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THE ADMINISTRATION=S TAX CUTS AND THE LONG-TERM BUDGET OUTLOOK

The 75-year Cost of the Administration=s Tax Cuts Is More than Three Times the Long-term Deficit in Social Security and Larger than the Long-term Deficits in Social Security and Medicare Combined

by Peter Orszag, Richard Kogan, and Robert Greenstein[1]

The Administration=s budget shows substantial long-term deficits.[2] It states that these deficits — and thus the Areal fiscal danger@ — arise almost exclusively from Social Security and Medicare. It declares that Athe Social Security and Medicare shortfalls compel change. They must not be left hanging over the heads of our children and grandchildren.@[3] The Administration is correct to identify the projected deficits in Social Security and Medicare as important problems requiring attention from policymakers. But it is a mistake to exclude the Administration=s own tax cuts from discussions of the projected long-term fiscal imbalances that face the nation. The long-term cost of those tax cuts, as well, will hang Aover the heads of our children and grandchildren.@

To help illuminate these issues, this analysis examines and compares the fiscal dimensions of two major items: the projected long-term actuarial deficit in Social Security and the long-term cost of the Administration=s tax cuts. It also compares the combined deficit in Social Security and the Medicare Hospital Insurance program to the cost of the Administration=s tax cuts.

As this analysis shows, the long-term cost of the Administration=s tax cuts is *more than three times* the entire long-term Social Security shortfall. The Administration=s tax cuts would cost between 2.3 percent and 2.7 percent of Gross Domestic Product (GDP) over the next 75 years. According to the just-released Social Security Trustees Report for 2003, the Social Security deficit amounts to 0.7 percent of GDP.

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[2] See, for example, Charts 3-2 through 3-7 in the *Analytical Perspectives* of the Administration=s budget.

[3] Office of Management and Budget, *FY 2004 Budget of the United States*, AThe Real Fiscal Danger.@

Administration tax cuts, Social Security deficit, and Medicare HI deficit over next 75 years

	Present value over the next 75 years, % of GDP	Present value over the next 75 years*, $ trillion
2001 tax cut if made permanent	1.5% to 1.9%	$7.9 trillion to $10.0 trillion
Dividend / capital gains	0.3%	$1.6 trillion
Tax-free savings accounts	0.3%	$1.6 trillion
Other proposed tax cuts	0.2%	$1.1 trillion
Total, Administration tax cuts	***2.3% to 2.7%***	***$12.1 trillion to $14.2 trillion***
Social Security actuarial deficit*	0.73%	$3.8 trillion
Medicare Hospital Insurance actuarial deficit*	1.11%	$6.2 trillion
Combined Social Security and Medicare HI deficit*	***1.84%***	***$10.0 trillion***

* Assumes level of GDP and interest rates projected by the Social Security actuaries. May not add due to rounding.

The cost of the Administration=s tax cuts is between about one-third and one-half larger than the combined actuarial deficit in Social Security and the Medicare Hospital Insurance program. The projected deficit in the Medicare Hospital Insurance (HI) program is 1.1 percent of GDP, and the combined Social Security and Medicare Hospital Insurance deficit is 1.8 percent of GDP. The cost of the Administration=s tax cuts, at 2.3 to 2.7 percent of GDP, is substantially larger than the *combined* deficits in Social Security and the Medicare HI program.

It also may be noted that even without the Administration=s proposals to expand the availability of the tax-free savings accounts — the part of the Administration=s tax-cutting agenda that has the smallest chance of being approved — the long-term cost of the tax cuts still is about three times the Social Security shortfall and exceeds the combined Social Security and Medicare HI shortfall.

Social Security and Medicare

According to the recently released, official estimates of the Social Security actuaries and trustees, issued March 17, 2003, the projected long-term deficit in Social Security over the next 75 years — the traditional period used for measuring Social Security=s long-term solvency — equals 1.92 percent of the wages, salaries, and self-employment income that will be subject to the payroll tax during this period. This amounts to $3.8 trillion in present value. (Present value is the amount today that, with interest, would exactly cover these future costs.) The trustees= report also shows that, measured as a share of the economy, the Social Security shortfall equals 0.73 percent of Gross Domestic Product over the next 75 years.[4]

[4] Under the Social Security actuaries= intermediate projections, the projected 75-year deficit amounts to 1.92 percent of taxable payroll. Over this 75-year-period, taxable payroll will amount to 38 percent of the Gross

The Tax Cut and Social Security, Measured in Perpetuity

It is possible to examine the size of the deficit in Social Security in perpetuity (rather than over 75 years) and the cost of the tax cuts in perpetuity. Such a comparison can be made using the methodology described here to estimate the permanent cost of the tax cut. The Trustees Report includes an estimate of the permanent Social Security deficit. In both cases, the projection horizon is extended far beyond 75 years. Projections of costs in perpetuity are subject to even more uncertainty than the already uncertain estimates for 75 years, or even for 10 years. Birth, death, and productivity rates a century or several centuries from now are highly speculative. We would not recommend basing analyses or making policy decisions on estimates of costs in perpetuity.

The present value of the cost of the tax cut in perpetuity, estimated as above but extending the analysis beyond 75 years, equals between $18 trillion and $21 trillion. The trustees report estimates the Social Security shortfall projected in perpetuity at $10.5 trillion. (See page 61 of the Trustees Report.)

In other words, the projected cost of the tax cuts in perpetuity is close to twice the projected cost of the Social Security shortfall in perpetuity. Shifting the focus beyond 75 years does not alter the finding that the long-term cost of the tax cuts is noticeably larger than the long-term deficit in Social Security.

The same table in the trustees= report shows that the deficit in the Hospital Insurance component of Medicare (Medicare Part A) amounts to 1.11 percent of GDP over the next 75 years and that the combined deficit in Social Security and Medicare HI amounts to 1.84 percent of GDP.[5]

Domestic Product when both are expressed in present value. As a result, the 75-year imbalance amounts to 0.73 percent of GDP, which is equal to 1.92 percent of taxable payroll multiplied by 38 percent. The figure of 0.73 percent of GDP appears in Table VI.F5 on page 174 of the Trustees Report, March 17, 2003.

[5] Table VI.F5 on page 174 of the Trustees Report, March 17, 2003. The Administration shows somewhat larger figures for the Social Security and Medicare deficits in its budget. The reason is two-fold: First, the Administration=s figures exclude the Social Security and Medicare Trust Funds. They thus focus on the future cash flow associated with the programs (which ignores the existence of the trust funds), rather than the actuarial deficits (which include those trust funds). Our figures are consistent with the actuarial deficits computed by the Social Security actuaries and reported by the Social Security trustees. Second, the Administration=s figures include Part B of Medicare (Medicare physicians= services). Our figures include the Hospital Insurance component (Part A) of Medicare, but not Medicare Part B. Under federal law, Medicare Part B, like most government programs, is supported primarily by general revenues rather than by a dedicated trust fund. Calculating an actuarial deficit in Part B thus is akin to computing a Adeficit@ in the Defense Department or in other parts of government that are supported by general revenues; such a Adeficit@ has little meaning unless it is calculated for *all* federal programs taken together, relative to all projected general revenues. Nonetheless, even relative to the Administration=s figures for Social Security and Medicare, the tax cuts are substantial, and it is inappropriate to exclude them from a discussion of the long-term fiscal outlook.

The Administration=s Tax Cuts

To measure the long-term cost of the Administration=s tax cuts, we assemble estimates from the Congressional Joint Committee on Taxation and the Congressional Budget Office, as well as estimates based on the Urban Institute — Brookings Institution Tax Policy Center model. We assume that the cost of a tax cut will remain constant as a share of GDP after 2013, which is the standard approach that the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office use when preparing long-term fiscal projections. In this case, such an approach is likely to understate long-term revenue losses because the costs of several provisions of the Administration=s tax proposals, such as the repeal of the estate tax and the creation of Retirement Savings Accounts and Lifetime Savings Accounts, are virtually certain to grow faster than GDP for many years after 2013.[6]

Budget policies are not commonly discussed in terms of their costs over 75 years, in part because the resulting figures would be mind-numbing. But it is instructive to do so, given the concerns over the long-term health of the federal budget. We divide the Administration=s tax proposals into four components:

- *The 2001 tax cut.* The Administration=s budget would repeal the scheduled expiration of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 and make the 2001 tax cuts permanent.[7] The magnitude of the revenue loss from EGTRRA over the next 75 years depends to some degree on the individual Alternative Minimum Tax (AMT). The AMT runs parallel to the regular income tax system; it uses a somewhat different measure of income, permits fewer deductions, and applies flatter rates than does the regular income tax. In theory, each taxpayer must calculate tax liability under both the conventional income tax and the AMT and pay the larger liability. In practice, the AMT currently generates larger liability for so few taxpayers — about 3 percent of them — that few filers, other than the tiny minority who might be affected, bother with it. Because the AMT is not adjusted for inflation while the ordinary income tax is, the AMT applies to a larger number of taxpayers with each passing year. In addition, EGTRRA, which reduced ordinary income tax rates but not the tax rate that is applied under the AMT, will greatly increase the number of people subject to the AMT. All told, by 2010 an estimated 36 million filers will become subject to the AMT under current law.[8] No one expects this to occur; neither party will allow millions of middle-class taxpayers to be

[6] Burman, Gale, and Orszag (2003) show growing revenue losses over time from the savings account proposals. See Leonard E. Burman, William G. Gale, and Peter R. Orszag, AThe Administration=s New Tax-Free Saving Proposals: A Preliminary Analysis,@ *Tax Notes*, March 3, 2003.

[7] This analysis includes both the existing cost of EGTRRA and the cost of its permanent extension.

[8] Leonard E. Burman, William G. Gale, Jeffrey Rohaly, and Benjamin H. Harris, AThe Individual AMT: Problems and Potential Solutions,@ Urban-Brookings Tax Policy Center Discussion Paper No. 5, September, 2002. Forthcoming, *National Tax Journal*.

subjected to the AMT. The Administration has proposed AMT relief through 2005 and stated that it intends to come back in 2005 and propose ongoing AMT relief. The type of long-term Afix@ adopted for the AMT will affect the cost of the 2001 tax cut. The more generous the AMT fix, the higher the cost of the 2001 tax legislation. The reason for this is that under current law, the AMT reduces the revenue loss from EGTRRA, since the AMT prevents many taxpayers from enjoying the full tax cut they would otherwise receive under EGTRRA. Addressing the AMT problem therefore raises the cost of EGTRRA.[9] Depending on the degree of AMT reform, Auerbach, Gale, Orszag, and Potter (2003) estimate that the revenue loss from EGTRRA over the next 75 years (assuming it is made permanent) will amount to between 1.5 percent and 1.9 percent of GDP.[10])

- *Dividend tax proposal.* The Administration has proposed that dividends and capital gains be tax-free at the individual level to the extent that corporations pay tax on the underlying earnings. The Joint Tax Committee and CBO estimate the cost of this proposal in 2013 at $58 billion.[11] That is more than 0.3 percent of CBO=s projected GDP for that year. We use 0.3 percent of GDP as our estimate of the 75-year revenue loss from the proposal.[12]

- *Tax-free savings accounts proposal*. The Administration has proposed to create a new set of tax-preferred accounts that would greatly expand opportunities for tax-sheltered saving. The Administration itself shows basically no revenue effect from the introduction of such accounts over the next 10 years, largely because the proposal would shift revenue from outside the 10-year window to inside that window; that revenue shift hides the long-term cost of the proposal. A major study issued by the Urban Institute-Brookings Institution Tax Policy Center estimates that this proposal

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9 Note that any AMT relief would not only make EGTRRA more expensive (as estimated for the purposes of this analysis) but would lose additional revenues as well. The additional revenue losses are not counted in this anlaysis.

10 Alan J. Auerbach, William G. Gale, Peter R. Orszag, and Samara Potter, ABudget Blues: The Fiscal Outlook and Options for Reform,@ in Henry Aaron, James Lindsay, and Pietro Nivola, *Agenda for the Nation* (Washington: Brookings Institution, forthcoming). Related estimates using the Urban-Brookings Tax Policy Center model suggest a 75-year cost (for 2002-2075) for EGTRRA of approximately 1.6 percent of GDP if the AMT is indexed to inflation from 2002 forward and the revenue loss is assumed to be a constant share of GDP from 2013 onward. This option would leave about 11.5 million taxpayers on the AMT in 2013. The 75-year revenue loss rises to more than 1.8 percent of GDP if a more aggressive AMT reform, which would reduce the number of taxpayers on the AMT to below current levels, were adopted. The broader 1.5 percent to 1.9 percent of GDP range used in this paper encompasses these alternative estimates.

11 Joint Committee on Taxation, AEstimated Budget Effects of the Revenue Provisions Contained in the President=s Fiscal Year 2004 Budget Proposal,@ March 4, 2003.

12 The revenue loss is approximately 0.25 percent of GDP in years before 2008, which slightly reduces the 75-year revenue loss relative to GDP. For example, a loss of 0.25 percent of GDP for the first 10 years, followed by 0.33 percent of GDP for the rest of the 75-year period, generates a revenue loss of 0.31 percent of GDP in present value over the 75-year period as a whole.

will lose 0.3 percent of GDP after a decade, with increasing losses thereafter.[13] We use 0.3 percent of GDP as our 75-year revenue estimate. This estimate likely understates the revenue loss over the 75-year period. The Tax Policy Center analysis finds that the revenue loses would equal 0.5 percent of GDP after 25 years and continue to grow for some years after that.

$ *Other tax proposals*. The Administration has proposed a variety of other tax cuts, including a new health insurance tax credit, expanded Medical Savings Accounts, and others. The Joint Tax Committee and CBO estimate the cost of these other revenue proposals at $50 billion in 2013. That is 0.28 percent of projected GDP. We use 0.2 percent of GDP as our estimate for the revenue loss over 75 years.[14]

Conclusion

The nation faces significant long-term fiscal problems, which will increasingly manifest themselves after the baby boomers retire in large numbers. The nation also is likely to face needs in the decades ahead that will require resources in other areas, including areas relating to children, the environment, the large number of Americans without health insurance, the lack of a Medicare prescription drug benefit, and the uncertain costs of homeland security, as well as other problems that inevitably will arise in the future but that we cannot foresee today. A balanced long-term fiscal policy is likely to entail some changes in Social Security and Medicare to reduce their future claims on the budget. The Administration=s tax proposals, however, make the long-term budget problem substantially worse and consume resources that could play a constructive role in Social Security and Medicare reform.

The projected cost of the Administration=s tax cuts over 75 years amounts to between 2.3 and 2.7 percent of GDP, depending on the degree to which the Administration proposes relief from the individual Alternative Minimum Tax. Even the 75-year cost at the bottom of the range is more than three times the size of the long-term deficit in Social Security. The tax cuts also are about one-third to one-half larger than the *combined* projected actuarial deficits in Social Security and the Medicare Hospital Insurance program over the next 75 years. Policymakers concerned about the long-term fiscal health of the nation would do well to consider the very large long-term cost of the Administration=s tax cuts.

[13] Leonard E. Burman, William G. Gale, and Peter R. Orszag, AThe Administration=s New Tax-Free Saving Proposals: A Preliminary Analysis,@ *Tax Notes*, March 3, 2003. If the Administration=s dividend proposal is enacted, the cost of the savings account proposal would be about 10 percent less than estimated by Burman, Gale, and Orszag because some of the private savings sheltered under the Asavings@ proposal would already be tax free under the dividend proposal. Incorporating this interaction still produces a revenue estimate of 0.29 percent of GDP (the revenue loss from the savings proposal in the absence of the dividend proposal is approximately 0.32 percent of GDP, assuming that EGTRRA is extended past 2010).

[14] We reduce the estimate to 0.2 percent of GDP to be conservative and to reflect the effect of the revenue losses before 2013.