CENTER ON BUDGET AND POLICY PRIORITIES

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Opening Statement by William Gale,
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At a Teleconference Held by the Center on Budget and Policy Priorities
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Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts, <http://www.cbpp.org/4-14-04tax-sum.htm>

Tax Returns[*] is a useful, comprehensive summary of the Administration's tax agenda that also contains a significant amount of new material. I just want to add three points to this discussion.

First, the Administration's tax agenda has two positive aspects, both of which have been squandered by other policy decisions that were made.

One of these positive aspects is the timing of the tax cuts: they were ideally timed to help the economy during the downturn. However, for a number of reasons the structure of the tax cuts was simply not oriented to provide short-term stimulus. Not only did most of the tax cuts go to high-income households, which are less likely to spend any extra money they receive than low-income households are, but the 2001 tax cut phased in slowly over time. Recent studies by Matt Shapiro at the University of Michigan show that a delayed tax cut can be worse than no tax cut at all in the short run, because it gives people an incentive to put off more-productive behavior.

In addition, a number of the tax cuts, like the 2002 "bonus depreciation" provision, were officially temporary but obviously were intended to become permanent. (Surveys suggest that business executives thought they would be made permanent.) Because of that, these tax cuts are less likely to have an impact in the short run, since businesses that expect the tax cuts to be made permanent will feel no urgency to invest before they expire.

The last reason the tax cuts were not well structured to provide short-term stimulus was simply their magnitude. To the extent that the size of the cuts spooks financial markets or causes interest rates to rise, it's going to hurt investment in interest-sensitive sectors, like durable goods.

So although the timing of the tax cuts was good, their structure trumps their timing. All in all, I think it's hard to argue that these were well thought out, given the short-term problems the economy faced.

The other positive aspect of the Administration's tax agenda is that some of the tax cuts reduced marginal tax rates. That obviously is a good thing to do from an efficiency perspective: all other things being equal, everyone (broadly speaking) is in favor of cutting marginal rates. The key, though, is whether all other things are equal. If you cut marginal tax rates and finance it with increased budget deficits, almost all of the studies that have been done — including all the ones

[*] Isaac Shapiro and Joel Friedman, *Tax Returns: A Comprehensive Assessment of the Bush Administration's Record on Cutting Taxes*, Center on Budget and Policy Priorities, April 2004.

by CBO and the Joint Tax Committee and the ones that I and other people have done — suggest that you don't raise economic growth. That's because the negative effects of bigger deficits and lower national saving outweigh the positive effects of lower marginal tax rates, so the overall effect on growth is negative in the long term.

On the other hand, if you finance marginal tax rate cuts by broadening the tax base or with well-designed spending cuts, you can get an increase in growth. But I think it's fair to say that we're not seeing any base broadening, and we're certainly not seeing spending cuts, much less well-designed spending cuts. So once again, a positive element of the Administration's tax agenda is trumped, in this case by the fact that the tax cuts weren't financed in a way that produces economic growth.

That's my first broad point: that there are positive aspects to the tax cuts that essentially were squandered. My second broad point concerns what is likely to happen down the road. The key question is whether the tax cuts will be made permanent, and that question immediately brings two other issues to the fore: how to pay for them, and what to do about the Alternative Minimum Tax.

On the issue of paying for the tax cuts, a temporary tax cut might be deficit financed to give the economy a short-run boost, but if you're talking about a permanent tax cut on the order of 2 percent of GDP, you simply have to pay for it, either with other tax increases or with spending cuts. Thus far, the Administration has said nothing about how it would pay for the tax cuts.

As for the Alternative Minimum Tax, by 2009 the AMT will be taking back about a quarter of the tax cuts that have been passed the last few years, and about half of the tax cuts for people in the $100,000-$200,000 range. By 2014, the AMT will be taking back 40 percent of the tax cuts and about three-quarters of the tax cuts for people in the $100,000-$200,000 range.

So no permanent tax-cut proposal should even be on the table unless we have a way to pay for it and a way to fix the AMT.

In a paper that Peter Orszag and I published about a month ago, we showed what kind of spending cuts it would take to pay for making the tax cuts permanent and fixing the AMT. If you exclude interest payments on the national debt and spending for Social Security, Medicare, Medicaid, defense, and homeland security, you would have to cut all other government spending by *more than half* in 2014 to pay for the tax cuts and AMT reform in that year. We're talking about monumental cuts that, as far as I know, no one on either side of the aisle has supported.

Alternatively, you could raise taxes, but you'd need a 34 percent increase in payroll tax revenues or a more than 100 percent increase in corporate tax revenues to cover those costs.

So it's hard — in fact, it's impossible — to talk about the effects of permanent tax cuts without talking about how to pay for those tax cuts and how to fix the AMT. Every time the President says, "We should make my tax cuts permanent," the first response should be, "How are we going to pay for this and how are we going to fix the AMT in the process?"

The last broad point I want to make has to do with the Administration's behavior. *Tax Returns* is very good at laying out a variety of misleading claims that the Administration has made and at setting the record straight. I want to focus on two aspects.

One of these is budget gimmickry. The 2001 tax cut, with its gigantic expiring provisions, fundamentally changed the way budgets are used in the United States. The 2003 tax cut, although it didn't involve quite as much money, was even more egregious in having different elements expire at different points in time so that the tax cut could be fitted within the budget constraints.

As a result, the 2003 tax cuts would cost two to three times as much as their official cost if they are extended through the decade.

This year I think we've set another record for budget gimmickry with the new budget rules the Administration has proposed, under which the official cost of making the tax cuts permanent would be zero.

The other aspect is what I call "no analysis." It's important to realize that the President has been pushing these tax cuts since 1999, when he was a presidential candidate and was trying to fight off an attack by Steve Forbes from the right. Since then, he's used his tax cuts as the answer to Steve Forbes, the answer to a booming economy with a booming stock market, the answer to a recession with a falling stock market, the answer to a terrorist attack, the answer to high energy prices — you name it, the tax cut is the solution. And yet astonishingly, as far as I know the Administration has never conducted an analysis of the long-term effects of the tax cuts.

That's really remarkable, given that tax cuts have been the centerpiece of the Administration's domestic agenda for the whole first term. In fact, the Administration has put out almost as much analysis of the Kerry economic plan as of its own plan. And I think it's time to call them on the carpet and get them to say what they think would actually happen if we made the tax cuts permanent.