The Cost of the Tax Bill: Do We Count Fairly?

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There are some reasons to like, and some to dislike, the 1999 tax legislation. Perhaps the principal item that I, among others, worry about is the long-term cost of the tax cuts in the face of the imbalance in the federal government's retirement and health programs. Many of the provisions being considered are phased in at a slow rate but are running with a full head of steam once the baby boomers begin to retire. Thus the bill is less of a threat to short- term deficits than to covering the long-term costs associated with the retirement of the baby boomers.

Here, however, a confession, of sorts, is required. We don't always count fairly when looking at the long-run costs. What do I mean? We have a system that does not provide complete or consistent comparisons for different types of proposals. Essentially, we measure costs off of a baseline of current law, but current law represents a wide range of standards. As a consequence, traditional revenue estimates can mislead as to the long-term impact of tax cuts on federal revenue collection.

For some provisions, current law is a set of rules that over time are scheduled to expire. Then, when we measure costs of a bill, it is relative to zero for the years after expiration. For example, take the research tax credit. Since it is scheduled to expire, any extension of what would be thought of as current law involves a significant commitment of funds. If the credit is made permanent, then a large positive cost is assessed for all future years. If, however, our baseline were to be current levels of (tax) expenditures on this program, then there would be little or no cost associated with the simple extension of the program.

Another set of rules applies to provisions that are permanent, but decline in relative value over time. For example, the dependent care tax credit allows each taxpayer a maximum amount that has not increased along with child care costs or even inflation. Simply restoring the real value of the credit to individuals is labeled a cost.

Many pension rules operate in a similar vein. The maximum deposit to an individual retirement account has been constant for a long time, thus effectively reducing its real value. Here some of the long-term costs would appear much smaller if measured relative to current costs as a percent of national income or gross domestic product (GDP).

Still other tax expenditures grow at a much faster rate. New tax shelters are invented every year and sold to the public at an accelerating rate. Many of these tax avoidance activities are parts of "current law" that have not yet been fully mined. They will grow exponentially if either ignored or further encouraged; alternatively, a damper may be measured as causing significant "revenue growth" in the "out years" beyond budget projections simply by removing some of that exponential growth in current law cost. From another perspective, the cost of inaction is zero relative to current law, but billions relative to practices allowed under current law.

Turning from the tax expenditure side to the more direct tax side of the budget, we again find that "current law" sets very mixed standards. Some taxes, such as excise taxes, are often set in nominal terms such as "10 cents a gallon." As inflation and real growth in the economy occur, these taxes collect smaller and smaller shares of GDP.

Other taxes under current law grow more or less in line with the economy. Social security taxes grow at about the same rate as wages: the statutory tax rate is constant, and the wage base itself is indexed to grow at the rate of growth of average wages. The net effect is to keep average collections at about the same percentage of national income.

Some taxes, however, are scheduled to grow much faster than the economy. A primary example here is the alternative minimum tax on individuals. Within a few decades, collections under this tax are scheduled to grow

by tens of billions of dollars per year, as millions of additional taxpayers begin to pay the tax and larger portions of their net income become subject to its provisions. Few members of Congress understood this growth implication when they voted for the AMT, and no one believes that it can survive in its current form. But it is "current law"—the baseline off of which we measure changes in costs. If this Congress doesn't stop the growth, a later Congress will be left with the task. Getting the job done now in lieu of other tax cuts could even save money in the long run, since other tax cuts today plus AMT relief tomorrow could add up to a higher cost.

Of course, many items are hybrids—having some features that will reduce costs over time and other features that will increase costs. The estate tax rules are scheduled under 1997 law to allow higher unified credits against the tax for the next few years. After that period, however, wealth growth in the economy will subject larger numbers of taxpayers to this tax. At that point, if not before, revenues from this source will grow significantly faster than the economy as a whole. Hence, modest cuts in the estate tax show up as a much larger cost when measured relative to current law than when compared to current collections or current revenues as a percent of national income.

In sum, current law sets a baseline that can be misleading when measuring the costs of a tax bill. A different baseline would yield a very different perception of when the tax bill was costing revenues and when it was not. In the current tax bill, perhaps the most misleading of all is the long-term revenue loss pegged onto the AMT changes that mainly prevent it from taxing at a level never intended in the first place.

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