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NEW TAX CUT LAW USES GIMMICKS TO MASK COSTS; ULTIMATE PRICE TAG LIKELY TO BE $800 BILLION TO $1 TRILLION

Final Bill Both More Costly and More Regressive than Administration Plan

By Robert Greenstein, Richard Kogan, and Joel Friedman

The tax-cut package the President signed into law May 28 carries an "official" cost of $350 billion through 2013, but does so only through the massive use of budget gimmicks. Every provision in the bill but one expires between the end of 2004 and the end of 2008, and most or all of these provisions are nearly certain to be extended. If the provisions are extended, the cost of the legislation through 2013 will be $807 billion to $1.06 trillion.[1]

In addition, the bill is heavily tilted toward the upper end of the income scale, with households that make over $1 million a year receiving an average tax cut or $93,500 in 2003, while households in the middle of the income spectrum receive an average tax cut of $217. Some 36 percent of households will receive no tax cut at all; 53 percent will receive $100 or less. Because the bill provides the preponderance of its tax cuts to higher-income tax filers, a group more likely to save rather than spend its tax benefits than middle- or low-income households, the bill also is likely to be highly inefficient in boosting the economy in the near term.

The Budgetary Impact

The White House and the Congressional Republican leadership have indicated they intend to come back in subsequent years and seek to extend most of the provisions in the legislation that are slated to expire.

- If the bill's provisions (except the one providing relief from the Alternative Minimum Tax) did not expire prematurely, the cost through 2013 would be $807 billion to $1.06 trillion before counting interest costs, depending on how one measures the cost of extending the bill's business depreciation tax cut. The legislation's ultimate cost thus is likely to surpass the $726 billion cost of the Administration's plan.[2] (If, contrary to expectations, the depreciation provision is

[1] Estimates of the cost of extending the expiring tax provisions contained in this legislation were prepared by the staff of the Center on Budget and Policy Priorities, based on estimates from the Joint Committee on Taxation and the Congressional Budget Office. As explained in the Appendix, removing the expirations contained in the new tax-cut law would not itself make various provisions of the law permanent; many provisions of the new law are accelerations of provisions enacted in 2001, and the provisions of the 2001 tax law are scheduled to expire at the end of 2010. Extending beyond 2010 those provisions of the new tax law that accelerate tax cuts enacted in 2001 would add *an additional $440 billion* in cost in the years 2011 through 2013. This $440 billion in cost, which the President proposed in his fiscal year 2004 budget, would be in addition to the cost estimate discussed here of $807 billion to $1.06 trillion for the new tax-cut law.

[2] The reason the ultimate cost of the new law is likely to be greater than the cost of the Administration's package is that the new law contains a business tax cut that was not part of the Administration's plan (the "bonus depreciation"

not extended, the ultimate cost will be $671 billion.[3] See page 6 for a discussion of costs related to the depreciation provision. See the appendix for further details on the cost estimates.)

House Speaker Dennis Hastert apparently agrees with an estimate of this size. The Speaker stated on May 22: "The $350 [billion] number takes us through the next two years, basically. But also it could end up being a trillion-dollar bill, because this stuff is extendable."[4]

- Because the legislation will increase deficits and thereby add to the national debt, it also will result in increases in interest payments on the debt. Assuming the bill's provisions are extended, the bill will result in an additional $300 billion to $400 billion in interest payments on the debt through 2013, bringing the bill's total cost to between $1.1 trillion and $1.5 trillion over the coming decade.

- In combination with the 2001 tax cut, the legislation puts the nation on a path of very low revenue collection levels. Based on the latest Congressional Budget Office projections and the Joint Tax Committee's estimates of the cost of the legislation, revenues will fall this year to between 16.4 percent and 16.7 percent of the Gross Domestic Product — *the lowest level, as a share of the economy, since 1959*. Individual and corporate *income* tax collections this year will be at their lowest level, as a share of the economy, since 1943.

Effects on Households at Different Income Levels

The Urban Institute-Brookings Institution Tax Policy Center has produced a detailed analysis of the legislation's impact on different categories of tax filers. That analysis shows:

- The new law will provide an average tax cut in 2003 of $93,500 to tax filers who make more than $1 million per year. This exceeds the $89,500 average tax cut these individuals would have received under the Administration's tax-cut package.

- Some 50 million households — 36 percent of all households in the United States — will receive no tax cut whatsoever in 2003. Some 74 million households — 53 percent of all households — will receive a tax cut of $100 or less. (This includes the households that will receive no tax cut.)

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provision) and expands another business tax cut (the business expensing measure) beyond what the Administration had proposed.

[3] The depreciation provision is the one provision that the White House and/or Republican Congressional leaders have not already indicated they favor extending. Nevertheless, major efforts to extend the depreciation tax break are expected in 2004, and the design of the final legislation — under which the depreciation provision expires at the same time as all of the bill's middle-class tax cuts, which almost certainly will be extended — heightens the chances that the depreciation provision will be extended as part of a larger, "must-pass" tax-cut extension bill in 2004.

[4] Mark Wegner and Richard E. Cohen, "Hastert Salutes 'Trillion-Dollar' Tax Bill, Looks to Medicare Debate," *Congress Daily AM*, May 23, 2003.

BROOKINGS ECONOMISTS FIND MAGNITUDE OF GIMMICKS REPRESENTS SHARP DEPARTURE FROM THE PAST

The new law squeezes a large array of tax cuts into a $350 billion package by "sunsetting" most of the tax cuts (i.e., scheduling them to expire) after a few years. The 2001 tax cut, as well, made extensive use of sunsets for the same purpose.

Since sunsets are not new to the tax code, this raises a question: is the aggressive use of sunsets in this year's legislation and in the 2001 tax act a new and dangerous development from the standpoint of fiscal integrity and responsibility, or is it a time-honored practice, even if it represents a dubious way for Congress to do business?

In a new analysis, Brookings Institution economists William Gale and Peter Orszag answer this question.[a] They find that while sunsets have long been part of the tax code, such measures traditionally have involved only relatively minor tax provisions with small costs. The degree to which sunsets are now being used for provisions with large costs represents a sharp departure from the past.

For each year going back to 1996, Gale and Orszag use Congressional Budget Office data to estimate the cost in the tenth year that would result from extending all of the tax provisions slated to expire over the coming decade. They find:

- At no time from 1996 to January 2001 would the cost of extending all of the expiring tax provisions have amounted to more than $22 billion in the tenth year. As a percentage of the Gross Domestic Product, the highest level that the cost in the tenth year reached was 0.14 percent of GDP.
- In dramatic contrast, with enactment of the new legislation, the cost of extending all tax provisions that are now scheduled to expire over the decade ahead is $430 billion in the tenth year (i.e., in fiscal year 2013), or 2.4 percent of GDP.
- To gain a sense of the magnitude of 2.4 percent of GDP, it is triple the size of the Social Security shortfall over the next 75 years, as projected by the Social Security Trustees. The Trustees place the size of the Social Security shortfall at 0.73 percent of GDP over the 75-year period.

Gale and Orszag also find that the cost over the next ten years of extending all of the tax provisions that now have sunsets, including those in the new law, is nearly $2 trillion. They note that this "is roughly as large as the official costs of the 2001, 2002, and 2003 tax cuts combined."

[a] William G. Gale and Peter R. Orszag, "Sunsets in the Tax Code," The Brookings Institution, May 23, 2003, (forthcoming in *Tax Notes)*.

Among the households that will not receive any tax cut are millions of filers who do pay income tax. Single filers in the current 10-percent bracket who do not claim children will receive no tax reduction from the legislation unless they have dividend or capital gains income.

- The average tax cut in 2003 for households in the middle of the income spectrum (i.e., the middle fifth of households) will be $217. The average tax cut for the bottom fifth of households will be $1.

In addition, the bill's capital gains and dividend provisions are likely to lead to increased use of tax shelters by wealthy taxpayers and corporations. (See page 5.) In a move that will exacerbate this problem, the final legislation dropped all of the provisions the Senate bill had approved to curb corporate tax shelter abuses.

Compared to Senate Bill, Final Bill Features More Lavish Benefits for High-income Families and Stingier Benefits for Lower-income Working Families

The tax-cut provisions in the final bill are much closer to the House bill than the Senate bill. The final legislation contains both the House capital gains/dividend proposal and the House business depreciation provision (in both cases, with earlier expiration dates than in the House bill). Neither of these provisions was present in the Senate bill. The final bill also artificially sunsets all of the broad, middle-class tax cuts in the package after 2004, terminating at that time the increase to $1,000 in the child tax credit, the bill's tax breaks for married filers, and the widening of the 10 percent tax bracket. The Senate bill did not artificially sunset the child credit or the 10-percent bracket provisions.

Overall, the final bill manages to provide both more lavish benefits for very wealthy filers and more penurious benefits for low-income working families than the Senate plan. It provides larger benefits for the very affluent because capital gains income is even more concentrated at the top of the income scale than dividend income is.

The plan is less favorable for low-income working families than the Senate plan because it *drops* a Senate provision to accelerate a component of the child tax credit enacted in 2001 that is targeted on working families with children that have incomes in the $10,000 to $30,000 range.

- Tax Policy Center analyses show that 18 percent of married and head-of-household filers with children would have received no tax cut in 2003 under the Senate-passed bill, but 29 percent of such filers will receive no tax cut under the final bill.
- For example, married filers that have two children and incomes between $10,500 and $21,325 will receive no tax cut under the final bill. All such households would have received a tax cut under the Senate bill as a result of the Senate provision accelerating that part of the child tax credit that is targeted on lower-income working families.
- The jettisoned Senate provision would have benefited 11.9 million low-income children and their families — one of every six children in the nation.[5]

The final agreement is, in fact, tilted against lower-income working families with children. The final legislation accelerates all of the child tax credit and marriage penalty relief provisions of the 2001 tax-cut legislation that benefit *middle- and upper-income families*, while failing to accelerate either of the child tax credit and marriage penalty relief provisions enacted in 2001 that are targeted on *low- and moderate-income working families*. The consequence is that low-income working families — the very group most likely to spend rather than save any tax-cut dollars they receive — are largely left out of the legislation.

[5] These figures are Center on Budget and Policy Priorities calculations based on Citizens for Tax Justice data.

HOW SKEWED IS THE LEGISLATION TO THE TOP?

Analysts generally regard the degree to which a tax cut increases the after-tax income of different groups of tax filers as probably the best measure of the tax cut's impact on households in different income categories. The Tax Policy Center's analysis of the legislation's impact on after-tax income provides further evidence of the degree to which the legislation tilts toward those in the upper parts of the income scale.

- In 2003, the after-tax income of the middle fifth of households will rise by an average of 0.8 percent as a result of the legislation. After-tax income will rise just 0.3 percent for the next-to-the-bottom fifth of households and will not increase by any discernible amount for the bottom fifth.
- By contrast, after-tax income will increase by 3.6 percent for the top one percent of households, more than four times as much as for the middle fifth.
- After-tax income will rise by 4.4 percent for those with incomes of more than $1 million.

These figures are for 2003. The distribution of the tax cuts that the new legislation provides ultimately will become even more skewed toward high-income households. The primary provisions that will benefit middle-income households are simply accelerations of provisions enacted in 2001 that were scheduled eventually to take effect anyway. The legislation's principal *new* tax cut — the reduction in capital gains and dividend taxes — provides tax-cut benefits heavily concentrated on the upper end of the income scale. Tax Policy Center data show that 48 percent of capital gains income and 15 percent of dividend income go to households with incomes of over $1 million.

The final bill does include a Senate provision providing $20 billion in fiscal relief to state governments over the next two years. A number of states will lose some state revenue, however, as a result of the legislation's depreciation and small business expensing provisions (due to linkages between federal and state tax codes). If those provisions are extended and remain in effect through 2013, states will lose an estimated $15 billion over the decade as a result of these provisions.[6]

Bill Likely to Lead to More Tax Sheltering

Another concern about the final legislation is that it would likely encourage additional tax sheltering activity. A recent Tax Policy Center analysis of the House-passed tax cut for dividends and capital gains, which is essentially identical to the proposal in the final bill through 2007, found it could "invite a wave of tax shelters for corporations and individuals."[7] The Tax Policy Center analysis explains that under current law, nearly all individual tax shelters take advantage of the differential between regular income tax rates and the lower capital gains tax rate. These shelters avoid tax by converting income normally taxed at the regular individual income rates into income that can be taxed at the lower capital gains rate. By further reducing

[6] These estimates take into account that a number of states have decoupled their tax codes from the federal tax treatment of depreciation. For states that have *not* decoupled, the revenue losses in 2004 from these provisions will wipe out roughly one-third to two-thirds of the fiscal relief these states will receive.

[7] Leonard Burman, William Gale, and Peter Orszag, "Thinking Through the Tax Options," Tax Policy Center, May 13, 2003.

the top capital gains rate from 20 percent to 15 percent, the legislation will widen this differential, exacerbate this problem, and "likely fuel the growth of individual tax shelters."

These concerns also apply when dividends are taxed at sharply lower rates than ordinary income, as they would be under the final legislation. *Wall Street Journal* news analyst David Wessel explained in a May 22 column, "The capacity of companies and rich investors to exploit, and sometimes create, tax loopholes appears almost unbounded. Taxing one kind of income a lot more than another creates incentives for tax games. Eliminating or sharply reducing the tax on dividends, without making sure that companies pay taxes, can offer all sorts of opportunities to the tax-averse."[8]

For instance, the Tax Policy Center finds that lowering the top dividend tax rate to 15 percent will likely create new incentives for investors to funnel income through corporations as a way to reduce their taxes. Investors will be able to arrange for such income to avoid corporate taxes through the use of existing corporate tax shelters and loopholes. Under the law as it stood until now, when corporate earnings sheltered from the corporate tax income were distributed to investors as dividends, they were subject to taxation at the full individual tax rates. By contrast, under the new law, these dividends will face only a 15 percent tax rate, or less than half the top individual rate. That should make these tax-avoidance schemes considerably more attractive. Michael Graetz, a tax expert at the Yale Law School and former Deputy Assistant Secretary for Tax Policy at the Treasury in the first Bush Administration, was quoted in the *Wall Street Journal* on May 22 as warning that "to the extent that you can pay tax-free dividends out of profits that have never been taxed, then it's 'Katy, bar the door' on tax shelters."[9]

The new law can be easily exploited for tax-sheltering activity in part because it *excludes* provisions included in the Administration plan and the Senate bill that were intended to thwart such tax-avoiding behavior. The Administration's proposal would have allowed special tax treatment for dividends paid to shareholders only to the extent that the dividends were paid out of corporate earnings that had already been subject to corporate tax. Such a requirement is missing from the final legislation. (Leonard Burman, a Senior Fellow at the Urban Institute and co-director of the Urban Institute-Brookings Tax Policy Center, has noted that about one-third of current dividends are paid out of corporate profits that are never taxed.) Similarly, the Senate bill included several provisions designed to clamp down on abusive tax-shelter activities, but all of those measures were dropped in conference. As a result, creative tax lawyers and accountants will find little difficulty dreaming up, in the words of the *Wall Street Journal's* David Wessel, "clever ways to use the new law to help wealthy clients avoid taxes."

Estimating the Cost of the Depreciation Provision

The March 2002 stimulus legislation established a temporary provision (known as "bonus depreciation") under which, until September 2004, businesses can immediately deduct 30 percent of the cost of new investments they make in equipment and facilities. The final legislation both increases this deduction to 50 percent of the cost of new investments and extends

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[8] *Ibid.*

[9] David Wessel, "Dividend-Tax Cut Runs Risk of Opening Doors to New Shelters," *Wall Street Journal*, May 22, 2003.

the provision through the end of 2004. Under the legislation, this provision will expire on the same day as the increase in the Child Tax Credit to $1,000, the widening of the 10-percent tax bracket, the legislation's tax reductions for married filers, and the provision shielding many middle-income filers from the Alternative Minimum Tax. Having the depreciation provision expire at the same time as these other provisions sets the stage for the depreciation provision, which enjoys strong corporate support, to be included in 2004 in a package extending these other, virtually-certain-to-be-renewed provisions.

If the depreciation provision is extended and does not expire, its cost will be approximately $400 billion through 2013. This is much greater than the "official" cost of $9 billion for the provision. Only a small cost is shown for this provision in the official cost estimates, because if the provision really were allowed to expire at the end of 2004, most of the tax breaks it would provide through the end of 2004 would simply represent an acceleration of tax deductions that firms otherwise would have taken in subsequent years. This provision is relatively inexpensive if it truly is temporary, but very costly if it is extended when it is scheduled to expire and never allowed to terminate.

The $400 billion cost cited above is the cost of extending the 50-percent bonus depreciation provision through 2013, as compared to its cost under the law as it stood prior to enactment of the new legislation. Under the prior law, the 30-percent bonus depreciation was scheduled to end in September 2004. It is quite possible, of course, that the existing 30-percent depreciation provision might have been extended even if Congress had not included the expanded depreciation provision in the new law. As a result, the added cost that is likely to result in the depreciation area from the new law could be seen as being the *difference* between the cost of extending the prior 30-percent depreciation provision through 2013 and the cost of extending the new 50-percent depreciation provision. The Congressional Budget Office has estimated that the cost of extending the 30-percent depreciation provision would have been about $255 billion through 2013. If one assumes that $255 billion of the $400 billion in cost from extending the depreciation provision of the new law would have occurred even without the new law, then the likely added cost through 2013 resulting from the new law as a whole amounts to $807 billion, rather than $1.06 trillion.

This lower figure of $807 billion still exceeds the $726 billion cost of the Bush plan. Moreover, there is a reasonable case for using the approach that assigns a cost of approximately $400 billion to extending the depreciation provision of the new law and thus an ultimate cost of $1.06 trillion to the new law as a whole. By extending the depreciation provision through December 31, 2004 *and sunsetting the child tax credit, 10-percent bracket, and marriage penalty relief provisions on the same day*, the new law makes it more likely that the depreciation provision will be extended. This arrangement sets up the depreciation provisions to be included in a larger package of tax-cut extensions, with that package now virtually assured of enactment in 2004. If, on the other hand, the depreciation provision simply dies at the end of 2004 and is not extended in any form — which seems unlikely, especially given the intensive corporate lobbying efforts to extend it that are widely anticipated — the ultimate cost of the new law through 2013 would be $671 billion.

Appendix

THE COST OF THE FINAL BILL

The "official" cost of the legislation is $350 billion through 2013, less than half the $726 billion cost of the Administration's package.

Yet the legislation does not really reduce the cost of the Administration's package to $350 billion; it likely *increases* the cost. Seven of the eight tax cuts in the legislation include expirations dates, or "sunsets," in 2004, 2005, or 2008. If these tax cuts really were allowed to expire, tax rates would increase or tax credits or deductions would shrink after these sunset dates. That is unlikely to occur. The President and Republican Congressional leaders intend to make most or all of these expiring provisions permanent tax policy. It is better, therefore, to view the legislation as one whose provisions will not be allowed to expire as scheduled. We estimate that if the provisions of the new law (except for relief from the Alternative Minimum Tax) are extended when the new law slates them for expiration, the legislation will cost $807 billion to $1.06 trillion, as shown below. If the bonus depreciation provision *is* allowed to expire after 2004, which seems unlikely, the cost of the legislation ultimately would total $671 billion through 2013.

Table 1

Comparison of the Cost of Tax-Cut Packages

2003-2013 totals in billions of dollars; Congressional expiration dates in ***[brackets]***

	Bush package	New law	New law if tax cuts are extended
Top-bracket rate reductions	74	74	74
Child tax credit ***[expires 2004]***	90	32	90
10% bracket ***[expires 2004]***	45	12	45
Tax breaks for married couples ***[expires 2004]***	55	35	55
Dividends and capital gains ***[expires 2008]***	396	148	*325*
Expand §179 business expensing ***[expires 2005]***	29	1	*35*
Increase AMT exemption ***[expires 2004]***	37	18	18
Expand bonus depreciation ***[expires 2004]***	n.a.	9	*145-400*
State fiscal relief	n.a.	20	20
TOTAL	726	350	*807-1,062*

Source: Joint Committee on Taxation, except for estimates in italics, which are derived by the Center on Budget and Policy Priorities. Columns may not add because of rounding. See the text for a discussion of issues related to the estimates for the bonus depreciation provision. Note that this table treats both the Bush and the Congressional AMT provisions as temporary, for comparability.

This analysis focuses on the expiration dates contained in the new tax-cut legislation. It should be noted that the 2001 tax cut itself expires in its entirety at the end of 2010. Our cost estimate of $807 billion to $1.06 trillion does *not* include the cost of extending the tax rate reductions, the increase to $1,000 in the child tax credit, the widening of the 10 percent bracket, or the married-couple tax reductions of the new law beyond 2010; we did not include those costs because the 2010 sunsets were already in statute and are not part of the newly-enacted legislation. Extending these four tax-cut provisions for the years 2011 through 2013 would cost an additional $440 billion, according to the Joint Committee on Taxation.

The President has proposed such extensions and included the $440 billion in costs (as well as the cost of various other tax cuts) in his fiscal year 2004 budget. In that budget, he displayed the $440 billion in costs (and the cost of various other tax cuts) separately from his $726 billion "growth" package. For comparability purposes, this analysis does not include this $440 billion in cost in assessing the budgetary impact of the tax legislation just enacted.

Nevertheless, the intention of the Administration and the Congressional Leadership to extend the $1,000 child tax credit, the 10-percent bracket, and the tax breaks for married couples applies not just to the sunsets for these provisions written into the new legislation, but also to the 2010 sunset that was enacted as part of the 2001 tax cut. Likewise, the Administration and the Congressional Leadership intend to make the rate reductions permanent rather than let them expire after 2010.

As a result, the *full* revenue loss through 2013 from the tax policies that the Administration proposed for the tax provisions listed in Table 1 is $440 billion greater than the $726 billion cost of the Administration's "growth" package, bringing the total cost to $1.166 trillion. Similarly, the cost of the measures included in the new tax-cut law will be $440 billion greater if the tax-cut measures that the new law accelerates are extended beyond 2010. If this $440 billion in costs is taken into account, the cost of the new legislation, with its provisions extended at least through 2013, rises to $1.247 trillion or $1.502 trillion (as compared with the $807 billion or $1.062 trillion cost discussed in this analysis). In addition, when increased interest payments on the debt are included, the cost of the new legislation, if all of the tax cuts in it are made permanent or extended at least through 2013, totals $1.6 trillion or $1.9 trillion through 2013.

Table 2

Comparison of the Cost of Tax-Cut Packages without 2010 Sunsets

2003-2013 totals in billions of dollars

	Bush proposals	New law	New law if tax cuts are permanent
10% and top-bracket rate reductions	470	86	470
Child tax credit	157	32	157
Tax breaks for married couples	78	35	78
Dividends and capital gains	396	148	*325*
Expand §179 business expensing	29	1	*35*
Increase AMT exemption	37	18	18
Expand bonus depreciation	n.a.	9	*145-400*
State fiscal relief	n.a.	20	20
TOTAL	1,166	350	*1,247-1,502*

Source: Joint Committee on Taxation, except for estimates in italics, which are derived by the Center on Budget and Policy Priorities. Columns may not add because of rounding. JCT documents do not separate the post-2010 cost of extending the upper-bracket rate reductions from the cost of extending the 10% bracket. See the text for a discussion of issues related to the estimates for the bonus depreciation provision. Note that for comparability purposes, this table treats both the AMT provisions in the original Administration package and those in the newly enacted law as temporary.