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EXTENDING THE TAX CUTS WOULD COST $2.1 TRILLION THROUGH 2015

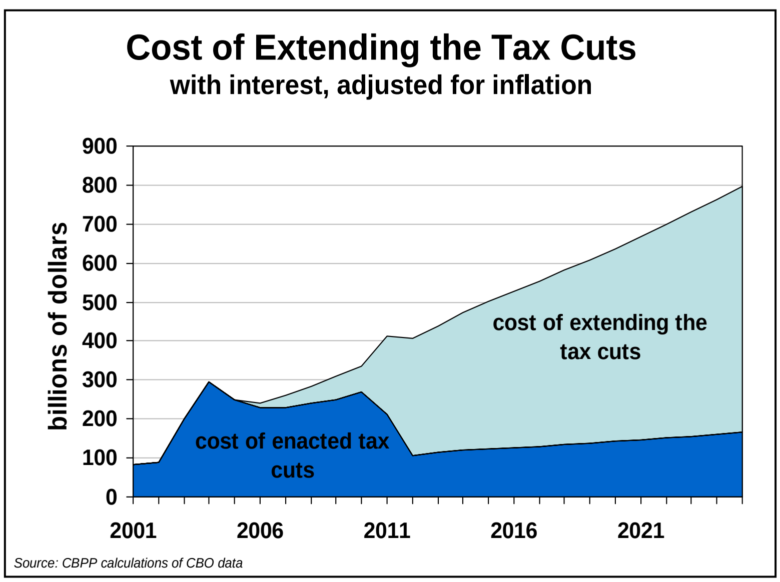
By Joel Friedman, Ruth Carlitz, and David Kamin

During his first term, President Bush signed into law legislation that cut individual income tax rates, repealed the estate tax, and reduced taxes on capital gains and dividends. These tax cuts and others, enacted in 2001 and 2003, will expire between the end of this year and 2010. The Administration has called for making these tax cuts permanent, but has not proposed measures to offset the cost of extending these tax cuts. As a result, the Administration's proposal would be extremely costly and would contribute significantly to the growth of deficits over the long term.

- Making permanent the tax cuts enacted in 2001 and 2003 would have a direct cost of $1.8 trillion through fiscal year 2015, based on Congressional Budget Office estimates. This includes the cost of extending the Alternative Minimum Tax relief associated with these tax cuts.[1]

- Without offsets, the cost of these tax cuts would increase the annual deficit and thus would add to the federal debt. The interest payments associated with this higher level of debt will be nearly $300 billion through 2015. Consequently, the total cost of the tax cuts, including the related interest costs would be $2.1 trillion over the period.

- Nearly 90 percent of these costs would occur in the second half of the next decade, since most of the tax cuts do not expire until the end of 2010. In



[1] The 2001 and 2003 tax cuts exacerbated existing problems with the AMT. The total above includes $487 billion to extend the AMT relief associated with the 2001 and 2003 tax cuts, but not the $205 billion of AMT relief that would be needed to address the AMT problem that pre-dated these tax cuts. Note that the President's 2006 budget includes no extension of AMT relief. In addition, the Administration estimates that extending the 2001 and 2003 tax cuts would cost about $200 billion less than the CBO estimates used in this analysis.

2015, the extended tax cuts alone would cost $376 billion, an amount equal to 1.9 percent of the nation's economy or Gross Domestic Product in that year.

- In the decade beyond the current ten-year budget window, covering the period 2016 through 2025, when all of the tax cuts would be in effect for the full ten years, the cost of extending these provisions would be $4.6 trillion before interest costs, and $7.2 trillion including the additional interest costs the tax cuts would automatically generate.[2] It is during this same decade that the baby boomers will begin to retire in large numbers and their health care and pension costs will begin to rise.

These costs would be in addition to the high price being paid for the tax cuts already enacted.

- Through fiscal year 2005, the Bush tax cuts enacted since 2001 have cost $819 billion. Before they expire, they will cost another $1 trillion, for a total cost of $1.9 trillion.

- Because these tax cuts have not been paid for, their cost represents a permanent increase in the debt. The associated interest payments will continue even after the time when the enacted tax cuts are scheduled to expire. That is why the graph on the previous page shows a cost associated with the enacted tax cuts of more than $100 billion a year even after they have expired in 2010. In total, the interest costs associated with the enacted tax cuts will be $1.1 trillion through 2015.

- The combined cost of the tax cuts enacted since 2001 and the cost of extending the tax cuts would be $5.1 trillion through 2015, when interest costs are included. Of that total, $4.2 trillion would occur in the period between 2006 and 2015 (see Appendix table).

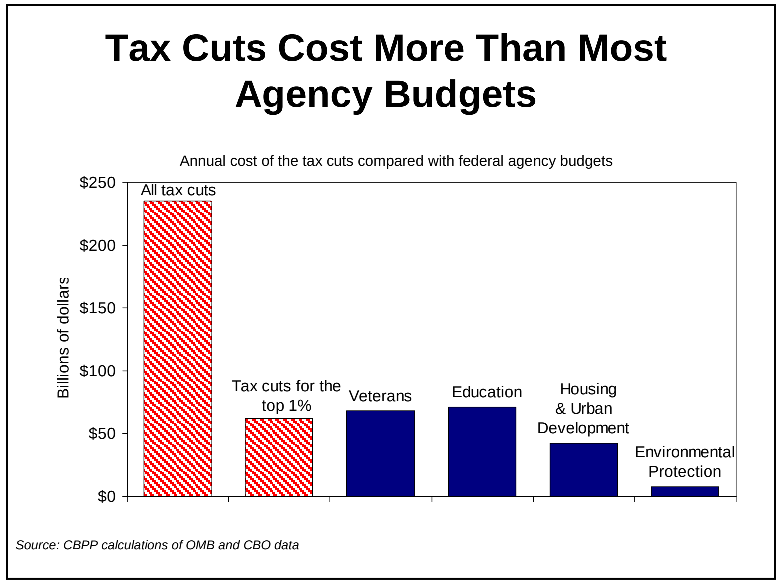
Below are two examples that attempt to put these cost figures in proper perspective. The first example relates the annual cost of the tax cuts to the budgets of several federal agencies, such as the Departments of Education and Veterans Affairs. The second example looks at cost of the tax cuts relative to the shortfall in the Social Security Trust Fund.

Tax Cuts Cost More Than Most Federal Agencies

As enacted, many of the tax cuts affecting high-income families have not yet taken full effect. The estate tax, for instance, is only repealed in 2010; two provisions from 2001 — the repeal of the personal exemption phase out for high-income taxpayers ("PEP") and the repeal of the limitation of itemized deductions for high-income taxpayers ("Pease") — only begin to phase in starting in 2006 and take full effect in 2010. The chart below takes the cost of the tax cuts

[2] These estimates are expressed in nominal dollars, and thus have not been adjusted for inflation. If they were adjusted for inflation and expressed in constant 2005 dollars, the cost of extending the tax cuts would be $1.5 trillion for the first ten-year period through 2015, and $3.3 trillion for the second ten-year period, 2016 through 2025. With interest cost included, the totals would be $1.8 trillion in the first decade and $5.1 trillion in the second decade.

when they all are fully in effect and translates this annual cost into current dollars, so the cost of the tax cuts can be compared to the current budgets of various federal agencies. As the chart on the next page indicates, when the tax cuts are fully in effect:



- Their cost will be more than three times the cost of the budget for all federal education programs and assistance — at elementary, secondary, and post-secondary levels combined — and more than three times the cost of all veterans programs (including veterans health care, veterans pensions, veterans disability compensation, and other services).

- The cost of the tax cuts will dwarf the budgets of smaller departments; for instance, the cost of the tax cuts will be 30 times the Environment Protection Agency's budget and more than five times the cost of all housing and urban and community development programs operating by the Department of Housing and Urban Development.

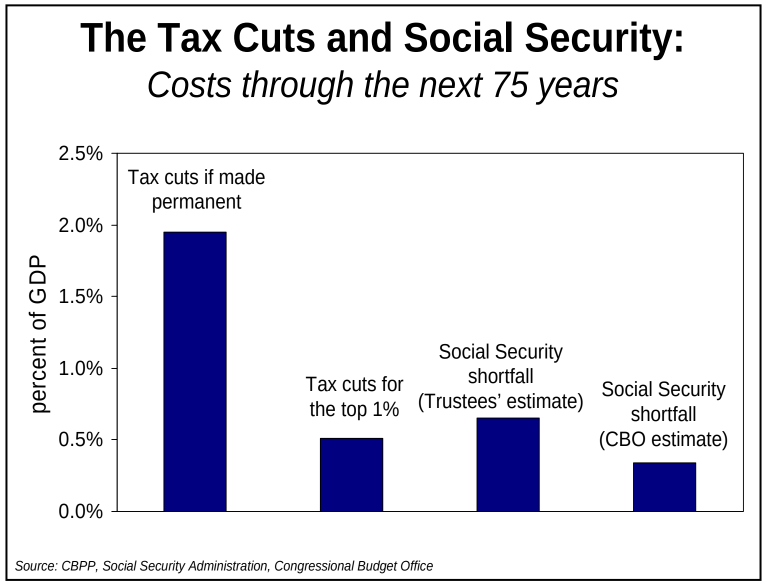
- Just the cost of the tax cut for the top one percent of households — whose incomes average about $1 million a year — will be nearly the same amount the federal government spends on education, as well as everything it spends for veterans.

Tax Cuts Cost Three to Six Times More than Social Security Shortfall

The Administration has been highlighting the size of the shortfall in the Social Security Trust Fund in an effort to build support for its proposal to replace part of Social Security with individual accounts.[3] Yet the size of the Social Security shortfall pales in comparison with the cost of the fiscal shortfall that would be created by making the tax cuts permanent. According to the Social Security actuaries, over the next 75 years — the period traditionally used to assess Social Security's finances — the deficit in the Social Security trust fund equals 0.7 percent of GDP. The Congressional Budget Office, which uses somewhat different assumptions than the actuaries, estimates that the Social Security shortfall is more modest — 0.4 percent of GDP over the next 75 years. In contrast, the cost of making permanent the tax cuts enacted in 2001 and 2003 is equal to roughly 2 percent of GDP over the next 75 years.

[3] See Jason Furman, William Gale, and Peter Orszag, "Would Borrowing $2 Trillion for Individual Accounts Eliminate $10 Trillion in Social Security Liabilities," Center on Budget and Policy Priorities, December 13, 2004.

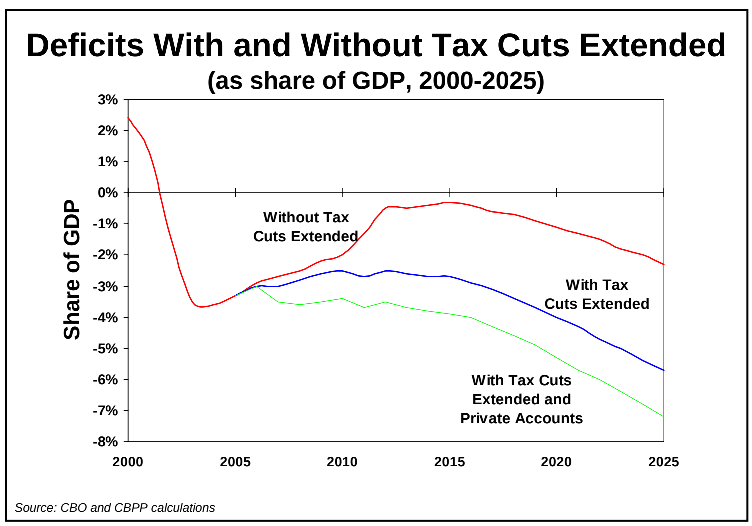
- Thus, the cost of making the tax cuts permanent will be *three to six times larger* than the size of the Social Security shortfall over the next 75 years.[4]



- In fact, the share of the tax cuts going to the top one percent of the income spectrum (about 0.5 percent of GDP) is of the same magnitude as the Social Security deficit.

Cost of Tax Cuts Worsens Deficit Outlook

The high cost of the tax cuts contributes significantly to the deterioration of the nation's fiscal outlook. As the baby boomers begin to retire in large numbers, the nation's fiscal position will become increasingly strained. As depicted in the graph below, making the tax cuts permanent will make a bad situation considerably worse.[5]



- The cost of extending the tax cuts becomes most apparent starting in 2011, by which time all of the tax cuts enacted since 2001 are slated to have expired. If the tax cuts are not extended, the projected deficit

[4] The cost of the tax cut still exceeds the size of the Social Security shortfall even if projections extend beyond the 75-year time frame to an "infinite horizon," a time-frame that the Administration has been emphasizing.

[5] These projections start with the Congressional Budget Office's baseline projections through 2015, which reflect current law only. All projections also assume the extension of certain tax provisions (known as "extenders") that are routinely renewed whenever they are slated to expire, as well as extension of relief from the Alternative Minimum Tax. Projections of the cost of extending tax cuts assume extension of the 2001 and 2003 tax cuts, as well as continuation of the additional AMT relief associated with those tax cuts.

Tax Cuts Do Not Pay For Themselves*

Some will argue that these scenarios are unrealistic because they fail to take into account the positive effects of the tax cuts on the economy. The implication is that the tax cuts will cause the economy to expand so much that the economy will produce approximately the same level of revenue with the tax cuts as it would produce without them; in short, the tax cuts would pay for themselves. But no reputable economist — liberal or conservative — has ever shown that tax cuts pay for themselves. For instance, N. Gregory Mankiw, the current chairman of the President's Council of Economic Advisers, has written that there is "no credible evidence" that tax cuts can pay for themselves, and that an economist who makes such a claim is a "snake oil salesman who is trying to sell a miracle cure."**

Others may argue that the growth effects of making the tax cuts permanent could still yield enough additional revenues to offset a portion (rather than all) of the tax cuts' high cost. Studies by the Congressional Budget Office, Joint Committee on Taxation, Federal Reserve economists, and other economists, however, have yielded a substantial body of evidence indicating that that these claims are very unlikely to be realized. Most recently, Brooking Institution economists William Gale and Peter Orszag concluded that the design of the tax cuts and the fact that they have not been paid for — and thus add to the deficit — means that making the tax cuts permanent without offsetting their large cost would be "likely to reduce, not increase, national income in the long term."*** Lower growth would mean that these tax cuts could actually end up costing more, not less, than current estimates show.

Finally, it is worth noting that historical evidence also confirms the intuitive conclusion that tax cuts reduce revenues. Over the post-war period, the economy grew at about the same rate during the different business cycles, but the growth of revenues fluctuated depending on the tax policy being pursued. For instance, the economy grew at an average annual rate of 2 percent per person during both the 1980s and the 1990s, but revenues grew more than twice as fast (even excluding capital gains) during the 1990s, when taxes were increased, than they did during the 1980s, when taxes were cut. Similarly, CBO is projecting typical rates of economic growth through 2015 but very slow revenue growth over the period, assuming the tax cuts are extended.****

* This draws from Richard Kogan, David Kamin, and Joel Friedman, "Too Good To Be True: Tax Cuts Do Not Pay For Themselves," Center on Budget and Policy Priorities, March 22, 2004.

** N. Gregory Mankiw, *Principles of Economics* (Fort Worth, TX: Dryden, 1998), p. 29-30.

*** See William Gale and Peter Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," Tax Notes, October 18, 2004

****See Richard Kogan, "The Simple Story: Tax Cuts Lose Revenues," Center on Budget and Policy Priorities, January 25, 2005.

would shrink to $81 billion in 2012, or about one-half of one percent of GDP.

- In contrast, if the tax cuts are extended, deficits would be over $400 billion by 2012, or 2.5 percent of GDP.

After 2015, the deficit outlook begins to deteriorate under both scenarios, reflecting the impact on the budget of the higher health care and pension costs associated with the retirement of the baby-boom generation. But the situation is far more dire if the tax cuts are extended. Deficits will be between 2.5 and 3.5 percentage points higher as a share of GDP if the tax cuts are extended.[6] By 2025, the cost of extending the tax cuts and the associated interest payments will have added $9.3 trillion to the debt, an amount that itself would be equal to one-third of the U.S. economy in that year. This added burden would make it substantially more difficult to overcome the significant fiscal problems the country will face.

The fiscal situation worsens to an even greater extent if one considers the impact on the deficit of the President's other current major initiative — the introduction of private accounts into Social Security. Press reports indicate that the President is likely to propose borrowing to cover the initial costs of establishing private accounts. Under the principal Social Security plan the President apparently is considering, the main plan his Social Security commission devised, the federal government would have to borrow an additional $1.4 trillion through 2015,[7] and $3.2 trillion through 2025, according to CBO. The higher levels of debt would continue for many years, as CBO projects that private accounts will elevate the level of federal debt through 2064. Between them, these two Presidential initiatives — making the tax cuts permanent and creating individual accounts — would add $14.0 trillion to the debt by 2025, an amount equal to 50 percent of GDP in that year.

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[6] In 2015, the direct cost of the tax cuts is projected to be 1.9 percent of GDP. This cost as a share of GDP is held constant in our projections for years after 2015. The interest costs associated with these tax cuts, however, continue to grow (and to increase as a share of GDP) throughout the projection period.

[7] These estimates are based on Congressional Budget Office cost projections. Another commonly used estimate comes from the Social Security Administration actuaries, who placed the 10-year cost at $2 trillion. That figure, which covers the period 2005-2014, assumed that individual accounts were adopted in 2004. The CBO estimate assumes that workers begin diverting payroll tax revenue into individual accounts in 2007.

APPENDIX TABLE

Cost of Tax Cuts As Enacted and of Making the Tax Cuts Permanent, Through 2015*
(in trillions of dollars)

Cost of tax cuts as enacted	
Enacted tax cuts without interest costs	
Cost 2001 through 2005	$0.8
Cost 2006 through 2015	1.0
Total cost, 2001 through 2015	1.9
Enacted tax cuts with interest costs	
Cost 2001 through 2005	$0.9
Cost 2006 through 2015	2.1
Total cost, 2001 through 2015	3.0
Cost of extending tax cuts**	
Cost 2006 through 2015	$1.8
Interest costs	0.3
Total cost, 2006 through 2015	2.1
Cost of enacted and extended tax cuts	
Cost 2001 through 2015	$3.7
Interest costs	1.4
Total cost, 2001 through 2015	5.1

Notes:

*Figures are based on Joint Committee on Taxation and Congressional Budget Office estimates of the cost of tax-cut provisions through 2015, and CBPP calculations. Interest costs are calculated using CBO's standard methodology and assumptions.

** Includes the extension of all tax cuts enacted in 2001 and 2003, except for bonus depreciation; includes only the share of AMT relief that is associated with the 2001 and 2003 tax cuts (and thus excludes the portion of AMT relief needed to address the underlying AMT problem that pre-dated these tax cuts). Estimates do not include the cost of extending new temporary tax cuts that were part of the 2004 corporate tax package; nor do these estimates include the cost of continuing the so-called "extenders," a group of "temporary" tax breaks that pre-dated the Bush administration and that always are extended on a bipartisan basis when they come up for renewal.