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ADMINISTRATION CRITIQUE OF CENTER ANALYSIS DOES NOT WITHSTAND SCRUTINY

Despite Manipulating the Numbers, the Administration Itself Finds the Long-term Cost of the Tax Cut to be as Large as the Social Security Shortfall

On August 2, the Center issued an analysis showing that the 75-year cost of the recently enacted tax cut (assuming its provisions are made permanent) is more than twice as great as the 75-year shortfall in the Social Security Trust Fund. Specifically, the cost of the tax cut amounts to 1.6 percent of the Gross Domestic Product (GDP) over 75 years, while the 75-year shortfall in Social Security — as measured by the Social Security Trustees, who include Treasury Secretary Paul O'Neill and other Administration officials — equals 0.7 percent of GDP. Likewise, the present value of the tax cut over 75 years is $7.7 trillion while the present value of the Social Security shortfall over 75 years is $3.2 trillion.[1] Thus, the cost of the tax cut is more than double the size of the Social Security shortfall. These estimates of the size of the tax cut are based on estimates prepared by the Joint Committee on Taxation, Congress' official tax estimator.

The Bush Administration responded by saying that the cost of the tax cut is only one percent of GDP (rather than 1.6 percent) while the Social Security shortfall is, likewise, close to one percent of GDP (rather than 0.7 percent).[2]

The Administration's response is noteworthy in two respects:

- Administration officials have often portrayed the tax cut as modest and fiscally responsible but the Social Security shortfall as massive and a risk to the nation's future fiscal health. In its response to the Center's analysis, the Administration itself indicates that the revenue loss from the tax cut is as large as the Social Security shortfall. The Administration claims both costs are about 1.0 percent of GDP.

[1] The "present value" of the Social Security shortfall is the amount today that, with interest, would cover the 75-year shortfall. Similarly, the present value of the tax cut is the amount today that, with interest, would equal the revenue loss from the tax credit over the next 75 years.

[2] See Glenn Kessler, "Study Knocks Tax Cut, Predict Budget Woes," Washington Post, August 2, 2001, pg. A-17.

- Also of note, the Administration's figures for both the size of the Social Security shortfall and the size of the tax cut simply are not valid. The Administration's Social Security estimate differs from that issued by the Social Security Trustees, while its tax cut estimate fails to include the cost of various provisions of the tax-cut law.

The Dimensions of the Social Security Shortfall

The Administration claims the Center has underestimated the Social Security shortfall by reporting it as 0.7 percent. The 0.7 percent figure comes directly from the 2001 Social Security Trustees report.[3] This figure was prepared by the highly respected Office of the Chief Actuary at the Social Security Administration. Treasury Secretary Paul O'Neill and several other cabinet officers are among the Trustees who signed the report.

Thus, the Administration is not criticizing a Center estimate. It is essentially claiming that an estimate produced by the Social Security actuaries — and approved by Secretary O'Neill and other cabinet secretaries when they signed the Trustees report — is wrong.

How did the Administration alter the actuaries' estimate and come up with its own estimate that the Social Security shortfall equals nearly one percent of GDP? The Administration did so by ignoring the assets of the Social Security Trust Fund and effectively assuming that the Trust Fund's $1.1 trillion of Treasury bonds cannot be used to finance Social Security benefits. This contradicts the long-established practice of the Social Security actuaries and other analysts in producing estimates of the Social Security system. As the actuaries and other analysts have long recognized, these Treasury bonds are backed by the full faith and credit of the U.S. government and surely will be honored, just as the Treasury bonds that private investors hold will be.[4] A second problem with the Administration's estimate is that it relies on a methodology that is internally inconsistent and technically flawed. (See appendix.)

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[3] See Table VI.E5 of the report. The widely cited Social Security shortfall figure of 1.86 percent of taxable payroll over 75 years is equal to 0.7 percent of GDP. Both figures appear in the Trustees' report.

[4] Since the rest of government must pay interest to the Social Security Trust Fund on the bonds the Trust Fund holds — and ultimately must buy these bonds back when the Trust Fund needs them converted to cash — the Administration apparently is arguing that the cost to the government as a whole is closer to 1.0 percent of GDP. The fact that the rest of the government must cover the cost of the bonds does not alter the fact, however, that the shortfall in the Social Security system is 0.7 percent of GDP. The bonds the Trust Fund holds are assets to the Trust Fund and surely will be honored, just as the Treasury bonds that private investors hold will be. The fact that the Trust Fund's bonds are a liability to the rest of government does not alter that reality. This is why the actuaries and trustees of the Social Security system, including the current Bush Administration trustees, always include the Trust Fund's bonds as part of Social Security financing when they estimate the size of Social Security's shortfall.

The Size of the Tax Cut

On June 20, the Joint Committee on Taxation (JCT) provided an estimate of the cost of the tax cut in 2011 if all provisions of the tax cut are extended. The JCT estimate shows the tax cut would cost 1.75 percent of GDP in 2011.

To estimate the cost of the tax cut in years after 2011, we assumed the cost would remain constant at 1.75 percent of GDP. Assuming that the cost of a tax cut will stay constant as a share of GDP once the tax cut is phased in fully is the standard approach that the Congressional Budget Office, the Office of Management and Budget, and the General Accounting Office all use when preparing long-term fiscal forecasts. Since the JCT estimates show that the tax cut will cost less than 1.75 percent of GDP in years before 2011 while it is phasing in, the cost for the 75 years as a whole is 1.6 percent of GDP.

How did the Administration come up with the lower figure of 1.0 percent of GDP for the cost of the tax cut when phased in fully? The answer is that it didn't. The Administration's 1.0 percent of GDP figure turns out *not* to be an estimate of the full cost of the tax cut, when fully phased in and with all provisions extended, but rather the cost of the tax cut, as enacted, in 2010. That figure reflects only a little more than half of the full cost of the tax cut. The Administration's figure provides a deceptively low estimate of the full cost of the tax cut, with all provisions extended, for three reasons.

- The Administration's estimate assumes that the provisions of the tax cut artificially slated to expire in 2004, 2005, and 2006 actually die — including the provision that provides relief through 2004 from the mushrooming Alternative Minimum Tax. The Administration's estimate thus assumes that 35.5 million taxpayers will be subject to the AMT in 2010, as compared with 1.4 million today. No credible observer believes Congress will fail to act on this issue and will simply allow the AMT-relief provision of the tax cut to expire — and AMT relief to die — in 2004.

- The Administration's estimate also does not include the cost of estate tax repeal. Under the new tax law, the estate tax will not be repealed until 2010. As is well known by tax analysts, the cost of a change in the estate tax does not show up until a year or two *after* the change takes effect. This is because there is normally a lag of a year or so between the time an individual dies and the time that individual's estate is settled and tax is paid on it. Thus, the estimate for the cost in 2010 of the estate tax provisions of the new tax law largely reflects the cost of the estate tax provisions in effect *in 2009*, before estate tax repeal has occurred.

- Of lesser importance, the cost estimate for 2010 reflects only a modest fraction of the cost of raising the child tax credit from $800 per child in 2009 to $1,000 per child in 2010. Most of the cost of this increase in the child tax credit will not show up until 2011, because some of the child tax credit that many families receive is provided in tax refunds the families receive the following year, after they file their taxes.

In short, the Administration's estimate that the cost of the full tax cut is 1.0 percent of GDP relies upon gimmicks embedded in the tax bill to make that cost appear lower than it actually is. The Center's estimate, which reflects the Joint Tax Committee's estimate of the cost of the tax cut if all provisions of the tax cut are extended, is the legitimate estimate of the tax cut's long-term cost if it is made permanent.

The Administration's attempt to defend its tax cut by claiming that the Center overstated the tax cut's costs and underestimated the size of the Social Security shortfall does not withstand scrutiny. Unfortunately, it is the Administration that has manipulated the numbers.

Appendix

Additional Problems with the Administration's Social Security Estimate

The Administration may assert it is departing from the traditional approach to measuring the long-term deficit in Social Security because it is measuring a different concept: the cost to the government of projected future Social Security deficits. Such a redefinition of the concept of "the long-term Social Security deficit" is misguided for two reasons.

First, it ignores the contributions that past and current Social Security surpluses have made to national saving. The Social Security program has contributed to national saving by accumulating reserves. Such increased saving will make it easier for the government to meet its future obligations. The balance in the Trust Fund thus is both an asset to the Social Security system (as noted above) and a reflection of the economic contribution that the partial advance funding of Social Security has made to national saving. The increased saving expands future output and also future revenues for the government as a whole. By ignoring the Trust Fund balance, the Treasury analysis is implicitly assuming that the Social Security system has contributed nothing to national saving.

Second, the Treasury calculations contain a technical inconsistency. A present value measures the current cost that, *with accumulated interest*, equals a future cost. Therefore, in computing a present value, the Administration is assuming that Social Security surpluses in the future will accumulate interest income, and Social Security deficits in the future will incur interest costs. Yet by excluding the value of the Trust Fund, the Treasury analysis ignores the interest income on past Social Security surpluses (as reflected in today's Trust Fund balance). In other words, the Treasury analysis is assuming that *future* Social Security surpluses (or deficits) entail interest income (or costs), but that *past* Social Security surpluses did not generate interest income.