Should the President’s Tax Cuts Be Made Permanent?

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The 2001, 2002, and 2003 tax cuts were signature items in the Bush administration’s fiscal policy. All of the provisions of those tax cuts, however, expire by the end of 2010 and some expire earlier, including several that terminate at the end of this year. A prominent feature of the president’s most recent budget is the proposal to make almost all the provisions of the 2001 and 2003 tax cuts permanent. This article evaluates the administration’s proposal, with the following conclusions:

- **The role of expiring tax provisions has changed dramatically over time.** Expiring tax provisions (or “sunsets”) have long been a feature of the tax code, but they have traditionally involved relatively minor provisions. Beginning with the 2001 tax cut, however, the use of sunsets grew explosively. As a result, whether expiring provisions in general, and the administration’s tax cuts in particular, are extended has become one of the central fiscal issues facing the nation.

- **No permanent tax cut proposal can be sensibly discussed without addressing the alternative minimum tax.** Under the administration’s budget, which does not address the long-term AMT problem, 30 million households will face the AMT by 2009 (up from three million today). By 2014, 44 million households will face the tax and the AMT would take back 40 percent of the ostensible tax cuts from making the 2001 and 2003 laws permanent. Fixing the AMT is not only necessary to avoid further complexity in the tax code, but would substantially raise the cost of making the tax cuts permanent.

- **Making the 2001 and 2003 tax cuts permanent would generate large, backloaded revenue losses over the next 10 years.** Combined with a minimal AMT fix, described below, making the tax cuts permanent would reduce revenues by almost $1.8 trillion over 10 years. By 2014, the annual revenue loss would amount to $400 billion, more than 2 percent of gross domestic product.

- **Paying for the tax cuts would require monumental reductions in other spending or increases in other taxes.** To cover the revenue loss in 2014 would require a 48 percent reduction in Social Security benefits, complete elimination of the federal component of Medicaid, a 80 percent reduction in domestic discretionary spending, a 34 percent increase in payroll taxes, a 124 percent increase in corporate taxes, or changes of a similar magnitude. Even many of those who advocate making the tax cuts permanent, such as Federal Reserve chair Alan Greenspan, stipulate that a permanent tax cut is only appropriate if it is financed by other offsetting policy changes. Yet we know of no policymaker who would endorse the spending or tax changes noted above. In the absence of those policy changes, making the tax cuts permanent would create large, sustained deficits, that have potentially devastating long-term consequences.

- **Measured over a 75-year horizon, making the tax cuts permanent would cost as much as the combined shortfalls in the Social Security and Medicare trust funds.** Over the next 75 years, extending the tax cuts would reduce revenues by an average of 1.8 percent of GDP, which is equal to the combined shortfalls in the Social Security and Medicare hospital insurance trust funds over the same period. (The overall cost of the tax cuts is larger than 1.8 percent of GDP if the revenue reduction before the sunsets take effect is also taken into account.) Thus, to the extent that Social Security and Medicare’s hospital insurance program are considered major long-term fiscal problems facing the nation, making the tax cuts permanent should be seen as creating a fiscal problem of an equivalent order of magnitude.

- **Making the tax cuts permanent would be regressive.** After-tax income would increase by more than 9 percent for households in the top 1
percent of the income distribution, between 2 and 3 percent for households in the middle 60 percent, and only 0.1 percent for households in the bottom quintile. Also, the share of the tax cut accruing to high-income taxpayers would exceed their share of federal tax payments, so their share of the federal tax burden would decline. The annual tax cut among households with income above $1,000,000 would equal $144,000 (in 2004 dollars), which exceeds the total income of 94 percent of households. Moreover, to the extent that the tax cut would be financed by spending cuts or tax increases that are less progressive than the income and estate taxes being reduced, the overall effects will be even more regressive, and low- and moderate-income households may actually end up worse off, rather than simply obtaining relatively small tax cuts.

- **Making the tax cuts permanent is likely to reduce, not increase, the size of the economy in the longterm.** Studies from researchers in academia, the Federal Reserve, the Congressional Budget Office (CBO), and the Joint Committee on Taxation (JCT), as well as our own research, indicate that making the tax cuts permanent could increase the size of the economy slightly for a temporary period but would reduce the size of the economy in the longterm.

- **Making the tax cuts permanent would not reduce uncertainty.** Making the tax cuts permanent would raise the underlying fiscal gap — the difference between projected revenue and spending — and hence raise uncertainty about how the gap will eventually be closed. Also, making the tax cuts permanent would likely harm short-term economic activity.

- **By the standards applied to recent tax cuts, making the tax cuts permanent is not affordable.** Despite projections of large and growing surpluses at the time, even the 2001 tax cuts were made temporary, due in part to concerns that they would not ultimately be affordable. Since then, current and projected future budgets deficits have grown dramatically.

Section I provides background information on expiring tax provisions, why the recent tax cuts were temporary, and the administration’s proposal. Section II examines the 10-year revenue and budget costs of the proposal. Section III shows what other spending or tax changes would be needed to pay for the tax cuts. Section IV compares the long-term costs of the tax cuts to the actuarial shortfalls in the Social Security and Medicare trust funds. Section V examines the distributional effects. Section VI discusses the impact on economic growth. Section VII concludes.

**I. Background**

**A. The Growth of Expiring Provisions**

Through the 1990s, expiring tax provisions — or sunsets — applied generally only to a few minor provisions or to occasional, explicitly temporary tax
policies, and were largely limited to a set of tax credits and other provisions referred to collectively as “the extenders.” These provisions included items like the research and experimentation credit and were typically granted a continuance each time they were due to expire.

The use of sunsets changed dramatically in the Economic and Budget Outlook each year.

The 2001 tax cut would not have received 60 votes as a permanent change (if it could have, the administration would have pushed for that). As a result, it could not be made permanent under reconciliation. (This demonstrates that support for making the full cuts permanent was limited, even then — at a time when the CBO (2001) projected budget surpluses were growing over time and totaled $5.6 trillion over the 2002-2011 period.) There is no requirement, however, that tax cuts be enacted through reconciliation legislation. Ronald Reagan’s 1981 tax cut, for example, was passed outside the reconciliation process, through regular legislation. (See Evans (2003) for discussion of the uses and history of reconciliation.)

To obtain permanent tax cuts in 2001 the administration could have pursued either of two strategies. The first would have been to continue to work through reconciliation but accept a smaller tax cut within the 10-year window in exchange for making the tax cut permanent. The Democrats had already offered a $900 billion tax cut, so there was room for negotiation. The second strategy would have been to introduce the 2001 tax cut as regular legislation. In that case it would have required only 51 Senate votes to be made permanent, but it would have been subject to filibuster. The administration did not want to expose the tax cut to the possibility of a filibuster.

In essence, the administration gambled in 2001 that it could get the larger annual tax cuts enacted then and made permanent at a future date, rather than adopting smaller tax cuts that very likely could have been made permanent in the first place. At the same time, given the large and growing projected surpluses for the next decade, that decision looked like a fairly safe bet. The drastic change in the budget outlook since January 2001 — CBO’s projected baseline budget now faces a deficit of $2.2 trillion between 2002 and 2011, a turnaround of $8.5 trillion since January 2001 — and the associated increase in concern about the fiscal outlook may make the administration’s gamble look ill-advised (from the administration’s own perspective) in retrospect. For example, in 2001 CBO projected a baseline budget surplus of $889 billion for 2011. As of January 2004 the baseline budget projection for 2011 was a small deficit.

In contrast to the 2001 legislation the 2002 tax cut was explicitly intended to be temporary. In particular, the bonus depreciation provision was intended to be temporary and thereby create an incentive to accelerate investment that had been planned for the future. To the administration’s credit, the budget notes explicitly that the provision was intended to be temporary and opposes making the provision permanent.

Finally, the 2003 tax cut — the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) — was made temporary for reasons similar to those governing the 2001 tax cut. The administration and congressional Republican leadership wanted to create as large a tax
cut as possible in the early years of the legislation, while still adhering to the letter (if not the spirit) of the budget resolution limiting the tax cut to $350 billion over 10 years. Like EGTRRA, JGTRRA was passed under reconciliation and was also essentially a gamble on the administration’s part that it could make the tax cuts permanent at some later date.

C. The Proposal to Make the Tax Cuts Permanent

The 2001 and 2003 tax cuts and the administration’s proposals to make them permanent contain a hodgepodge of tax provisions that phase in and expire at different times. In Tables 1a-1d, we divide the enacted policies and proposals into four broad categories: general income and estate tax cuts; tax cuts for saving; and tax cuts for education.

Table 1a shows general income and estate tax cuts. The 2001 tax cut reduced and eventually repealed the estate tax; cut the top four income tax rates; repealed the phaseouts of personal exemptions and itemized deductions; created a new 10 percent tax bracket; and temporarily boosted the AMT exemption. Relative to those changes, the 2003 tax cut accelerated the scheduled reduction of the top four income tax rates. It also accelerated the scheduled expansion of the 10 percent bracket and raised the AMT exemption, but those features were only temporary, expiring at the end of 2004. The 2003 tax cut also cut dividend and capital...
gains tax rates. The administration’s FY 2005 budget would make all of the general income and estate tax cuts permanent, except for the higher AMT exemption amount, which would be extended only for one more year.

Table 1b shows tax cuts aimed at families and married couples. Three of these provisions — the expanded child credit, the higher standard deduction for married couples, and the expanded income range for the 15 percent bracket for married couples — expire at the end of 2004, as does the expansion of the 10 percent bracket noted above. All of these provisions essentially sunset twice — once in 2004 and again in 2010. For example, under current law the child credit is set at $1,000 but only through the end of 2004. At that point, it falls to $700, only to rise again to $1,000 in 2010, and then fall to $500 (its pre-EGTRRA value) in 2011.

Table 1c reports tax cuts for saving. All of the tax cuts aimed at high-income households — higher contribution limits and Roth IRA contributions — are proposed to be made permanent. But the saver’s credit, which provides a progressive, nonrefundable matching credit for contributions to 401(k)s and IRAs made by moderate-income households is allowed to expire at the end of 2006. Table 1d shows education subsidies. All of these are proposed to be made permanent, except the deduction for education expenses, which expires in 2006.

Essentially, the president proposes to extend and make permanent almost all of the features of the 2001 and 2003 tax cuts, with a few notable exceptions — including the saver’s credit, the AMT exemption, and the education deduction. While policymakers may be able to postpone action on the provisions that expire in 2008 (dividend and capital gains tax cuts) and 2010,
some of the key provisions expire in 2004 and a decision on at least a temporary extension will have to be made soon.

II. Revenue and Budget Costs Over Ten Years

A. As Reported in the Budget

We begin by examining the proposal to make the tax cuts permanent assuming that the AMT is changed according to the small and temporary adjustment proposed in the president’s budget. Specifically, the AMT exemption for married couples is $58,000 but is slated to fall to $45,000 at the end of 2004. In addition, a temporary provision allowed the use of nonrefundable tax credits under the AMT. The president’s budget would extend the exemption at $58,000 for one additional year so that it expires at the end of 2005, and also allow nonrefundable credits to be claimed under the AMT through 2005.

The top panel of Table 2 shows the revenue loss and the total budget cost (including the increase in debt service payments because of higher levels of federal debt) of the administration’s proposal, as reported in the budget. Over the next 10 years the proposal would reduce revenues by $1.01 trillion. This includes $23 billion for the AMT and $990 billion (the figure reported by the administration) for the other provisions of EGTRRA and JGTRRA that it proposes to extend.

Within the 10-year budget window, more than 80 percent of the revenue loss occurs after 2009. This is notable both because the president’s budget does not present annual unified budget projections beyond 2009 and because of the president’s goal of cutting the deficit in half by 2009. Extending the tax cuts would create significant increases in deficits just after 2009. Thus, the combination of focusing on 2009 for budget purposes and beyond 2009 for tax cut purposes is quite misleading. The costs grow over time. In 2014 the administration’s proposal would reduce revenues by $243 billion, or 1.3 percent of GDP. That would be a recurring annual cost that would extend indefinitely in time (contingent on the AMT, discussed below).

B. With a Modest AMT Fix

The administration’s official revenue estimates should not be taken at face value. Under the administration’s proposals 30 million tax filers would face the AMT in 2009 and 44 million would in 2014 (Figure 2). Under the administration’s proposal one-sixth of the income tax cuts from the 2001 and 2003 legislation would be erased by the AMT by 2006, one-quarter by 2009 and almost 40 percent by 2014, including more than half for households with income between $75,000 and $100,000 and three quarters for households with income between $100,000 and $200,000 (Table 3). It seems very unlikely that policymakers will allow this to happen.

Table 2: Extending and Indexing the AMT

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Index and Extend AMT 1</td>
<td>-164</td>
<td>-264</td>
<td>-428</td>
<td>-51</td>
</tr>
<tr>
<td>Extend Estate Tax Repeal</td>
<td>-9</td>
<td>-172</td>
<td>-180</td>
<td>-54</td>
</tr>
<tr>
<td>Extend Other Non-AMT Provisions of EGTRRA, JGTRRA</td>
<td>-172</td>
<td>-979</td>
<td>-1,150</td>
<td>-293</td>
</tr>
<tr>
<td>Total Revenue Change</td>
<td>-344</td>
<td>-1,414</td>
<td>-1,758</td>
<td>-398</td>
</tr>
<tr>
<td>Interest 2</td>
<td>-34</td>
<td>-255</td>
<td>-290</td>
<td>-90</td>
</tr>
<tr>
<td>Total Budget Cost</td>
<td>-379</td>
<td>-1,669</td>
<td>-2,048</td>
<td>-487</td>
</tr>
</tbody>
</table>

1The Budget of the U.S. Government, Fiscal Year 2005.
2Authors’ calculations using January 2004 CBO debt service matrix.
3Authors’ calculations using microsimulation model of Tax Policy Center. Under indexing of the AMT the number of taxpayers on the AMT is 6.5 million in 2014, compared to 3.6 million in 2005.
simple first step toward reform would index the AMT for inflation starting in 2005. Under that proposal, about 6 million taxpayers would face the AMT in 2014.

The second panel of Table 2 shows that the revenue costs of making the tax cuts permanent are much higher when the AMT is indexed for inflation. It also shows that the combined costs of making the tax cuts permanent and indexing the AMT are even higher. Under current law, extending and indexing the AMT would reduce revenues by about $428 billion over the next decade. With that change, making the selected features of the 2001 and 2003 tax cuts permanent would reduce revenues by an additional $1.33 trillion. The total revenue loss would be $1.76 trillion and the effect including debt service payments would increase the deficit by $2.05 trillion over the next 10 years. In 2014 the revenue loss would be $398 billion, or about 2.2 percent of projected GDP (CBO 2004).

III. Paying for the Tax Cuts Over 10 Years

In 2001 the administration argued that the tax cuts would be “paid for” out of the surplus. Despite the problems with that claim (see Auerbach and Gale 2001, for example), the argument appears to have carried the day at that time. In 2002 and 2003 the tax cuts were explicitly temporary and intended to boost a sagging economy.

But a permanent tax cut, as the administration is proposing, has to be financed, ultimately with either lower spending or higher revenues from other sources. In the short term it can be financed by borrowing. Such borrowing does not remove the need to cut spending or raise other revenues; it just postpones the day of reckoning. Reflecting this simple accounting fact, Alan Greenspan has emphasized that the tax cuts should not be extended unless they are offset with spending reductions (the offset he prefers) or other revenue increases over the next decade.

Table 4 shows the type of cuts that would be necessary in 2014 to finance the costs of making the tax cuts permanent in that year. Similar estimates would apply to other years. The table examines the two versions of the administration’s tax cuts described in Table 2 — with the temporary AMT fix proposed by the administration and with the AMT extended and indexed for inflation. The table shows that to extend the tax cuts, keep the number of AMT taxpayers down to 6 million (which is still higher than the 3 million that currently pay the tax), and offset the revenue loss would imply one of the following options or changes of a similar magnitude:

- A 48 percent cut in Social Security benefits;
- A 57 percent cut in Medicare benefits;
- Complete elimination of the federal component of the Medicaid program;
- A 12 percent cut in all noninterest spending;

(Text continued on p. 1285.)
### Table 3
Effect of the AMT on the Administration’s Tax Cuts

<table>
<thead>
<tr>
<th>AGI Class (thousands of 2003$)</th>
<th>Percent of Tax Units With No Cut Due to AMT</th>
<th>Percent of Cut Taken Back by AMT</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>0.9</td>
<td>1.9</td>
</tr>
<tr>
<td>0-10</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>10-20</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>20-30</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>30-40</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>40-50</td>
<td>0.4</td>
<td>0.7</td>
</tr>
<tr>
<td>50-75</td>
<td>1.0</td>
<td>2.1</td>
</tr>
<tr>
<td>75-100</td>
<td>1.7</td>
<td>3.5</td>
</tr>
<tr>
<td>100-200</td>
<td>3.9</td>
<td>7.4</td>
</tr>
<tr>
<td>200-500</td>
<td>7.5</td>
<td>10.6</td>
</tr>
<tr>
<td>500-1,000</td>
<td>0.7</td>
<td>0.6</td>
</tr>
<tr>
<td>More than 1,000</td>
<td>0.6</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: Tax Policy Center Microsimulation Model.

*Baseline pre-EGTRRA law. Tax cuts include those currently in place and those the Administration has proposed extending.

### Table 4
Paying for Permanent Tax Cuts

<table>
<thead>
<tr>
<th>Revenue Loss in 2014 (in $ billions)</th>
<th>Administration’s Proposal¹</th>
<th>Including AMT Reform²</th>
<th>Memo: 2014 Baseline Revenue/Spending ($ Billions)³</th>
</tr>
</thead>
<tbody>
<tr>
<td>243</td>
<td>398</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Required Percentage Change in*:

- **All Non-interest Outlays**: -7, -12, 3,278
- **Discretionary Spending**: -21, -35, 1,149
- **Defense, HS, International**: -37, -61, 651
- **Other**: -49, -80, 498
- **Mandatory Spending**:
  - **Social Security**: -29, -48, 827
  - **Medicare**: -35, -57, 698
  - **Medicaid**: -70, -114, 348
  - **All Three**: -13, -21, 1,873
  - **Other**: -95, -155, 256
- **All Spending Except**:
- **Revenue**:
  - **Payroll Tax**: 21, 34, 1,173
  - **Corporate Tax**: 76, 124, 320

¹As proposed in the Administration’s FY2005 Budget. This allows the AMT exemption to revert to its 2000 level in 2006 and remain unindexed. About 44 million taxpayers would be on the AMT in 2014 under this proposal.

²Includes the cost of extending the AMT treatment of nonrefundable credits and the AMT exemption, and indexing the AMT for inflation starting in 2005 using the Tax Policy Center Microsimulation model. About 6 million taxpayers would be on the AMT in 2014 under this scenario.


*Percent cuts that exceed 100 are arithmetic artifacts. No program can be cut more than 100 percent.
The easiest way to put the tax cut proposals and the Social Security and Medicare shortfalls on equal footing is to examine them over the same time period. Table 5 provides calculations for 2003 to 2080. Over roughly the next 75 years, the actuarial shortfall in the Social Security and Medicare hospital insurance trust funds are 0.7 percent and 1.1 percent of GDP, respectively. Making the tax cuts permanent would reduce revenues by 1.8 percent of GDP, assuming an AMT fix — and if there were no AMT fix, virtually everyone would end up on the AMT. Thus, over the next 75 years, making the 2001 and 2003 tax cuts permanent and applying a modest fix to the AMT would cost as much as fixing the shortfalls in the Social Security and Medicare hospital insurance trust funds. This is simply another way of saying that the tax cuts would impose very substantial costs on future generations.

Figure 3 provides further evidence on this point, and is based on long-term budget projections from Auerbach, Gale, and Orszag (2003). The baseline unified deficits are very close to those presented by the administration in this year’s “Economic Report of the President.” The baseline deficit in 2075 is about 40 percent of GDP, relative to about 35 percent under the administration projections. As the figure shows, the long-term budget outlook does not change markedly under the type of Social Security reform favored by the administration. (The specific reform shown reflects “Model 2” as proposed by the president’s Commission to Strengthen Social Security. This reform was also the basis for Chart 6-6 in this year’s “Economic Report of the President,” which shows a very similar pattern to Figure 3.) Yet the figure also shows that extending the tax cuts after 2010 exerts a significant influence on the projected deficit. By 2075 the reduction in the unified deficit amounts to 13 percent of GDP, almost three times the reduction from the administration’s type of Social Security reform in that year.

### V. Distributional Effects

Table 6 shows the distributional effects in 2011 of enacting the administration’s proposal, including the fiscal danger” while ignoring the corrosive impact of its own proposed tax cuts on the fiscal balance.

<table>
<thead>
<tr>
<th>Table 5 Long Term Costs: Social Security, Medicare, and the 2001 and 2003 Tax Cuts, 2003-2080</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Security²</td>
</tr>
<tr>
<td>3.8</td>
</tr>
<tr>
<td>5.9</td>
</tr>
</tbody>
</table>

¹The present value of GDP through 2080 is calculated using nominal GDP growth rates and interest rates from Table VI.F7 of the 2003 OASDI Trustees Report.
²Authors’ calculations using the Social Security and Medicare Trustee reports.
³Cost of extending the 2001 and 2003 tax cuts obtained from CBO (2004) and assuming the revenue loss remains a constant share of GDP after 2014. The resulting stream is discounted to 2003 dollars and summed.
⁴Authors’ calculations using the Tax Policy Center Microsimulation Model to determine the costs of AMT reform through 2014 and CBO (2004) data for the other tax cuts, and assuming the combined revenue loss remains a constant share of GDP after 2014. The resulting stream is discounted to 2003 dollars and summed.

- A 53 percent cut in all spending other than defense, homeland security, Social Security, Medicare, and Medicaid;
- An 80 percent cut in all domestic discretionary spending;
- Complete elimination of all income support programs plus a 22 percent cut in Social Security benefits;
- A 34 percent increase in payroll taxes; or
- A 124 percent increase in corporate tax revenues.

Tax cuts are often portrayed by the administration as painless and simply “giving people their money back.” But the numbers above indicate that tens of millions of people would be hurt by tax cuts that are financed by spending reductions or other revenue increases (and tax cuts that are financed by borrowing merely impose burdens on an even greater number of members of future generations). In addition, to the extent that the tax cuts are financed with spending cuts or increases in payroll taxes, the net effect will be to make the package even more regressive than the tax cut per se.

### IV. Long-Term Costs

As the administration states in its current budget, “Federal responsibilities extend well beyond the next five or ten years and problems that may be small in that time frame can become much larger if allowed to grow.” (Analytical Perspectives, page 190). Although the costs of making the tax cut permanent over the next five to ten years are not small, the costs are even larger over longer periods. One of the accounting conventions typically employed in federal budgets — looking at the costs of tax cuts over ten years, but looking at the costs of Social Security and Medicare reforms over 75 years — tends to give a misleading picture of the relative importance of the various programs. In particular, the administration uses this convention misleadingly, to claim that the entitlement programs are “the real
modest AMT fix discussed above. The table shows that the tax cuts would be regressive. That should not be surprising, since the original tax cuts were regressive. The cuts provide a larger percentage increase in after-tax income for high-income households than for low-income households. If the tax cuts were made permanent, filers with income in the top 1 percent would receive a 9.2 percent increase in after-tax income, and filers in the middle 60 percent of the income distribution would receive between a 2 and 2.7 percent increase in after-tax income. Filers in the bottom quintile would receive an increase of just 0.1 percent of income.

To determine whether a tax cut is progressive or regressive requires looking at the percentage changes in after-tax income by income class, as above. But attention also naturally focuses on other measures. Table 7, for example, shows similar calculations by income level. Taxpayers with income above $1 million would receive average annual tax cuts of $144,000. Note that this does not include the estate tax. This is higher than the income of about 94 percent of tax filing units. All of those figures are consistent with the view that the share of tax cuts going to high-income households exceeds their pre-2001 share of federal tax payments.

An important caveat to those figures is that they do not include the effects of any spending programs that would be reduced to pay for the tax cuts. As emphasized above, a permanent tax cut must be financed either with spending cuts or other revenue increases. Given that the proposed tax cuts would reduce the most progressive taxes in the system, it is unlikely that any new revenue source would be as progressive as the ones being reduced. In addition, to the extent that spending is reduced, the changes are likely to hit lower-income families much harder than higher-income households.

For all of those reasons, the ultimate distribution of the burden of the tax cuts — plus the financing — is likely to be even more regressive than just the tax cut itself. Also, given the very small benefits from the tax cut accruing to low-income households, it is quite likely that those households would be unambiguously worse off, once the financing is taken into consideration, if the tax cuts are made permanent.

(Text continued on p. 1288.)
### Table 6
#### The Effect of Extending the Bush Tax Cuts and Indexing the AMT in 2005<sup>1</sup>
#### Distribution of Income and Estate Tax Changes by Percentile, 2011

<table>
<thead>
<tr>
<th>AGI Class&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Number (thousands)</th>
<th>Percent of Total</th>
<th>Percent Change in After-Tax Income&lt;sup&gt;3&lt;/sup&gt;</th>
<th>Percent of Total Tax Change&lt;sup&gt;4&lt;/sup&gt;</th>
<th>Average Tax Change (2004$)&lt;sup&gt;5&lt;/sup&gt;</th>
<th>Average Tax Rate&lt;sup&gt;6&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Current Law</td>
<td>Proposal</td>
</tr>
<tr>
<td>Lowest Quintile</td>
<td>30,392</td>
<td>19.4</td>
<td>0.1</td>
<td>0.0</td>
<td>-2</td>
<td>-11.4</td>
</tr>
<tr>
<td>Second Quintile</td>
<td>31,338</td>
<td>20.0</td>
<td>2.0</td>
<td>3.0</td>
<td>-295</td>
<td>-3.6</td>
</tr>
<tr>
<td>Middle Quintile</td>
<td>31,339</td>
<td>20.0</td>
<td>2.6</td>
<td>7.2</td>
<td>-712</td>
<td>7.1</td>
</tr>
<tr>
<td>Fourth Quintile</td>
<td>31,338</td>
<td>20.0</td>
<td>2.7</td>
<td>13.4</td>
<td>-1,332</td>
<td>11.7</td>
</tr>
<tr>
<td>Next 10 Percent</td>
<td>15,667</td>
<td>10.0</td>
<td>3.9</td>
<td>15.6</td>
<td>-3,088</td>
<td>14.7</td>
</tr>
<tr>
<td>Next 5 Percent</td>
<td>7,835</td>
<td>5.0</td>
<td>3.9</td>
<td>10.7</td>
<td>-4,248</td>
<td>17.4</td>
</tr>
<tr>
<td>Next 4 Percent</td>
<td>6,266</td>
<td>4.0</td>
<td>5.5</td>
<td>18.5</td>
<td>-9,169</td>
<td>22.6</td>
</tr>
<tr>
<td>Top 1 Percent</td>
<td>1,567</td>
<td>1.0</td>
<td>9.2</td>
<td>31.5</td>
<td>-62,491</td>
<td>31.1</td>
</tr>
<tr>
<td>All</td>
<td>156,689</td>
<td>100.0</td>
<td>4.4</td>
<td>100.0</td>
<td>-1,982</td>
<td>16.9</td>
</tr>
</tbody>
</table>

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1) and TPC calculations based on Treasury and JCT data.

* Less than 0.05%.

**Baseline is current law.

*Returns with negative AGI are excluded from the lowest income class but are included in the totals. Percentile breaks are: second quintile $8,795; third quintile $24,665; fourth quintile $46,807; next 10 percent $90,784; next 5 percent $134,455; next 4 percent $185,298; top 1 percent $423,493.

*Both filing and nonfiling units are included. Filers who can be claimed as dependents by other filers are excluded.

*Income tax and estate tax, net of refundable credits, as a percentage of average AGI.

### Table 7
#### The Effect of Extending the Bush Tax Cuts and Indexing the AMT in 2005<sup>1</sup>
#### Distribution of Income Tax Change by AGI Class, 2011

<table>
<thead>
<tr>
<th>AGI Class (2003 dollars)&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Number (thousands)</th>
<th>Percent of Total</th>
<th>Percent With Tax Cut</th>
<th>Percent Change in After-Tax Income&lt;sup&gt;3&lt;/sup&gt;</th>
<th>Percent of Total Income Tax Change&lt;sup&gt;4&lt;/sup&gt;</th>
<th>Average Tax Change (2004$)&lt;sup&gt;5&lt;/sup&gt;</th>
<th>Average Income Tax Rate&lt;sup&gt;6&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Current Law</td>
<td>Proposal</td>
<td></td>
</tr>
<tr>
<td>Less than 10</td>
<td>36,528</td>
<td>23.3</td>
<td>6.1</td>
<td>0.2</td>
<td>0.1</td>
<td>-7</td>
<td>-10.8</td>
</tr>
<tr>
<td>10-20</td>
<td>24,300</td>
<td>15.5</td>
<td>85.9</td>
<td>2.2</td>
<td>3.3</td>
<td>-351</td>
<td>-3.0</td>
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<tr>
<td>20-30</td>
<td>19,199</td>
<td>12.3</td>
<td>98.6</td>
<td>2.8</td>
<td>4.9</td>
<td>-671</td>
<td>5.3</td>
</tr>
<tr>
<td>30-40</td>
<td>14,727</td>
<td>9.4</td>
<td>99.5</td>
<td>2.4</td>
<td>4.4</td>
<td>-780</td>
<td>8.9</td>
</tr>
<tr>
<td>40-50</td>
<td>10,819</td>
<td>6.9</td>
<td>99.6</td>
<td>2.4</td>
<td>4.1</td>
<td>-981</td>
<td>10.6</td>
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<td>50-75</td>
<td>18,843</td>
<td>12.0</td>
<td>99.7</td>
<td>2.8</td>
<td>11.2</td>
<td>-1,553</td>
<td>12.2</td>
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<tr>
<td>75-100</td>
<td>12,213</td>
<td>7.8</td>
<td>99.8</td>
<td>3.8</td>
<td>13.5</td>
<td>-2,900</td>
<td>14.2</td>
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<td>100-200</td>
<td>14,670</td>
<td>9.4</td>
<td>99.9</td>
<td>3.8</td>
<td>23.7</td>
<td>-4,226</td>
<td>17.6</td>
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<tr>
<td>200-500</td>
<td>3,591</td>
<td>2.3</td>
<td>99.8</td>
<td>4.2</td>
<td>12.7</td>
<td>-9,260</td>
<td>24.2</td>
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<tr>
<td>500-1,000</td>
<td>563</td>
<td>0.4</td>
<td>99.9</td>
<td>5.9</td>
<td>6.2</td>
<td>-28,777</td>
<td>28.9</td>
</tr>
<tr>
<td>More than 1,000</td>
<td>290</td>
<td>0.2</td>
<td>99.8</td>
<td>6.9</td>
<td>15.9</td>
<td>-143,907</td>
<td>30.0</td>
</tr>
<tr>
<td>All</td>
<td>156,689</td>
<td>100.0</td>
<td>75.1</td>
<td>3.7</td>
<td>100.0</td>
<td>-1,670</td>
<td>16.3</td>
</tr>
</tbody>
</table>


* Less than 0.05 percent.

**Baseline is current law.

* Returns with negative AGI are excluded from the lowest income class but are included in the totals.

* Both filing and nonfiling units are included. Filers who can be claimed as dependents by other filers are excluded.

* After-tax income is AGI less estate tax and individual income tax net of refundable credits.

* Average income tax, net of refundable credits, as a percentage of average AGI.
VI. Economic Growth

Making the tax cuts permanent now would have differing effects on the economy in the immediate aftermath of passage, in the first few years after 2010, and in the longterm. Essentially, the immediate effect would likely be negative, the effects in the first few years after 2010 would likely be positive, and a variety of studies show that the long-term effects would be negative (unless the tax cuts were financed entirely by spending cuts, and even in that case, the effects might still be negative, depending on which components of spending were cut).

A. Immediate Effects

Making the tax cuts permanent would be a delayed tax cut. Even The Wall Street Journal (2002), a staunch advocate of tax cuts, observes that “delayed tax cuts depress the economy.” Economic evidence supports this view as well. For example, financial markets would quickly transmit the effects of higher expected future deficits into higher current long-term interest rates (Elmendorf and Reifschneider 2002, Gale and Orszag 2002), which dampen interest-sensitive consumer demand and business investment. There would be no boost in current after-tax income, though, as would occur from an immediate tax cut and hence it is unlikely there would be any countervailing factor boosting consumer spending. Nor is it likely that work effort would change much in anticipation of lower future tax rates, but note that if it did, it would decline, not rise, since lower future tax rates, if anything, make work in the future more attractive than work today.

The effects on corporate decisionmaking could be more positive, but this is mitigated by two factors. First, the bulk of the administration’s proposals have little direct effect on corporate finances. Second, even if the tax cuts are extended, there is no guarantee that rates would remain at the lower levels, and in fact good reason to believe they will not. The reason is that extending the tax cuts would significantly exacerbate the imbalance between projected federal spending and revenues (see section IV) and hence would require an even larger eventual fiscal adjustment than is currently needed to restore balance. Extending the tax cuts would shift the timing or nature of the underlying uncertainty, but by raising the overall needed adjustment, it is hard to claim the tax cut would reduce the level of uncertainty.

B. Short-Term Effects After 2010 and Long-Term Effects

In evaluating the effect of extending the tax cuts after 2010, it is important to distinguish the first few years of the extension from the ultimate effect. The reason is that tax cuts combine economic stimulus (higher after-tax income) and generally improved economic incentives (lower marginal tax rates) with increased deficits (which reduce national saving). The short-term benefit can come from both supply-side effects (to the extent that lower marginal tax rates encourage more work, saving, and investment) and from demand-side effects (the rise in after-tax income can boost spending, and if the economy is operating below capacity, the short-term stimulus from a tax cut is beneficial).

Over time, however, the adverse effects from deficit-financed tax cuts build, and so the economic cost of extending the tax cuts would gradually rise after 2010. Thus, relative to not extending the tax cuts, extension may exert a modest positive effect on the economy for a short period after 2010, before the negative consequences from the larger deficits rise and eventually dominate the overall effect.

The distinction between the short-term effects after 2010 and the long-term effects of making the tax cuts permanent can be elaborated by examining the estimated effects of the already existing tax cuts. Both the existing tax cuts and the prospective permanent extension of them can provide short-term boosts to the economy, but are likely to exert a negative effect on the economy in the long run. That is exactly the pattern reported by a variety of studies. CBO (2003) finds that, “The revenue measures enacted since 2001 will boost labor supply by between 0.4 and 0.6 percent from 2004 to 2008 and up to 0.2 percent in 2009-2013 . . . but the tax legislation will probably have a net negative effect on saving, investment, and capital accumulation over the next 10 years . . . . The laws’ net effect on potential output . . . will probably be negative in the second five years.” The JCT (2003) estimated that a plan very similar to the 2003 tax cut would boost GDP in the shortrun, but would end up reducing GDP relative to the baseline in the second half of the decade. Although the JCT does not report results beyond the 10-year window, the language implies that the growth effect would continue to decline.

Thus, the net effects of making the tax cuts permanent would be that output would rise somewhat in the period immediately after 2010, but that in the longterm, output would decline below what it otherwise would have been. Again, that is exactly what

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7Souleles (2002) shows that consumers did not raise their spending in response to the Reagan tax cuts, which were phased in, until the cash was in hand.
8We focus on 2010 because that is the year when the vast bulk of the provisions expire.
9Despite that fact, there is little evidence that the recent tax cuts have been the source of much of the recent spurt in economic activity. For example, Economy.com ascribes only about 1 percentage point of the 8 percent annual GDP growth rate in the third quarter of 2003 to tax cuts, with the rest due to monetary policy, government spending, a gradual reduction of structural imbalances, the resolution of economic uncertainty and pent-up investment demand, and the technology cycle (substantial replacement investment occurring 3–4 years after the pre-Y2K investment spurt).
10For example, after noting that the residential capital stock falls but nonresidential capital rises in the first 10 years (with the overall capital stock falling, as best we can estimate), JCT notes that “the simulations indicate that eventually the effects of the increasing deficit will outweigh the positive effects of the tax policy, and the build up of private nonresidential capital stock will likely decline.” Thus, in the longer run, the JCT analysis of Ways and Means Chair William Thomas’s foresees rising deficits, and declining residential and nonresidential capital stocks. Taken together, those imply declining GDP and GNP over time.
several studies show. In a variety of models, researchers generally have found that the net effects of the tax cuts on long-term growth will prove negative unless they are financed completely by cuts in unproductive spending (See Auerbach 2002, CBO (2002), Gale and Potter 2002, Elmendorf and Reifschneider 2002, and Orszag 2004).11

The distinction between short-term effects after 2010 and long-term effects also helps to clarify a set of CBO statements that some have found confusing and have misinterpreted. CBO (2004, page 2) notes that “The expiration of EGTRRA is estimated to reduce economic growth slightly after 2010.” But CBO Director Douglas Holtz-Eakin was quoted as saying that the net effect of extending the tax cut on long-term growth would be “modestly negative” (Catts 2004. See also Andrews 2004 and Weisman 2004). These statements are not contradictory. They are consistent with the notion that making the tax cuts permanent would provide a short-term boost to the economy after 2010, but that the long-term effects are negative. That finding is consistent with all of the analysis above, including the CBO’s (2002, 2003).

VII. Concluding Comments

The 2001 tax cut was designed in late 1999 and was a centerpiece of the president’s electoral campaign in 2000. Much of the 2003 tax cut was a partial, albeit temporary, acceleration of the 2001 tax cut. Now the administration proposes making those two tax cuts permanent. It is astonishing that, almost five years after the proposal was first made public, the administration has still not released an economic analysis of the long-term effects of the tax cuts or even a statement of how it intends to pay for the tax cuts. Even supporters of the tax cut would presumably like to know the answers to those questions.

Our research and that of others reveals the following principal conclusions:

• Despite a forecast at the time of ever-growing surpluses over the next 10 years, members of Congress were sufficiently concerned about the affordability of the president’s tax cuts in 2001 that they scaled back the proposal and made it temporary. Three years later the budget situation has deteriorated enormously and the legislated tax cuts themselves are much less affordable, to say nothing of making them permanent.

• The effects of making the tax cuts permanent depend critically on how the tax cut is financed. A permanent tax cut must be paid for with current and future tax increases, current and future spending cuts, or increased borrowing. Borrowing postpones, but does not eliminate, the need to raise taxes or cut spending.

References


Footnotes:

11Unproductive spending refers to spending that has no effect on investment or productivity. It thus does not include items like education, health care, infrastructure development, environmental protection, and many other government programs.
COMMENTARY/TAX BREAK

Congressional Budget Office. 2004b. “Preliminary Results of CBO’s Analysis of the President’s Budgetary Proposals for Fiscal Year 2005.” February 27.


