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HOUSE TO CONSIDER ADDITIONAL TAX CUTS WITHOUT OFFSETS

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The House of Representatives continues to press ahead with more tax cuts, despite clear signs that the enacted $1.35 trillion package of tax cuts (P.L. 107-16) is already straining the budget. The House is scheduled to consider energy legislation this week that includes tax breaks totaling nearly $34 billion over the next ten years. The bill, combined with other measures the House has recently passed — such as tax incentives for charitable giving and reductions in fees for the Securities and Exchange Commission — would raise to $61 billion the amount of revenue losses between 2002 and 2011 that the House has adopted beyond the $1.35 trillion package. This $61 billion total exceeds amounts set aside in the Congressional budget plan for additional tax cuts by $41 billion. Proposals to offset these additional tax cuts have so far been rejected in both the House Ways and Means Committee and on the House floor.

- Following enactment of the $1.35 trillion tax-cut package, a key question is whether any resources are available over the next ten years to pay for more tax cuts beyond those called for in the Congressional budget plan without dipping into the Medicare Hospital Insurance and possibly the Social Security trust fund surpluses.

- The recent focus on the longer-term budget outlook and the financing of Social Security and Medicare has also highlighted the need to ask whether these additional tax cuts are affordable beyond the ten-year budget window.

The longer-term view is particularly relevant, given that the full impact of the enacted $1.35 trillion tax-cut package will not be felt until the years beyond 2011. In a previous analysis, for instance, the Center estimated that the cost of the new tax-cut law will soar to $4.1 trillion in the decade after 2011, assuming the tax cut is extended.[1] It is during this period that the baby boom generation begins to retire and Social Security and Medicare costs mount. Enacting more tax cuts now and pushing costs in the second ten years above the $4.1 trillion level, as the House seems inclined to do, will only compound the long-term fiscal challenges that the retiring baby boomers pose for Social Security and Medicare.

When the impact of the enacted tax cuts is combined with the program initiatives in the Congressional budget resolution — such as to provide a Medicare prescription drug benefit,

[1] Joel Friedman, Richard Kogan, and Robert Greenstein, "New Tax-Cut Law Ultimately Costs as Much as Bush Plan: Gimmicks Used to Camouflage $4.1 Trillion Cost in Second Decade," *Center on Budget and Policy Priorities*, revised June 27, 2001.

increase payments to agricultural producers, and improve access to health insurance — the surplus outside the Social Security and Medicare Hospital Insurance trust funds appears to be about $500 billion through 2011. Some supporters of more tax cuts have cited this $500 billion figure as evidence that more tax cuts can be accommodated. But this $500 billion surplus does not really exist.

The $500 billion figure is a function of highly unrealistic assumptions that ignore costs virtually certain to be incurred. For instance, the $500 billion surplus assumes that no action will be taken to extend a variety of tax provisions that will sunset over the next decade. There is, of course, the artificial sunset in the $1.35 trillion package, whereby all the tax cuts expire at the end of 2010; but assuming the wholesale expiration of these tax cuts is not credible. In addition, a number of popular tax credits — including the research and experimentation credit — are scheduled to expire over the next few years. Congress has always extended these credits on a bipartisan basis in the past and is virtually certain to continue doing so; yet the $500 billion surplus excludes these costs. Nor does the $500 billion figure take into account the cost of addressing the problems associated with the Alternative Minimum Tax, which were compounded by the enacted tax-cut package. It is inconceivable that Congress would allow the number of taxpayers affected by the AMT to explode to more than 35 million — 25 times the number affected this year — as would occur if no action were taken.

The $500 billion surplus figure also understates future program expenditures. It does not, for instance, include the additional funds the Administration has already requested for defense — $18 billion in 2002 — and that it will likely request in future years (which would exceed $200 billion over the decade if the initial request simply grows with inflation). It also assumes a level of appropriations for non-defense programs that is $45 billion below the levels needed to keep pace with inflation. Past experience and the current bipartisan interest in boosting funding for education, health research, and other areas strongly suggest that this low spending level is unrealistic and unattainable.

Finally, the $500 billion surplus figure does not reflect the impact of the recent slowdown in the economy. The Congressional Budget Office is expected to release revised budget estimates in late August that take into account these recent changes in the economy. News reports indicate that the updated projections are likely to show smaller surpluses than CBO had previously assumed.

Even if only a few of these factors are taken into account, there is *no* additional surplus outside the Social Security and Medicare HI trust funds that can be used to fund new tax cuts. The additional cost of extending those popular tax credits scheduled to expire in the next few years would, by itself, eliminate the surplus entirely in 2003 through 2006. There appears to be a growing bipartisan recognition of these realities; recent Democratic and Republican analyses alike have shown that the combined effect of the enacted tax cuts, the spending assumed in the budget resolution, and the slowdown in the economy will sharply reduce or eliminate the available surplus in coming years (see box).

Bipartisan Acknowledgment of Budget Constraint

There appears to be a growing bipartisan consensus that there is no surplus outside the Social Security and Medicare Hospital Insurance (Part A) trust funds that can be used to pay for tax cuts or program increases beyond those assumed in the Congressional budget resolution. The Chairman of the Senate Budget Committee, Senator Kent Conrad, and the ranking member of the House Budget Committee, Rep. John Spratt, have both produced detailed analyses to this effect. It now appears that Republicans may broadly concur with such analyses.

In a July 27 article, the *BNA Daily Tax Report* quoted an "internal GOP memo" analyzing the surplus in the aftermath of the tax cut. According to BNA, the Republican memo stated: "We are possibly already into [the] Medicare [Part A] trust fund this year and every year through FY05. We also are very close to touching the Social Security surplus in FY03." Like the Democratic analyses, the Republican memo looked at the surpluses following enactment of the $1.35 trillion tax cut and assuming the spending levels in the Congressional budget resolution, which include a prescription drug benefit, assistance for farmers, and other initiatives. It then incorporated "educated guesses" about the fiscal impact of updated economic assumptions that the Congressional Budget Office is expected to release in the latter half of August. The GOP memo, according to the BNA article, concludes that "the result of this exercise is not pretty."

More specifically, the BNA reports the GOP memo found that, in 2002, the enacted tax cut along with the spending assumed in the budget resolution and the revised economic assumptions entirely eliminates the surplus outside the Social Security and Medicare HI trust funds. The budget outlook is even more constrained in subsequent years, when the GOP memo predicts that the surplus in the Medicare HI trust fund will be used to finance non-trust fund activities. This would be in violation of the Congressional budget resolution, which specified that surpluses in the Social Security and Medicare HI trust funds could only be used for those programs. The GOP memo predicts that $40.8 billion of the Medicare HI surplus will be used in 2003, $34.7 billion in 2004, and $26.8 billion in 2005. The Republican analysis reportedly points out that these projections would worsen if Congress were to adopt the President's request for an additional $18 billion for defense programs.

Congress has repeatedly expressed its intention to "wall off" the Social Security and Medicare surpluses so they cannot be used for purposes other than debt reduction. At this point, depending on the forthcoming CBO estimates, it may be impossible to avoid dipping into these trust fund surpluses and using them to cover current expenses.

Accordingly, any new tax cuts should, at the very least, be paid for by scaling back provisions of the new tax-cut law or providing offsetting revenues in other ways, such as closing unproductive tax loopholes. Yet, so far, the House has chosen to reject this approach, choosing instead to enact further tax cuts that can only increase the chances of dipping into the Social Security and Medicare surpluses.

The Cost of Tax Cuts to Date and the Congressional Budget Plan

The Congressional budget plan set aside $1.369 trillion over 11 years for tax cuts (not counting the nearly $400 billion of interest costs that will result because the tax cut soaks up funds that would otherwise have been used for debt reduction). Congress envisioned that $1.350 trillion of this amount would be used to accommodate the reductions in the income and estate taxes that President Bush requested. The remaining $19 billion was for other tax-cut measures.[2] In its final form, the tax-cut package cost $1.349 trillion, or $1 billion less than allocated, leaving $20 billion for all additional revenue-reducing measures.

The fact that the tax-cut law fit within the budget plan is deceptive, however. The only way lawmakers succeeded in fitting all the law's tax cuts within the plan's limits was by requiring that all of the provisions expire on December 31, 2010. In fact, the cost of the tax cuts in 2002 through 2010 is greater than the budget plan assumes. If policymakers prevent even a portion of the tax cuts from expiring as scheduled, the ultimate cost of the bill will exceed the amount set aside in the budget plan.

Even in the extremely unlikely event that all the provisions do expire as scheduled, the remaining $20 billion in the budget plan is insufficient to cover all the current tax-cut initiatives Congress is considering. The House has already passed two measures that total $27.3 billion over ten years, and is about to consider another measure that would result in a ten-year revenue loss of $33.5 billion. As shown in Table 1, these measures combined total $61 billion over ten years and exceed the allocation for tax cuts in the budget resolution by $41 billion.

- **SEC fees.** The House passed H.R. 1088, the Investor and Capital Markets Fee Relief Act, which would lower the transaction fees charged by the Securities Exchange Commission. CBO estimates that the bill would reduce revenues by $14.0 billion over ten years. The Senate has also passed a similar reduction in SEC fees.

- **Incentives for charitable giving**. The House passed H.R. 7, the Community Solutions Act, which would allow individuals who do not itemize their deductions to take a small deduction for charitable contributions ($25 per adult in 2002 rising to $100 in 2010) and would allow tax-free withdrawals from Individual Retirement Accounts for charitable contributions for individuals age 70½ and older. The Joint Committee on Taxation estimates that the measure will cost $13.3 billion over ten years.

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[2] The budget resolution — that is, the legislative instrument that embodies the Congressional budget plan — assumes that this $19 billion would be used by a reduction in SEC fees, the short-term extension of some expiring tax provisions, and certain Federal Reserve transactions.

- **Energy tax credits.** The House is scheduled to consider H.R. 4, the Securing America's Future Energy Act, which includes about 40 separate tax breaks to encourage energy production and alternative energy sources. The Joint Tax Committee estimates that the cost of these various tax breaks will be $33.5 billion over ten years.

Table 1

Enacted and Proposed Tax Cuts
in billions of dollars

	Eleven-Year Total 2001-2011
Tax cuts allowed under the budget plan:	
Allowable tax cuts	1,369
Enacted tax cuts	1,349
Remaining available tax cuts	20
Cost of House proposals with tax-cut provisions:	
SEC fee reduction (H.R. 1088)	14
Charitable deductions for non-itemizers (H.R. 7)	13
Energy tax credits (H.R. 4)	34
Subtotal	61
Total cost, enacted and proposed tax cuts	1,409
Amount by which enacted and proposed cuts would exceed the tax cuts allowed in the budget plan	41

Note: Totals may not add due to rounding

In addition to these measures that specifically reduce revenues, the Patients' Bill of Rights also results in revenue losses. CBO estimates that patient protections in the measure will result in a modest increase in health care costs that in turn will translate into modestly higher premiums for health insurance. Employers will accommodate these higher costs in part by setting wages somewhat lower than they otherwise would. Lower levels of taxable income translate into lower revenue collections. CBO projects, for instance, that the Senate-passed Patients' Bill of Rights would reduce income tax revenues by about $10 billion between 2002 and 2011. Although this loss of revenue is an indirect effect of the measure, it would nonetheless count against the allocation for tax cuts in the Congressional budget resolution. Versions of the Patients' Bill of Rights that may be considered by the House also include specific tax provisions that could result in further revenue losses of up to $5 billion over ten years.[3]

[3] For instance, H.R. 2653, the House companion to the Senate-passed Patients' Bill of Rights (Ganske-Norwood-Dingell), includes $2.6 billion over ten years of tax breaks mostly to assist the self-employed and certain small businesses with the purchase of health insurance. H.R. 2315 (the House Republican leadership's alternative to the Patients' Bill of Rights) includes provisions to expand significantly Medical Savings Accounts and establish Association Health Plans, which would result in a ten-year revenue loss of over $5 billion.

House Tax Credits Unlikely To Achieve Policy Goals

This report focuses on whether additional tax cuts, beyond the enacted $1.35 trillion package, are affordable. There are also concerns that many of the additional tax cuts the House has passed or is considering reflect poor tax policy. That is, they are unlikely to achieve their stated policy goals and will likely add to the complexity of the tax code. These criticisms apply to the House-passed proposal in H.R. 7 to allow taxpayers using the standard deduction to deduct charitable contributions as well as to many of the energy tax credits in H.R. 4.

The House-passed proposal to allow taxpayers who do not itemize their deductions to deduct charitable contributions costs $6 billion over ten years, or less than one-tenth the cost of the version proposed by the Administration. To hold down the cost, the deduction is limited to $25 for a single person in 2002 rising to $100 in 2010 (twice those amounts for a married couple). At these low levels, the proposal is unlikely to achieve its policy goal of stimulating more charitable giving. Instead, its primary effect is likely to be to give taxpayers a deduction for charitable donations they would have made anyway.

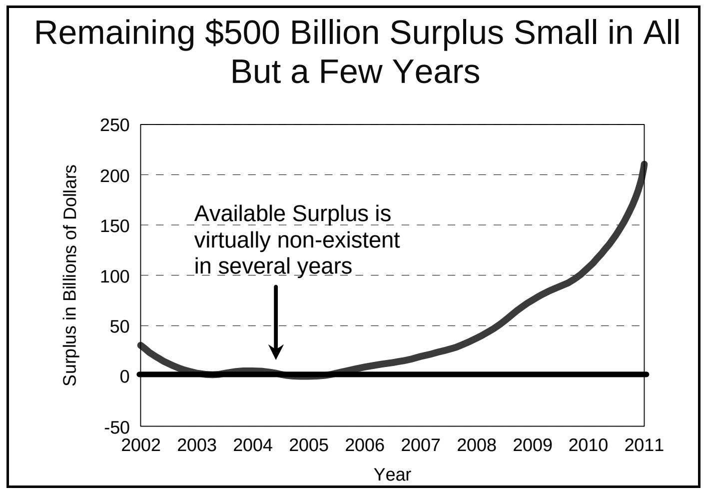
The proposed deduction for non-itemizers is worth only $2.50 for singles in the 10 percent bracket ($25 times 10 percent) and $3.75 for those in the 15 percent bracket in 2002, with the value of the deduction rising to $10 and $15 respectively by 2010. For those non-itemizers who currently make no charitable contributions, it is hard to imagine that these tiny tax savings represent the missing catalyst that will spur them to make a charitable gift. Further, it seems reasonable to asssume that non-itemizers who do currently give to charities are making gifts of $100 or $200 a year and therefore could take the full deduction without increasing their donations. Thus, the provision will primarily go toward reducing taxes for those who are already making charitable donations, while doing little to increase the flow of funds to charities.

Similarly, the dozens of small energy-related tax credits in H.R. 4 are unlikely to make an appreciable difference in meeting the nation's energy needs. Economists typically find these types of targeted tax credits inefficient or ineffective. Such credits can introduce distortions in the market, if funds are invested based on their tax savings rather than where they would be the most productive. Some might find these inefficiencies acceptable if the credits addressed important security, environmental, or other energy policy concerns. Given the small size and temporary nature of many of the credits in the House bill, however, it is questionable whether they will have much of an impact. Changes in the price of oil will likely be a far more influential factor in major energy investment decisions.

Finally, these types of tax breaks make the tax code more complex. The charitable deduction for non-itemizers would require yet another line on the tax form and impose a new recordkeeping burden for many taxpayers. Current energy tax credits are already very complex, and the many new credits in H.R. 4 would compound this complexity. Congress has added substantially to the complexity of the tax code this year with the enactment of the $1.35 trillion package; the resulting growth in the number of taxpayers affected by the AMT is just one example. Congress should now consider steps to simplify the tax system rather than adopting more tax breaks that further complicate the tax code while appearing unlikely to achieve their policy goals.

No Surplus Available for Additional Cuts

Some policymakers have suggested that even though new tax cuts might exceed the limits in the budget resolution, they are nonetheless affordable because there are still surpluses of $500 billion over the next ten years outside of the Social Security and Medicare Hospital Insurance trust funds. Yet this remaining surplus figure is misleading as an indicator of funds for additional tax cuts, both because the remaining surplus is concentrated in the last few years of the ten-year period covered by the Congressional budget plan and because it does not take into account other tax-cut and spending pressures that Congress will likely face.



The Congressional Budget Office estimated in April that the ten-year surplus outside of the Social Security and Medicare trust funds — whose surpluses Congress has voted to "wall off" and not use for tax cuts — would total $2.7 trillion. This total is reduced to $1.1 trillion by the enacted tax cuts plus the nearly $400 billion in higher interest costs. The policy changes assumed in the Congressional budget plan — Medicare prescription drug benefits and expansions in education, health, agriculture, veterans, and some other programs — would cost $590 billion over ten years, including interest costs. If Congress approves the expenditures called for in the budget plan, the $1.1 trillion surplus available for more tax cuts would be reduced to $497 billion.

However, as the remainder of this section discusses, the $497 billion figure is misleading. In fact, little if any surplus remains available for more tax cuts.[4] First, close to two-thirds of the $497 billion surplus does not occur until 2010 and 2011. Second, the $497 billion surplus figure vastly overstates the amount of the available surplus because it does not take into account the costs of various "must pass" items and other measures that are virtually certain to become law. In particular, it does not include the cost of extending a number of expiring tax provisions.

- ***Sunsets in tax-cut package*** — All of the provisions of the recently enacted tax-cut package (P.L. 106-17) expire by December 31, 2010. According to the Joint

[4] Many of the issues in this section are discussed in more detail in *How Much of the Surplus Remains After the Tax Cut?* Center on Budget and Policy Priorities, June 12, 2001, available at http://www.centeronbudget.org/6-13-01bud.htm.

Committee on Taxation, extending all of these provisions (except those related to the AMT) would cost an additional $138 billion between 2002 and 2011.

- ***Other expiring tax credits*** — A number of popular tax credits, such as the research and experimentation credit, are scheduled to expire. According to the Joint Committee on Taxation, extending these provisions (except those related to the AMT) would cost $81 billion between 2002 and 2011. These tax credits have been extended in previous years, and there is little reason to think that they will not be extended again. The budget resolution, however, provides less than $4 billion to extend these tax credits.

- ***Alternative Minimum Tax*** — The Joint Tax Committee estimated that, before enactment of the $1.35 trillion tax-cut package, the number of people affected by the AMT — a parallel tax system originally designed to ensure that upper-income taxpayers could not avoid paying income taxes altogether through the aggressive use of tax breaks — would have increased nearly 15-fold by the end of the decade, from about 1.4 million today to nearly 21 million in 2011. The enacted reductions in income tax rates, however, worsened this trend, pushing up the number of taxpayers hit by the AMT to over 35 million by the end of the decade. The Joint Tax Committee estimates that just removing this increase in the number of taxpayers affected by the AMT as a result of the tax-cut bill would cost $247 billion over the decade. But even at a cost of $247 billion, the changes would still leave some 21 million taxpayers affected by the AMT, including many middle-class taxpayers that were never intended to be snared by this alternative tax. So it is fair to assume that Congress will be pressured to take even more costly corrective action.

The $497 billion figure also assumes an unrealistically low level of discretionary spending for both defense and non-defense appropriations, as well as for natural disasters.

- ***Defense*** **—** The budget resolution contains slightly less for defense than the Bush budget, and the Bush budget was by its own admission only a placeholder. The Bush administration has now requested an $18 billion funding increase for defense for 2002 beyond the levels it initially requested. If this increase is extended for a decade, defense outlays would exceed the budget resolution by at least $200 billion. Moreover, further increases may be requested for 2003. For example, the current increase does not cover the costs of an accelerated missile-defense system. While we do not know the ultimate size of the defense increase the Administration will advocate, it could reach $400 billion over ten years beyond the figures in the budget resolution.

- ***Non-defense Appropriations*** **—** The budget resolution proposes to *cut* non-defense programs funded through the appropriations process (i.e., "non-defense discretionary" programs). Expenditures for these non-defense programs would be cut below the CBO baseline in every year and by $45 billion over ten years. History suggests such cuts are not likely to occur, especially if both education and health research are increased, as the President and a solid, bipartisan majority of Congress wish. A more prudent and realistic assumption is that non-defense appropriations will grow with inflation and the U.S. population — that is, the real, per-capita level of funding will be constant. This would add about $200 billion to the ten-year costs reflected in the budget resolution and is likely to be the minimum level provided. Indeed, this is a conservative assumption, as it would result in spending on these programs that as a share of GDP would fall from 3.3 percent to 3.0 percent by 2011, the lowest level on record. It is also worth noting that for 12 of the last 14 years, the real, per-capita funding for these programs has increased, even though most of that period was one of substantial deficits.

- ***Natural Disasters —*** The President's budget included an allowance of approximately $55 billion over ten years for natural disasters (e.g., hurricanes, floods, and earthquakes), which reflects the historical average level of expenditures on natural disasters. The congressional budget resolution cut the entire allowance. Of course, this won't prevent disasters from occurring or stop Congress from providing disaster relief; it only means that Congress is now pretending the costs will not occur.

Finally, the budget resolution allocates no funds to address the solvency of the Social Security or Medicare HI trust funds. Yet nearly all recent proposals to restore or significantly enhance Social Security solvency — by Republicans and Democrats alike — have relied in part on resources from the general fund to help mitigate the severity of the problem; without such resources, the magnitude of the benefit cuts or payroll tax increases needed to restore long-term solvency is likely to be too great for any solvency plan to survive. (In the past, we have suggested that $500 billion might be devoted to these purposes and noted that such an amount would go only 30 percent of the way to bringing 75-year solvency to Social Security and Medicare.)

As shown in Table 2, the potential costs that are not accounted for in the budget resolution total nearly $2 trillion, well above the roughly $500 billion available surplus identified by supporters of additional tax cuts. Even if Congress incurs just one-quarter of these additional costs, the remaining surplus is wiped out. *Simply extending the research and experimentation tax credit and other similar tax credits scheduled to expire in the next few years would wipe out the entire surplus outside the Social Security and Medicare HI trust funds in 2003 through 2006.*

Furthermore, none of these estimates take into account the impact on the surplus of anticipated changes to the CBO economic assumptions. CBO is expected to release a revised economic forecast in late August. At the very least, these estimates will incorporate the slower-than-expected growth in the first half of the year, reducing the surplus projections for 2001. How

Table 2

Additional Costs That Have Not Been Accounted For
in trillions of dollars

	Ten-year total 2002-2011
Remaining surplus after tax cut and budget resolution policies	0.5 trillion
Additional potential costs that have not been accounted for:	
Extension of sunsets in tax-cut law	0.1
Extension of other expiring tax credits (such as R&E credit)	0.1
Relief for Alternative Minimum Tax (AMT)	0.2
Defense appropriations	0.2 - 0.4
Non-defense appropriations	0.2
Natural disasters	0.1
Realistic costs of a prescription drug benefit	0.1
Social Security and Medicare reform / solvency	0.5
Interest on all of the above	0.2
Total, potential costs not accounted for	1.7 - 1.9

this will ripple through CBO's longer-term forecast is unclear, but recent press reports noted that CBO has implied that the surplus projections could shrink by $200 billion over the decade.

All of this strongly suggests that there is no available surplus outside of the Social Security and Medicare HI trust funds to pay for new tax cuts. Additional tax cuts can be accommodated only if they are accompanied by revenue offsets, most likely from scaling back provisions of the new tax-cut law, eliminating unproductive tax breaks, or a combinations of such steps. Yet if the House adopts the package of energy tax credits without offsets, it will be agreeing to another $33.5 billion in tax cuts over ten years, bringing to $61 billion the total tax cuts that the House has passed above and beyond the $1.35 trillion tax-cut package.