus and deficit levels for subsequent years, drops from surplus to deficit between 2000 and 2002 even without the tax cuts. This reflects the budgetary effects of the recession, revenue shortfalls from related causes such as the plunge in the stock market, and spending increases. As the graph indicates, Mr. Daniels is correct when he says that the surplus would have disappeared even without tax cuts. The CBO data and projections indicate, however, that this is true *only* with respect to 2002 and 2003. The graph shows that without the tax cuts, surpluses would reappear in fiscal year 2004.

- The CBO data also show that in the absence of the tax cuts, the baseline budget would be in surplus in every one of the ten years from 2004 through 2013 that CBO's new report covers.

Administration's Own Forecast Shows Permanent Deficits

The Administration's budget, issued February 3, includes large new tax cuts, as well as increases for the military and for prescription drugs, among other items. The budget shows that according to OMB's own projections, there will be deficits *every year for the next 75 years* if the

Administration's proposals are adopted (unless budget cuts or tax increases of considerable magnitude are subsequently instituted). This state of permanent deficits is shown in a table and graphs in *Analytical Perspectives*, one of the volumes that the Administration released on February 3 as part of the President's budget.[4] By contrast, in President Bush's *first* budget in 2001, he projected approximately 35 years of surpluses under his proposed policies before the pressure of the baby boomers' retirement finally became too great.

4 See table 3-2 and chart 3-2 on page 41, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004.

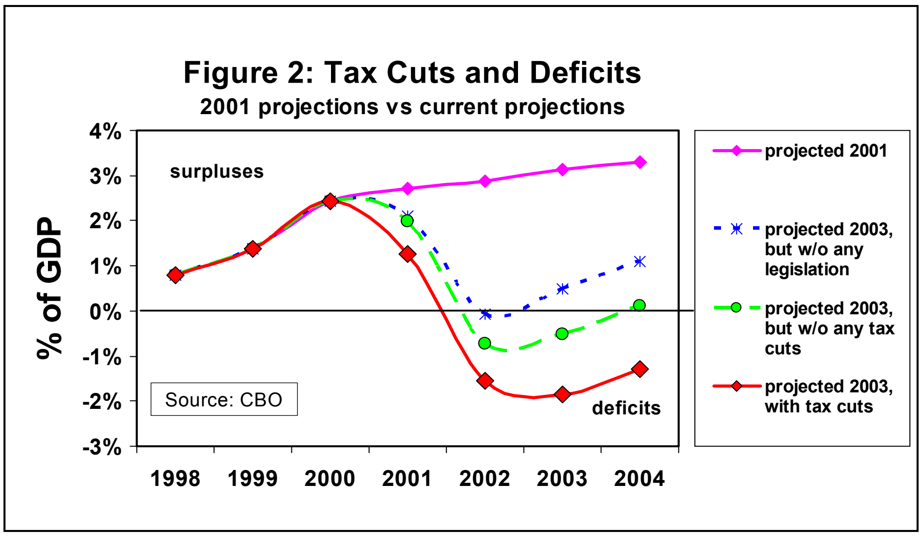
THE RECORD ON TAX CUTS AND DEFICITS
Part 2: How the Budget Has Changed From Its Projected Path

In January 2001, the Congressional Budget Office projected that the federal budget would be awash in large and growing surpluses at least for the next ten years. Those projected surpluses totaled more than $5.6 trillion over the ten fiscal years from 2002 through 2011. Even excluding the expected surpluses in the Social Security trust fund, the projected surplus totaled $3.1 trillion over the decade. These huge figures helped persuade many policymakers that large tax cuts were easily affordable.

CBO's most recent estimate shows that over the ten-year period 2002-2011, the $5.6 trillion in surpluses have been reduced nearly to zero. And outside of Social Security, the ten-year budget is now estimated to be in deficit by $2.2 trillion.[5] What happened?

To begin with, CBO and others now recognize that the $5.6 trillion forecast of 2001 was far too rosy. Even if no tax cuts or program increases had been enacted in the two years since CBO issued its 2001 report, some $2.6 trillion of the projected $5.6 trillion surplus would have disappeared and only $3.0 trillion in surpluses would remain. Simply stated, the "economic and technical" estimates CBO made in 2001 were too optimistic, and not just because of the unanticipated recession. CBO now believes it over-estimated the level of budget surpluses by more than $200 billion in *every* year of the decade.

In addition to the $2.6 trillion in overly optimistic economic and technical projections, Congress enacted legislation over the last two years that CBO estimates will cost $3.0 trillion over the decade, eliminating the remaining surpluses. Of that $3.0 trillion of legislation, some 58 percent represents the cost of tax cuts enacted in the last two years. Another 24 percent represents increases in military funding.[6] Together, tax cuts and military increases constitute 83 percent of the ten-year costs of legislation enacted in the last two years. Many of the remaining costs also were requested by the President, e.g., for homeland security or education.



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[5] Even the new CBO projections should not be taken as the likely course of future deficits or surpluses because they omit trillions of dollars of legislation that Congress is likely or virtually certain to enact. See "CBO Projections Understate Potential Deficits Because They Leave Out Large Costs That Are Very Likely to Occur," Center on Budget and Policy Priorities, revised January 31, 2003, available at http://www.cbpp.org/1-28-03bud.pdf.

[6] As in Part 1, all costs discussed in this analysis include both direct costs and the related costs of increased interest on the debt.

Looking at Figure 2 in More Detail

The top line of Figure 2, on page 6, shows the surpluses that CBO projected in January 2001. The next lower line, the dotted line, shows those surpluses were dramatically overstated, given the recession and related mis-estimates. This dotted line shows that if no budget increases or tax cuts had been enacted since 2001, the surpluses still would have disappeared in 2002 because of the recession but would reappear almost immediately thereafter.

The next lower line, the dashed line, shows the additional effect of budget increases enacted since January 2001. Stated another way, it shows CBO's estimates and projections of what deficits or surpluses would be if everything were the same as it now appears to be, *except* that no tax cuts had been enacted. Without the tax cuts, the budget for 2004 — the coming fiscal year — would be in balance.

Finally, the solid line on the bottom of the graph shows CBO's latest projections, taking into account everything that has happened since 2001, including the tax cuts.

Table 1 presents the same information in dollar and percentage terms, focusing on 2003 and 2004, as well as on the ten-year totals from 2002 through 2011. Tax cuts account for 58 percent of the cost in 2003 and 2004 of legislation enacted since January 2001. As Table 1 indicates, tax cuts also account for 58 percent of the cost *over ten years* of such legislation. Of the costs that are due to legislation enacted since January 2001, the share attributable to tax cuts is essentially the same over ten years as it is in 2003 and 2004 because the big 2001 tax cut phases in slowly while the 2002 "stimulus" tax cut loses revenues almost exclusively in 2002, 2003, and 2004. The backloaded nature of the 2001 tax cut is offset by the frontloaded nature of the 2002 "stimulus" legislation.[7]

Table 1
Changes in CBO Projections Since January 2001
in billions of dollars

	2003-2004 average	Ten-year total, 2002-2011	Share of the $3 trillion, 10-year cost of legislation attributable to each type of legislation
CBO's projected surpluses, January 2001.	**378**	**5,610**	
Remove over-optimistic estimates	-290	-2,577	
CBO's projected surplus, January 2003, *if* no legislation had been enacted.	**88**	**3,033**	
Tax cuts	-150	-1,757	58%
Military appropriations	-60	-736	24%
Non-defense appropriations (including homeland security)	-26	-321	11%
Entitlement legislation*	-24	-199	7%
Subtotal, all legislation	-260	-3,013	100%
CBO projections, January 2003.	**-172**	**20**	

* Entitlement legislation includes the farm bill, extended unemployment compensation, 911 victims compensation, the airline bailout, student loan changes, veterans' education benefits, and dual benefits for military retirees and veterans, among others.

[7] Measured relative to CBO's actual, optimistic projection of January 2001, tax cuts account for 27 percent of the total budget deterioration in 2003 and 2004 and 31 percent of the deterioration over ten years. Measured in this manner, tax cuts constitute a smaller share than 58 percent because the *total* deterioration of the surplus includes the $2.6 trillion

THE RECORD ON TAX CUTS AND DEFICITS
Part 3: A Dynamic View of the Tax Cuts

It may be argued that the analyses in parts 1 and 2 do not present a complete picture of the role of tax cuts to date because the economy would have been in worse shape without the tax cuts. The President's Council of Economic Advisors has made such an argument. In an analysis issued February 14, 2002, the CEA stated that the 2001 tax cut improved economic growth by 1.2 percentage points in the third and fourth quarters of 2001 and by 0.5 percentage points during 2002, relative to what it otherwise would have been. This CEA analysis was based on the standard and widely accepted Keynesian view that if, during a recession, the government puts cash in the hands of taxpayers and consumers by cutting taxes or increasing government expenditures, some of that cash will be spent, thereby stimulating the economy.[8]

How much difference would this assumed economic stimulus make to our analysis of the role of tax cuts in causing deficits? To answer this question, we assume that the 2001 tax cut improved economic performance fully as much as the CEA estimated, even though some recent research suggests this is unlikely to have been the case.[9] Second, we assume, to be favorable to the Administration, that the deterioration of *future* surpluses caused by the tax cuts did nothing to raise long-term interest rates and thereby harm the economy in the short run — or if it did, that the CEA accounted for that effect in its analysis.[10] Third, we assume that the faster economic growth that the

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deterioration that resulted from downward re-estimates of economic and technical factors, along with the $3.0 trillion deterioration caused by legislation.

[8] "President Bush's 2001 Tax Relief Softened the Recession," Council of Economic Advisors, February 14, 2002, available at http://www.whitehouse.gov/cea/TaxReliefActUpdate_Feb02wp.pdf. The CEA report says, "Various provisions of the Tax Relief Act have helped boost aggregate demand. … The timing of rebates and the reductions on withholding proved propitious: they added significant economic stimulus by boosting consumers' purchasing power during a period of sluggish economic activity. … without this tax relief, the 2001 recession would have been deeper and longer." The CEA repeats this conclusion in "Strengthening America's Economy," February 4, 2003, available at http://www.whitehouse.gov/cea/cea_growth_package_macroeconomic_effects.pdf . This CEA white paper says, "Household spending … has been supported by the continued growth of real personal income … as a result of both the 2001 tax cut and supportive monetary policy."

[9] See "Did the 2001 Tax Rebate Stimulate Spending? Evidence from Taxpayer Surveys," Matthew D Shapiro and Joel Slemrod, NBER working paper 9308, October 2002.

[10] A recent review of the academic literature shows a consensus that a reduction in projected long-term surpluses or an increase in projected long-term deficits will increase real long-term interest rates in both the short run and long run, relative to what those interest rates would otherwise have been. Some 12 out of the 17 relevant economic studies found this effect, while an additional four of these studies found mixed effects. Only one study found no such effect. See William G. Gale and Peter R. Orszag, "The Economic Effects of Long-Term Fiscal Discipline," The Brookings Institution, December 17, 2002, available at http://www.brookings.org/views/papers/gale/20021217.htm. The Administration has responded that interest rates do not move in lock-step with deficits. This rejoinder, however, is unpersuasive. The fact that interest rates do not move in lock-step with deficits is not meaningful, since many other factors also affect interest rates; the change in expected future deficits is only one such factor. The question is *not* whether interest rates move in lock-step with changed deficit projections — they do not because a number of factors also can change — but rather whether increases in projected deficits will raise long-term interest rates *after all other factors are controlled for*. Gale and Orszag show that increases in expected future deficits have this effect and that most economic studies that controlled for other factors found such an effect. Data showing little connection between long-term interest rates and short-term fluctuations in deficits or surpluses also is beside the point, as the relevant question is not whether temporary ups and downs in the federal budget affect long-term

Table 2

How the Analysis in Parts 1 and 2 Would Change if the Net Tax Cuts Were Seen as Less Costly Because of Revenue Feedback Generated by Keynesian Stimulus

		Results shown in Parts 1 and 2	Results with revenue feedback implied by CEA analysis
Analysis in Part 1:			
	Total deterioration of the surplus from 2000 to 2003 and 2004 (average), as a percent of GDP	4.0% of GDP	4.0% of GDP
	Amount of that deterioration caused by enacted tax cuts	1.3% of GDP	1.2% of GDP
	Share of that deterioration caused by enacted tax cuts	33% of the total	29% of the total
Analysis in Part 2:			
	Avg. cost in 2003-2004 of all legislation since 2001	\$260 billion	\$241 billion
	Avg. costs of enacted tax cuts in 2003-2004	\$150 billion	\$132 billion
	Tax cuts as a share of all legislation	58%	54%

Note: ratios are based on unrounded figures

CEA believes occurred in 2001 and 2002 not only produced a faster recovery in those years, but also a higher level of GDP in 2003 and 2004 than would otherwise have occurred, a claim CEA did not itself make in its analysis. Finally, we assume for each dollar of increased GDP, revenues increase by 20 cents, slightly more than the CEA generally assumes.[11] The assumptions employed here are favorable to advocates of "dynamic scoring" of tax cuts and are likely to overstate, perhaps by a substantial amount, the effects of the tax cuts in generating revenue "feedback."

Under these assumptions, the effect of the tax cuts on the budget would be reduced, but only by a modest amount. Instead of the tax cuts costing a total of \$300 billion in revenues and interest payments on the debt in 2003 and 2004, as CBO estimates, the tax cuts would have cost \$263 billion — or 87 percent as much.

Thus, even when assumptions favorable to the Administration are used, the conclusions change little. The tax cuts continue to represent a major factor behind the deterioration of the surplus.

We noted earlier that CBO data indicate the tax cuts enacted to date account for 33 percent of the deterioration in the budget from the actual surplus in fiscal year 2000 to the projected, average deficits in fiscal years 2003 and 2004. If, using the assumptions favorable to the Administration, one concludes that the tax cuts would cost only 87 percent as much as CBO says, the tax cuts would account for 29 percent of the budget deterioration.

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interest rates but whether changes in projected, *long-term* surpluses or deficits affect long-term interest rates. As the Gale/Orszag study demonstrates, the evidence supports such a link, and most macroeconomic models reflect it.

[11] The CEA's most recent white paper uses a slightly lower estimate: "When computing the impact of faster growth on Federal budget receipts, CEA followed the historical evidence and assumed that a \$1 rise in real GDP generates 19 cents of Federal revenue." CEA, *op. cit*. The white paper also pointed out that revenue feedback would be lower than 19 percent to the extent that some additional growth of nominal GDP was due to higher inflation.

We also noted that tax cuts accounted for 58 percent of the cost in 2003 and 2004 of the legislation enacted since January 2001. If the tax cuts cost 87 percent as much as CBO has estimated, they would account for 54 percent of the costs of legislation, still more than all other types of legislation combined.

It should be noted that the figures cited here that rest upon the CEA assumptions necessarily distort the findings in the Administration's favor. The figures we have generated using the CEA estimates assume that the tax cuts stimulated the economy as the CEA claims, but that increased spending for defense, homeland security, unemployment compensation, and the like provided *no* stimulus whatsoever. Such an assumption defies reason since these budget increases have put cash in the hands of consumers just as the tax cuts have done.

Conclusion

The tax cuts enacted in 2001 and 2002 have played a substantial role in the disappearance of surpluses and their replacement with deficits. CBO data show that without the tax cuts, the budget would be returning to surplus in the coming year, 2004, and would remain in surplus for a decade or longer, even with the military buildup to date, the increased costs of homeland security, and other program increases that have been enacted since 2001.

Today, the budget is on a very different course. OMB itself now projects that under the policies proposed in the Administration's new budget, the federal government would remain in deficit virtually forever.