Joint Economic Committee Democrats

Representative Pete Stark (D-CA) – Ranking Member

Economic Policy Brief **May 2003**

Republican Tax-Cutting Strategy Fails the Economy

The American economy is "soggy," according to Treasury Secretary John Snow. One reason is that the President and the Republican Congress continue to pursue trickle-down policies, instead of offering a real jobs and growth plan that would get the economy back to full employment quickly without undermining long-term growth.

A true stimulus plan would be fast-acting, in order to boost aggregate demand and put people back to work quickly without hurting long-term economic growth. Far from being the best policies to get the economy back to full employment as quickly as possible while enhancing its long-term growth prospects, Republican "jobs and growth" plans provide little job-creating fiscal stimulus now when it is really needed, even as they drain national saving through swollen deficits. Their plans weaken our ability to address fundamental future retirement and health care challenges and merely pass along the responsibilities to our children and grandchildren, all for the sake of more tax cuts that primarily benefit the richest of households.

The tax cut plans passed by the House and the Senate, recently culminating in the conference agreement, originated with the President's "Jobs and Growth Initiative," a plan that would cost $726 billion in 2003-2013 (a trillion dollars when additional interest costs are counted). The conference agreement and all of the Republican plans share a common set of objectives—and a common set of flaws—that make them particularly inappropriate for addressing the real economic problems facing the American economy.

No Matter How You Gimmick It, It's Still the President's Plan

The Administration's original "Jobs and Growth" tax cut proposal had a ten-year cost of $726 billion, or $994 billion with added interest costs. The centerpiece of the plan was the exemption of dividend income from individual income taxes, which alone amounted to nearly $400 billion. Congressional versions of the President's plan have scaled back the official costs in order to satisfy moderate Republicans—who maintain that the size of the President's original version is fiscally irresponsible. The conference agreement limits the tax cut to a $350 billion budget constraint, adopting the tighter constraint of the Senate version but more of the features of the House version. Contrary to the spirit of fiscal responsibility, the conference agreement squeezed into a tighter budget constraint only by relying on gimmicks similar to those used for the 2001 tax act, with tax cuts "sunsetting" after only a few years. Without those gimmicks, the costs of this "more affordable" tax cut are nearly as high as the President's original version.

In working with Congress to obtain its dividend tax cut, the Administration suggested both phasing in various parts of their growth package as well as letting other parts expire within the budget window. Congressional Republicans ran with these ideas.

The original House plan terminated many of its features at the end of 2005, although tax cuts for dividends and capital gains continued through 2012. The Senate plan phased in a dividend exemption in two years, with a 50 percent exemption in 2003 and a full exemption in 2004-6, after which dividend income would revert to a fully-taxed status. The conference agreement basically squeezes in the more generous capital income tax cuts of the House bill into the tighter Senate budget constraint by sunsetting the House tax cuts sooner. Dividend and capital gains tax cuts terminate after 2008 instead of after 2012, while the tax cuts more likely to benefit lower-income households (expansion of the 10-percent bracket, marriage penalty relief, and increased child tax credit) sunset at the end of 2004 instead of 2005. The conference agreement also leaves out the provision in the Senate bill that would have increased the refundable child credit for more low-income families.

After passage of the original Senate version, Senator Nickles tried to defend the sunset gimmick, claiming that the sunsetting of the dividend exemption would provide a good "testing" phase for dividend tax relief. But realistically, it will be nearly impossible to cancel such generous tax breaks, whether or not they have had any positive (or negative) effect on the economy.

As a result, Congressional versions of the Administration's growth plan effectively maintain the President's centerpiece dividend tax cut, and are realistically much more expensive than their official costs indicate. Simply continuing all of the proposed tax cuts through the end of the ten-year budget window brings the cost of the House, Senate, and conference plans to nearly $700 billion, close in size to the Administration's original $726 billion proposal.

The Tax Policy Center and The Center on Budget and Policy Priorities have estimated that, ironically, the true permanent ten-year cost of the House and conference plans is greater than the President's original growth plan, and could reach over $1 trillion (even without counting added interest costs) through 2013. While the President's original plan proposed to cut taxes on dividends and capital gains from corporate earnings that were already taxed at the corporate level, the House and conference plans actually go further by sharply reducing taxes on all capital gains and dividends, not just those from previously taxed corporate earnings.

Would the Republican Tax Cuts Really Create Jobs?

No. The Republican tax cuts are not well suited to stimulating employment growth over the near term.

Most economists recognize that the policies which work best at reviving growth and putting people back to work in a slumping economy are not the same as the policies that work best at promoting and maintaining sustainable long-term growth and a rising standard of living. The goal of the former is to stimulate purchases of goods and services immediately. Consumption is valued over saving when trying to get the economy out of a short-term slump, whereas encouraging saving is the priority when the goal is to promote stronger long-term growth. Slumps are relatively rare in the modern U.S. economy, but we are in one now and our first priority should be to avoid the economic waste associated with excess unemployment and underutilized industrial capacity.

Alternative tax and spending policies have varying impacts on jobs and growth. In a "soggy" economy, with excess unemployment and idle industrial capacity, the immediate problem for policy is weak demand for goods and services. An appropriate response is to stimulate purchases of goods and services by putting money in the hands of people who will spend it quickly. Government spending is best suited to that task, but targeted tax cuts could also work to the same effect.

Table 1

Description of Tax Cut Packages

	Administration	House	Senate	Conference Agreement
Individual provisions				
Cuts in the upper-bracket tax rates.	Accelerate the reduction in the top four tax rates scheduled to take place in 2004 and 2006. The rates would drop from 38.6, 35, 30, and 27 percent to 35, 33, 28, and 25, respectively, retroactive to January 1, 2003.	Same as the Administration.	Same as the Administration.	Same as the Administration.
Increase in the income limits for the lowest income tax bracket	Accelerate the increases in the income limits for the 10 percent income tax bracket scheduled to take effect in 2008. The income limits would increase from $12,000 to $14,000 for married couples and from $6,000 to $7,000 for single filers. No change for head of household filers.	Same as the Administration for 2003-2005. **Sunsets after 2005.**	Same as the Administration.	Same as the Administration for 2003 and 2004. **Sunsets after 2004**.
Tax cuts for certain married couples filing joint returns.	Accelerate the increase in the standard deduction and the end point of the 15 percent tax bracket for married couples scheduled to effect in 2008 and 2009. Scheduled increase in the start of the EITC phase-out range for married couple not accelerated. The standard deduction for married couples would increase to twice the standard deduction for singles. The end point of the 15 percent tax bracket would increase to twice the end point for singles.	Same as the Administration for 2003-2005. **Sunsets after 2005.**	Increases the standard deduction and the end point of the 15 percent tax bracket for married couples to 195 percent of the amount for singles in 2003 and to twice the amount for singles in 2004. **Sunsets after 2004**.	Same as the Administration for 2003 and 2004. **Sunsets after 2004**.
Increase in the child tax credit	Accelerate increase in child credit scheduled to take effect in 2010. The child tax credit would increase from $600 to $1,000 per child starting in 2003.	Same as the Administration for 2003-2005. **Sunsets after 2005.**	Same as the Administration, but also accelerates the scheduled increase in the child credit refundability rate. The refundability rate would increase from 10 percent to 15 percent.	Same as the Administration for 2003 and 2004. **Sunsets after 2004.**
Temporary AMT relief	Raise the individual alternative minimum tax exemption by $8,000 for married couples and $4,000 for singles. **Sunsets after 2005.**	Raise the individual alternative minimum tax exemption by $15,000 for married couples and $7,500 for singles. **Sunsets after 2005.**	Raise the individual alternative minimum tax exemption by $11,500 for married couples and $5,750 for singles. **Sunsets after 2005.**	Raise the individual alternative minimum tax exemption by $9,000 for married couples and $4,500 for singles. **Sunsets after 2004**.

Table 1(continued)

Description of Tax Cut Packages

	Administration	House	Senate	Conference Agreement
Reduce taxes on dividends and capital gains				
	Exempt dividends that were fully taxed at the corporate level from individual income tax. Corporate earnings that were fully taxed but not distributed as dividends would increase the basis of corporate stock, lowering future individual income taxes on capital gains.	Tax all dividends and capital gains at a 15 percent rate (5 percent for taxpayers in the two lowest tax brackets.). **Sunsets after 2012.**	Exempt 50 percent of all dividends from individual income tax in 2003. Exempt 100 percent of all dividends from income tax starting in 2004. **Sunsets after 2006**.	Tax all dividends and capital gains at a 15 percent rate (5 percent for taxpayers in the two lowest tax brackets in 2003-2007. 0 percent rate for taxpayers in the two lowest tax brackets in 2008.) **Sunsets after 2008**.
Business Incentives				
Increase expensing for small business	Increase the amount of investment that small business can deduct immediately (expense) from $25,000 to $75,000. Increase the income level above which the expensing limit phases out from $200,000 to $325,000	Increase the amount of investment that small business can deduct immediately (expense) from $25,000 to $100,000. Increase the income level above which the expensing limit phases out from $200,000 to $400,000. **Sunsets after 2007.**	Same as the House	Increase the amount of investment that small business can deduct immediately (expense) from $25,000 to $100,000. Increase the income level above which the expensing limit phases out from $200,000 to $400,000. **Sunsets after 2005**.
Temporarily extend 5-year net operating loss carryback	No provision	Extend the 5-year net operating loss carryback through 2005. Waive the alternative minimum tax 90 percent limitation on the allowance of losses. **Sunsets after 2005.**	No provision	No provision
Temporarily expand and extend bonus depreciation	No provision	Increase the portion of business investment that can be immediately deducted to 50 percent. **Sunsets after 2005.**	No provision	Increase the portion of business investment that can be immediately deducted to 50 percent. **Sunsets after 2004.**
Other Provisions				
State fiscal relief	No provision	No provision	$10 billion for Medicaid assistance, $6 billion for state governments and $4 billion for local governments.	$10 billion for Medicaid assistance and $10 billion for state governments.
Revenue offsets	No provision	No provision	Includes $35 billion from repealing the exclusion for foreign earned income, $18 billion from extension of certain custom fees, and $19 billion from curtailing tax shelters.	No provision

Table 2

Total Cost of the Tax-Cut Packages in 2003-2013
(Billions of dollars)

	Administration	House	Senate	Conference Agreement	Conference Agreement without sunsets
Individual provisions					
Accelerate reduction in upper bracket tax rates	74	74	74	74	74
Accelerate the expansions of the 10% bracket	45	19	45	12	45
Accelerate tax cuts for certain married couples	55	43	28	35	55
Accelerate increase in child credit to $1,000	90	45	93	33	90
Temporarily increase the AMT exemption	37	53	49	18	18
Total for individual provisions	301	234	290	172	282
Reduce taxes on dividends and capital gains					
Total	396	277	124	148	305
Business Incentives					
Increase expensing for small business	29	3	3	1	34
Temporarily extend 5-year net operating loss carryback	na	15	na	na	na
Temporarily expand and extend bonus depreciation	na	22	na	9	9
Total for business incentives	29	39	3	10	43
Other provisions					
State fiscal relief	na	na	20	20	20
Simplification and other provisions	na	na	5	na	na
Revenue offsets	na	na	-93	na	na
Total	726	550	350	350	650

Source: Joint Committee on Taxation (JCT) and the Joint Economic Committee Democratic Staff.
Note: Estimates for the Administration, House, Senate, and Conference agreement proposals are from the JCT. The estimate for the Conference agreement without sunsets assumes that all individual provisions except the temporary increase in the AMT exemption are extended for the full budget period, subject to the sunset of all provisions of the 2001 Tax Act after 2010. The estimate also assumes that the increase in expensing limits for small business and the reduction in the tax rates on dividends and capital gains extend beyond 2013.

But the tax cuts favored by Republicans are not designed to help the economy now. They provide less job-creating stimulus now when it is needed the most than the Democratic alternatives. Moreover, they provide unnecessary and counterproductive stimulus once the economy is back to full employment; and they diminish future income by swelling the public debt and inhibiting investment.

Analyses of the job-creating stimulus from various tax cut or spending policies rank dividend or capital gains tax relief at the bottom in terms of effectiveness. For example, the private economic forecasting and consulting firm Economy.com estimates that the dividend tax relief in the President's program has almost no effect on GDP and jobs in the first year (9 cents of GDP per dollar of revenue loss, compared with $1.73 of GDP per dollar of extended unemployment benefits). In its analysis of the effects of changes in tax policy, the Congressional Budget Office found that capital gains tax cuts would mostly be saved, and hence would have only a small impact on purchases of goods and services and hence on jobs.

Most economists believe that tax cuts or spending increases that directly raise the disposable income of low- and moderate-income families are far more likely to be spent (and hence generate jobs and growth immediately) than tax cuts for higher-income taxpayers. The Republican proposals are heavily tilted toward higher-income taxpayers; the Democratic alternatives are more balanced.

Analysis by the Democratic staff of the Joint Economic Committee confirms these observations. The Democratic plans provide roughly twice the number of new jobs this year as the Republican plans (1.1 million versus 600,000 jobs by the end of 2003). The Democratic plans do not provide stimulus in subsequent years, because, once the economy is back to full employment, such stimulus is no longer needed. In contrast, the Republican plans continue to stimulate the economy in coming years and would most likely be offset completely by tighter monetary policy, which would produce higher interest rates but no additional jobs or growth. Moreover, as discussed below, the Republican plans increase the public debt, drain national saving, and weaken economic growth in the longer term.

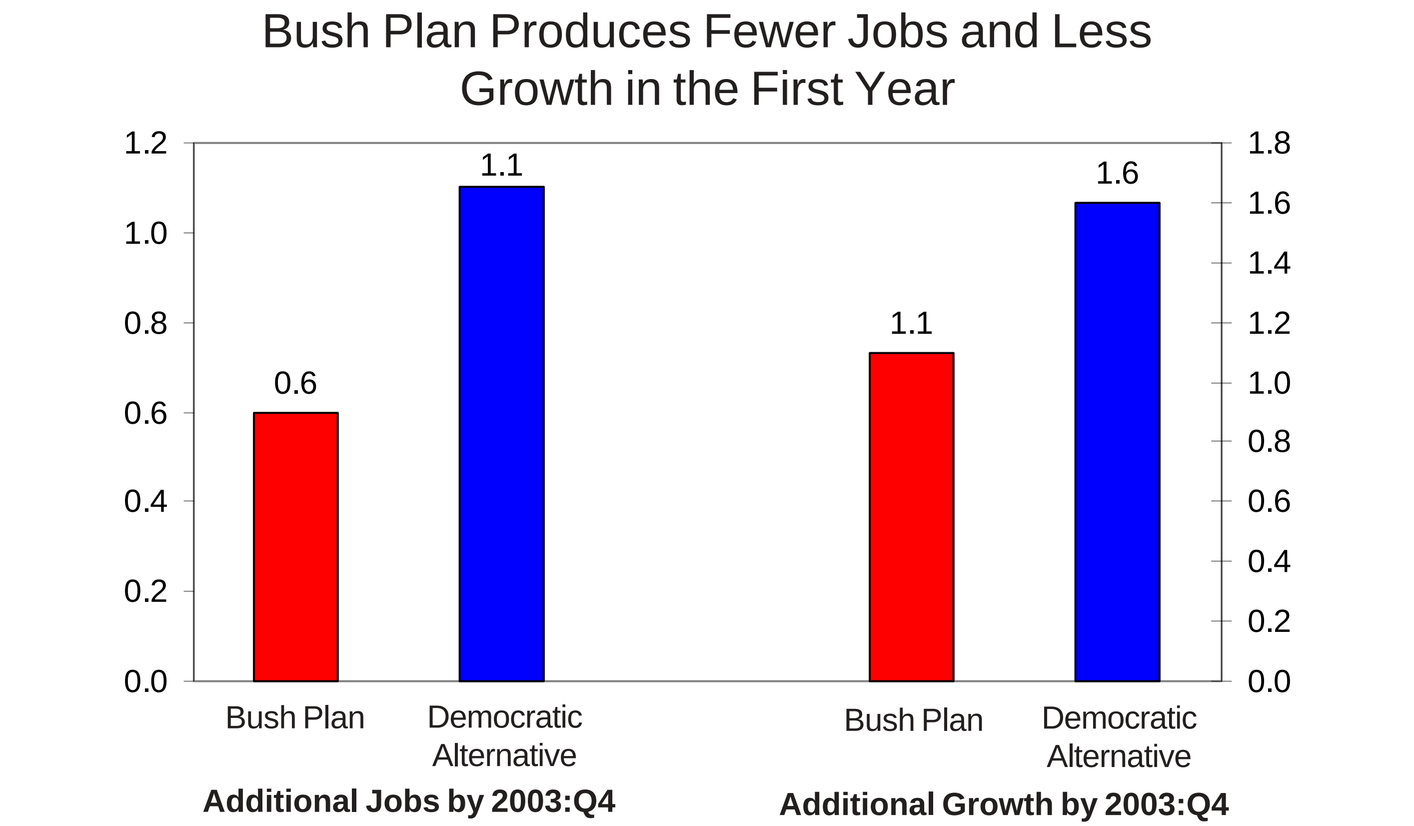
Would the Republican Tax Cuts Really Boost Long-Term Economic Growth?

No. The Republican tax cut plans would hurt our nation's longer-run economic prospects by reducing national saving and the funds available for investment.

By themselves, some kinds of tax cuts, such as reductions in marginal tax rates or reductions in taxes on investment, might contribute to long-term growth by encouraging labor force participation and capital formation. But even conservative economists who believe that the private sector is quite responsive to changes in tax rates do not believe that these responses would be so large as to offset the effects on the budget deficit. Public saving surely goes down a lot, while private saving may rise—but only by a little and with much greater uncertainty. Thus, the Bush tax-cut agenda will be harmful to national saving and economic growth. Contrary to the claims that Republican plans would provide a bigger boost to the longer-run economy, in fact, they would do much more harm than good.

The immediate effect of an extra dollar of federal borrowing to finance a tax cut is a one dollar reduction in the amount of national saving available to finance productive private investment. Private borrowers will then compete against each other for the available funds, raising interest rates. Three things can happen: some borrowers might decide that their investment is not worth undertaking at the higher borrowing cost; some additional private domestic saving might be forthcoming at the higher interest rate; and some foreigners may decide to lend more in the United States because of the higher interest rates.

Chart 1



The President's Council of Economic Advisers has estimated that the private saving response will be negligible, but that each dollar of debt will stimulate 40 cents of foreign capital inflows (purchases of U.S. assets that provide the funds to finance new investment). However, domestic investment financed by foreign borrowing makes a much smaller contribution to future domestic national income (and the U.S. standard of living) than domestic investment financed by U.S. domestic saving. Most of the earnings of that investment must be paid to the foreign lenders. Thus, irrespective of the impact on interest rates, increases in federal borrowing lead to less domestically financed investment and slower growth in national income.

An analysis by the JEC Democrats using macroeconomic models that account for the private saving response as well as the higher deficits found that because of its long-run budgetary costs, the President's original plan (with its $726 billion price tag) had adverse long-run supply-side effects that lowered national income in 2013 by 0.4 to 0.6 percent. If the proposal actually enacted were kept to $550 billion as required in the House, or $350 billion as required in the Senate, the adverse impact on growth would be correspondingly smaller. In fact, however, as discussed previously, Congressional plans use various gimmicks to limit the apparent size of their proposals. The true size could be as large as or larger than the President's original proposal, and hence the adverse effects on growth roughly equivalent or even worse.

The net negative impact of large tax cuts on the longer-run economy is a common finding under various types of macroeconomic models. Analyses by Professor Alan Auerbach (UC Berkeley) and Federal Reserve Board economists Doug Elmendorf and David Reifschneider found negative effects of the 2001 Bush tax cut on the longer-run economy. In their most recent (March 2003) analysis of the President's budget, the Congressional Budget Office found adverse macroeconomic effects if tax cuts are not paid for—that a proper "dynamic scoring" would raise, not lower, the costs of the Administration's tax proposals. Most recently (5/8/03), the Joint Committee on Taxation released estimates of the macroeconomic effects of the House Republican (H.R. 2) version of the Administration's jobs and growth plan, and found only negative effects on real economic activity and employment over the longer run (2009-13).

Economic theories that claim that private saving should fully make up for drops in public saving are unsupported by experience. What did we learn from the Reagan era and the fiscal discipline of the 1990s? The Reagan tax cuts pulled down both public saving and national saving; the tax cuts failed to generate the large supply-side responses that had been claimed by the proponents of the cuts. In 1993, President Clinton raised taxes to address the huge deficit problem, but the economic stagnation predicted by Republicans never happened; instead, the boost to public saving raised national saving and overall economic growth as well.

New Justifications for the Same Old Tax Cuts for the Rich

The Republican proposals are unfair and are heavily tilted toward the very top of the income distribution. Before the 2001 tax cut, the justification for large tax cuts for the rich was that we were simply "returning the people's money" and getting rid of surpluses that were too big, and the rich were the ones who paid the most in taxes (because they had an even larger share of income).

After the tax cut, the terrorist attacks, and the acknowledged recession, the justification for large tax cuts for the rich was that they were the people who would most likely spend their tax cuts—for short-term stimulus—but most likely save their tax cuts, too. Both can't be possible. What economic theory as well as empirical analyses tell us is that higher-income households actually save larger fractions of their income than other households, because they can afford to. So the short-term stimulus argument is unfounded. But the longer-term growth effects through the additional saving of high-income households are doubtful as well. Even though high-income households will indeed save some of their extra income, it is not clear that they would save a higher fraction of it than the public sector would have in lieu of the tax cut.

Now the message is job creation. The Republicans now claim that it takes money to create jobs, so that only through tax cuts for the rich will jobs be created. But most of the Republican's proposed income tax cuts reward capital owners (primarily the rich) without directly encouraging new capital investment or higher output. Such tax cuts can't be expected to create new jobs (even over the longer run) if they don't encourage output. Furthermore, to the extent that some of the tax cuts do reduce the cost of capital facing businesses, some businesses may be encouraged to substitute capital for labor without increasing their output, so that jobs are lost rather than gained. If the goal of the tax cut is really job creation, the tax cuts should be designed to directly encourage businesses to hire more workers.

The lion's share of the tax cuts enacted in 2001 already went to the very richest of households, particularly the tax cuts scheduled to take effect after 2002. By 2010 when the 2001 tax cut is fully phased in, over a third of the tax cut goes to the richest 1 percent of households, while less than one fourth goes to the entire bottom 60 percent. Despite this, the Administration proposed additional tax cuts that would clearly benefit only high-income households: the dividend tax exclusion (introduced as part of the "growth and jobs" plan) and the new savings incentives (proposed in the President's budget). As part of their growth and jobs package, the Administration also proposed to accelerate the portions of the 2001 tax act that highest-income households benefit the most from (rate reductions), while leaving unchanged (continuing to phase in slowly) elements of the 2001 tax cut that most benefit lowest-income families with children.

In advertising just how "fair" their growth package is, the Administration has repeatedly relied on the average tax cut statistic, stating that households will "on average" receive a tax cut of over $1000 in 2003. But this is far greater than what a typical household near the middle of the income distribution (a "median income" household) would receive; in fact, four-fifths of households would receive less than this amount. According to the Urban-Brookings Tax Policy Center, the middle 20 percent of households would get tax cuts averaging only $200 in 2003 from the President's plan. Meanwhile, households in the top 1 percent would enjoy an average tax cut of over $20,000, and millionaires would get tax cuts averaging about $90,000.

The congressional conference agreement keeps the spirit of the Administration's proposals—"leave no millionaire behind." Largely adopting the features of the original House plan, the conference version is even more tilted toward the very wealthy than the President's growth plan, because it replaces the President's dividend exclusion with a tax cut for all dividends and capital gains. Capital gains are even more concentrated at the top of the income distribution than dividends. Republicans like to argue that most households have at least some dividend or capital gains income, but this obscures the fact that most households have very small amounts of such income, and the wealthiest households receive most of this income. (The top five percent of households receives 75 percent of the benefits from reducing both capital gains and dividend taxes, and 64 percent of the benefits from the President's dividend tax cut.) According to the Tax Policy Center, under the House's capital gains and dividend tax cut (and hence under the conference agreement as well), millionaires would receive an average cut of over $40,000 in 2004 alone, while they would receive an average cut of around $30,000 from the President's dividend proposal. The conference agreement has the same capital gains and dividend tax cut, except that it sunsets sooner (after 2008 instead of after 2012) and for 2008 alone completely eliminates the capital gains and dividend tax for households in the bottom two tax brackets.

Republicans claim the five- or even zero-percent tax on capital gains and dividends for lower-income households makes their plan fair. But this is only a symbolic gesture of very little substance, because a zero rate can't help households that have none or little of that kind of income. Data from the Tax Policy Center indicate that only one out of ten households in the bottom 80 percent receives any taxable dividend or capital gains income, and that the typical tax cut for such households would be in the tens of dollars, not the tens of thousands of dollars that the millionaires would enjoy.

The conference agreement gives nearly 30 percent of the tax cut to the top 1 percent of households, but only 7 percent to the entire bottom 60 percent. The average tax cut for the over 80 percent of taxpayers with incomes of $75,000 or less is under $230. The average tax cut for millionaires is over $93,000. Appendix Table A shows the complete distribution of the tax cuts by income groups.

Top 1% of Households Get Bulk of Benefits Under Republican Tax Cuts

Share of 2003 Tax Cut Going to:

	Top 1%	Bottom 60%
Administration Proposal	28.0%	7.2%
Conference Agreement	29.1%	7.2%

Source: Urban-Brookings Tax Policy Center

Do the Republican Plans Adequately Respond to Individuals Who Have Borne the Brunt of this Recession?

No. Neither the House nor Senate versions of the stimulus proposals extend federal temporary unemployment insurance (UI) benefits, even though they expire at the end of May. The conference agreement also fails to add the extension but in separate legislation the current federal UI program is likely to be extended through the end of 2003. The House provided no assistance to the states, while the Senate bill and conference agreement provide a minimal amount of fiscal assistance to state governments.

The Long-Term Unemployed

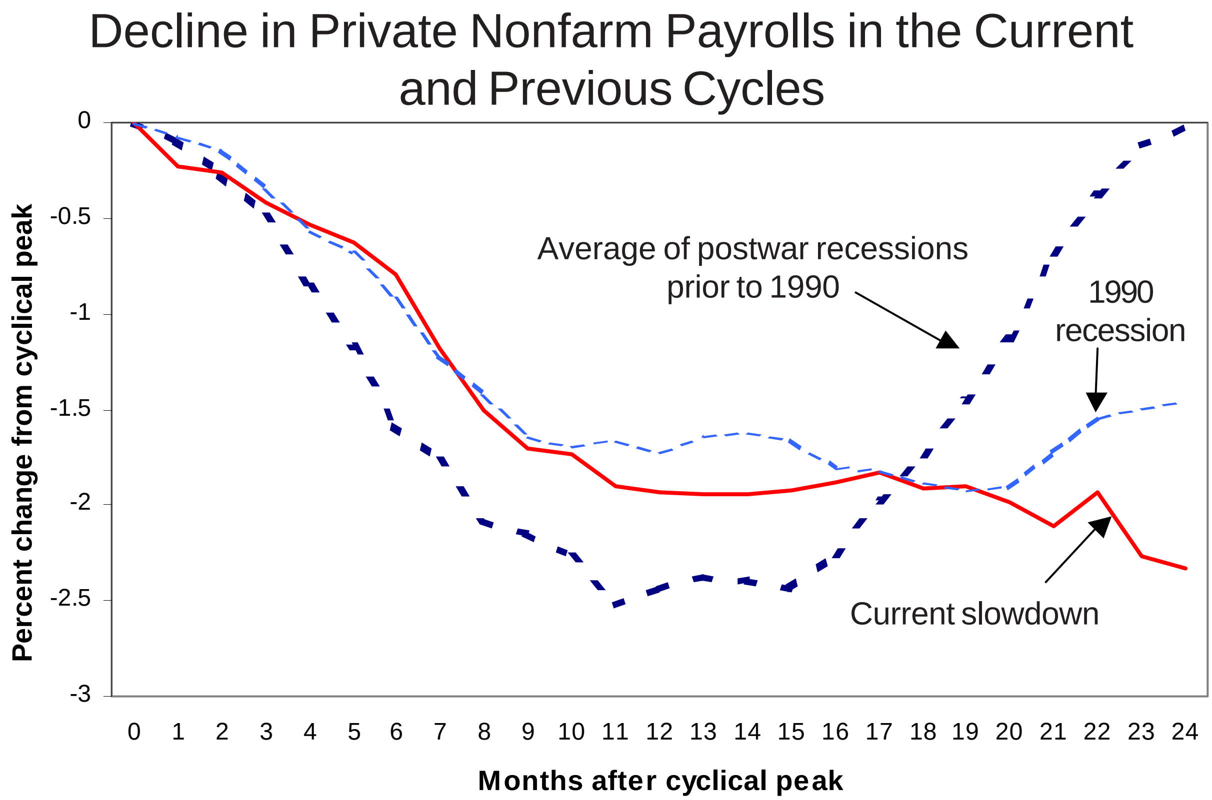
Although the temporary federal UI program will expire at the end of May for workers exhausting regular state UI benefits, neither the Administration budget, the House or the Senate Republican stimulus bills, nor the conference agreement extend the program. However, in separate legislation the current federal UI program is likely to be extended through the end of 2003. However, this separate legislation will not provide any further assistance to the approximately 1.1 million workers who have exhausted all of their unemployment benefits and still have not found work.

The unemployment rate today is 6.0 percent, higher than when the temporary federal UI program was created in March 2002, or extended in January 2003. During the last three months, over 540,000 private-sector jobs have been lost and the economy has lost 2.7 million private-sector jobs since the recession began. Private payrolls are 2.4 percent below their level in March 2001 when the recession began and job loss now exceeds that of the 1990 recession.(see chart below) On average, job losses in a recession bottom out after about 15 months and are erased within two years. The persistence of job losses at the 25-month mark in this recession is the most severe since the 1930s.

The latest employment report painted a bleak labor market picture. Overall, there are 8.8 million unemployed Americans, and about 4.4 million additional workers who want a job but are not counted among the unemployed. Another 4.8 million people work part-time because the economy is so weak. The average duration of unemployment spells rose substantially in the latest report to 19.6 weeks - the highest level since January 1984.

Yet despite this grim unemployment situation, the Republican plan does not provide additional weeks to unemployed workers who have exhausted all of their UI benefits without finding work. Initially the 1990s program was about 13 weeks more generous than today. Today, the 1990s program is at least 7 weeks more generous. A less generous program today is one of the reasons why more workers have exhausted all of their UI benefits without finding work. Thus, providing additional weeks of benefits to the 1.1 million unemployed workers who have exhausted all of their UI benefits without finding work would make the current program roughly comparable to the temporary federal UI program in the early 1990s. And the federal UI program has over $20 billion of assets paid for by workers, which now could be expended on their behalf.

Chart 2



Sources: JEC calculations using data from the U.S. Department of Labor and the National Bureau of Economic Research.

There is simply no good economic argument for why the federal program should not provide additional benefits to these exhaustees. These unemployed workers have borne the brunt or pain of this recession. A new Hart Research survey documents these tremendous hardships: 62 percent of those unemployed for nine months or longer have substantially depleted their savings, and just over half have borrowed money to meet basic expenses. Among workers who have run out of all unemployment benefits, nearly 7 in 10 report that exhausting their benefits has had a major impact on their financial situation.

The Fiscal Crisis of the States

Every week brings a new headline – or more – announcing another state's proposed cutbacks in services or program eligibility as it responds to a worsening budget crisis. Numerous spending cuts in social programs, including Medicaid, have been announced by states as they work to close their widening funding gaps. Some 22 states have proposed or adopted cuts in Medicaid and the State Children's Health Insurance Programs (SCHIP) that would drop coverage for at least 1.7 million people if all the proposals were adopted. Yet there was not one penny in the House Republican plan to assist States.

The conference agreement amended the Senate plan to provide $20 billion of fiscal assistance to state governments. One half ($10 billion) would be used to increase the federal matching rate in the Medicaid program. The remaining $10 billion would be allocated to states on the basis of population. These funds could be used for essential government services. However, a recent analysis by the Center on Budget and Policy Priorities concludes that the proposed federal tax changes will reduce state revenues substantially (by $15 billion to $37 billion over ten years). This could leave states on net with no additional—or even fewer—discretionary funds beyond those provided through the Medicare program.

The recession that began in March 2001 has hit state budgets from both sides. Income and sales tax revenues have fallen with reduced economic activity, while the demands on social services have grown as joblessness has increased and family incomes have declined.

Wanting to avoid cuts in entitlement programs and school aid, the states used a variety of options to close their 2002 budget gaps, including draining rainy day funds (26 states), raising certain taxes and fees (23 states), laying off employees, and borrowing against expected tobacco settlement payments. But revenues in the 2003 budgets continued to decline, and some expenditures grew faster than expected, so states were facing another $49 billion in deficits, that needed to be closed. In response, states are now resorting to more drastic fiscal measures, including cuts in Medicaid, education, childcare, and public safety. Prospects for 2004 are worse: the National Conference of State Legislators estimates that 41 states will face a cumulative budget shortfall of $78 billion.

Specific examples of cuts include about 200,000 people who have already lost Medicaid coverage in Tennessee (by the state's own estimate), nearly 23,000 adults in Connecticut who will lose Medicaid coverage starting in April (partly due to lowering income eligibility requirements from 150 percent to 100 percent of the poverty threshold), and a proposed change in eligibility requirements that would affect 50,000 working-poor parents (with incomes between 80 percent and 100 percent of poverty) in Ohio. GAO recently reported that some 23 states made changes in their child care programs that decreased the availability of child care assistance.

While the federal government can engage in deficit spending to meet immediate needs, the states currently cannot. Therefore, the federal government should provide relief to the states to help states mitigate the negative impacts of the recession on poor and working families. This will also aid job creation because states could reverse their cuts and inject additional spending into the economy quickly.

Are the Republican Tax Plans Fiscally Responsible?

No. The Republican plans would exacerbate the deterioration in the budget outlook to which the 2001 Tax Act was a major contributor. The preoccupation with tax cuts is especially irresponsible in light of the impending retirement of the baby boomers. Current tax cuts will increase the fiscal burdens passed along to our children and grandchildren.

What was a $5.6 trillion 10-year surplus when the President took office has disappeared, even without counting any current proposals. According to the Senate Budget Committee (based on the latest CBO data), enactment of the President's new budget proposals would result in a $2.1 trillion 10-year deficit over the original 2002-11 period—a turn-around of an astounding $7.7 trillion.

The Administration and Congressional Republicans have repeatedly claimed that their tax cuts are not large by historic standards and that any deterioration in the budget outlook was largely out of their control. Both of those claims are contradicted by the facts.

The 2001 tax cut had a $1.9 trillion ten-year cost, including interest on the added debt. The Administration's new proposals would add another $2.7 trillion, to bring the total cost of the Bush tax-cutting agenda—just in the immediate ten-year budget window—to $4.6 trillion. However, these already-huge numbers grossly understate the cost of a fully-phased in, permanent version of the full Bush tax cut agenda, which reaches 2.3 to 2.7 percent of GDP—greater in present-value terms than the entire long-term shortfall in Social Security and Medicare.

The true cost of the 2001 tax cut alone is much greater than the official cost, because of the gimmicks of phase-ins and sunsets. In addition, many of the standard assumptions made in budget projections are unrealistic when it comes to future tax and spending policy. A particularly large bias in official estimates comes from assuming that expiring tax provisions will indeed expire and that Congress will allow the Alternative Minimum Tax to increase taxes for a larger and larger segment of the population. The official cost ignores interest costs as well. As a result, a more realistic estimate of the cost of the 2001 tax cut is much greater than the official cost—nearly $2 ½ trillion over the first ten years, much greater than the $1.35 trillion as officially scored. A fully-phased-in version of the tax cut would cost even more over 10 years—over $4 trillion, even before counting interest payments.

According to an analysis by the Center on Budget and Policy Priorities based on CBO data, the tax cuts already passed are responsible for nearly 60 percent of the deterioration in the ten-year budget outlook (2002-11). The Administration has repeatedly claimed that the deterioration was largely out of their control, but the fact is that even including the effects of the recession and other technical changes to the CBO budget forecast, the tax cuts already passed are responsible for around a third of the deterioration in the 10-year budget outlook. And this share is based on officially-scored costs, which vastly understate the true costs of the tax cuts.

The budget situation would be even worse if not for the expected surpluses from the Social Security program. Over the ten years 2002 through 2011, the CBO projects that Social Security revenues will exceed program outlays by $2.2 trillion. The deficit in the rest of the federal budget will more than consume the entire Social Security surplus. The 10-year on-budget deficit—which excludes the off-budget transactions of Social Security and the Post Service—will reach $2.6 trillion in fiscal years 2002 through 2011. The President's 2004 budget would increase the 10-year on-budget deficit over the same period to $4.3 trillion.

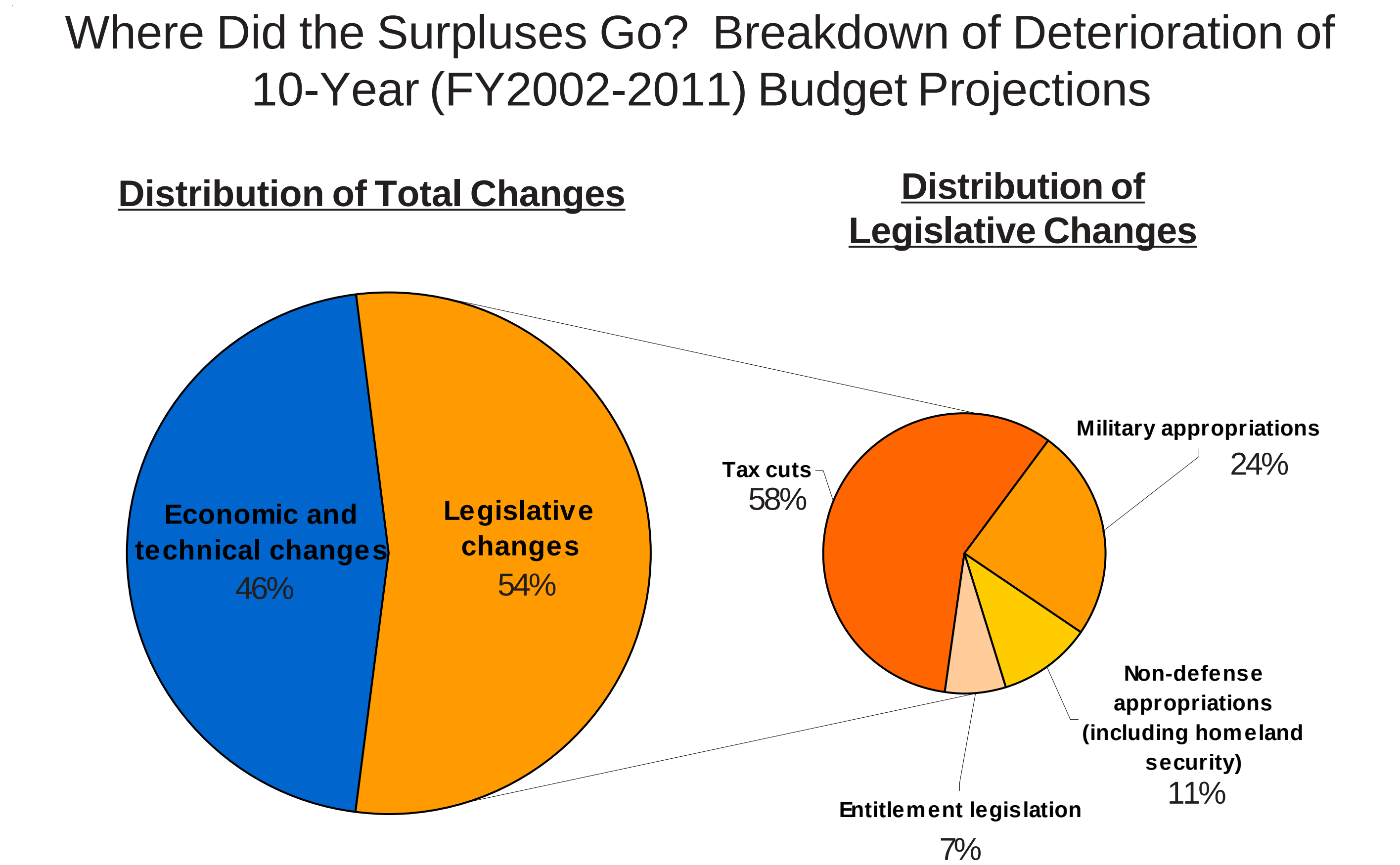
The Administration has also argued that their tax-cutting agenda is not large by historical standards, arguing that their tax cuts are similar in spirit, and smaller in size, than the Kennedy and Reagan tax cuts. But those comparisons are naïve. (See Box: "These Are Not the Kennedy or Reagan Tax Cuts")

The Administration also tries to argue that deficits don't hurt the economy, because the empirical evidence on deficits and interest rates is mixed. However, the latest research—including papers by Federal Reserve Board economists—consistently finds that a one percent increase in the long-term federal deficit as a share of GDP raises interest rates by about 25 to 50 basis points. But the effect of deficits on today's interest rates is not the essential economic problem with deficits. The true and unavoidable consequence of deficits is that they reduce national saving, reduce the resources available for productive investments, and hence reduce future economic growth.

Jeopardizing Social Security and Medicare and Sticking the Bill to Our Children

Tax cuts now mean even bigger tax increases or spending cuts later. The Bush tax cut agenda basically gambles away the income security of future generations, and for what? Current tax cuts to the rich, which Republicans claim will ultimately benefit everyone. Instead, those tax cuts will ultimately cost everyone.

Chart 3



Source: Center on Budget and Policy Priorities, based on CBO reports.

Our country's impending demographic challenge and corresponding fiscal pressures are a certainty. We were already faced with tough decisions ahead about how the retirement of the baby boomers would be made "affordable" to our government budget: either taxes will have to rise in the future, spending cut, or some combination of both. The Bush tax cut agenda is not responsible for that situation, but it surely and dramatically has made the tough problem even tougher. It makes the fiscal hole even deeper, and it unjustly pushes off most of the financial responsibility for the tax cuts and government programs we now enjoy, onto our children and grandchildren. We're putting our tax cuts on a credit card that our kids will have to pay off.

To put the long-term revenue losses from the Bush agenda in perspective, the Center on Budget and Policy Priorities has calculated that the long-run cost of the Administration's enacted and proposed tax cuts is between 2.3 and 2.7 percent of GDP, or between \$12.1 trillion and \$14.2 trillion in present value over 75 years. This amounts to more than three times the projected 75-year actuarial shortfall in Social Security.

While avoiding these huge tax cuts would not eliminate the challenges our nation faces with the impending retirement of the baby boomers, it would provide us with the resources needed to effectively strengthen the Social Security and Medicare programs. In embracing the

Administration's tax-cutting agenda, current policy makers choose to leave future generations to clean up the fiscal mess.

These Are Not the Kennedy or Reagan Tax Cuts

Republicans claim that the Bush tax cuts are smaller than the Reagan tax cuts of the 1980s, are comparable to the Kennedy-Johnson tax cuts, and will not reduce government revenue. These arguments are flawed. The reality is that Reagan increased taxes when it became clear that the budget outlook had deteriorated sharply, and Kennedy's tax cut came at a time when tax rates were extremely high and deficits small. Bush, in contrast, started with a tax system with much lower rates and has kept proposing additional tax cuts that will lead to large budget deficits. A careful comparison of the Bush tax-cut agenda with the Kennedy and Reagan experiences only exposes the weaknesses in the current Administration's position.

Kennedy cut taxes when the economic benefits were greater, while the economic costs were smaller. Before the Kennedy tax cut, the top marginal income tax rate was over 90 percent, and the tax cut reduced this to 70 percent. Today the top marginal tax rate is 38.6 percent. The potential efficiency gains from reducing very high marginal tax rates are much greater than the gains to be expected from lowering rates that are already low. Moreover, the potential cost to the economy because of the associated deficits was much smaller in the Kennedy era; when the Kennedy tax cut was enacted, the federal budget deficit was only $6 billion (much smaller than now, even as a share of GDP).

There are several lessons from the Reagan experience that the current Bush Administration has apparently chosen to ignore. The biggest lesson ignored was that deficits do matter. The budget deficits caused by the 1981 tax cut had an adverse effect on the economy. Despite having campaigned on a supply-side tax cut agenda, Ronald Reagan learned that the economic benefits of lower tax rates were outweighed by the costs of higher deficits. Reagan undid about a third of the 1981 cut with tax increases in 1982, 1983, and 1984. On net, Reagan cut taxes by about 2.1 percent of GDP, just slightly above official estimates of the Bush tax cut agenda (1.9 percent of GDP), but below more realistic estimates of the Bush agenda including some AMT reform, which would bring the Bush tax cuts up to between 2.3 and 2.7 percent of GDP.

The other lesson from the Reagan era was that the "supply-side" responses to tax cuts turned out to be disappointingly small. Instead, the largest economic effects came through the enlarged budget deficits and handcuffed monetary policy. Economic research since then has demonstrated that the adverse effects on the economy associated with the 1981 tax cut and the resulting large budget deficits outweighed any supply-side responses.

Despite the 1982 tax increase, the deficit hole that the Reagan Administration got us into took nearly two decades to get out of. Now the current Bush Administration chooses to ignore the subsequent and complementary lesson from the Clinton era: that deficit reduction can be on net a positive change for the economy, even when it has to involve tax increases.

Table 3

Administration Tax Cuts and Social Security Deficit Over the Next 75 Years

	Present Value Over the Next 75 Years, % of GDP	Present Value Over the Next 75 Years,* $ trillion
2001 tax cut if made permanent	1.5% to 1.9%	$7.9 trillion to $10.0 trillion
Dividend / capital gains proposal	0.30%	$1.6 trillion
Tax-free savings accounts	0.30%	$1.6 trillion
Other proposed tax cuts	0.20%	$1.1 trillion
Total, administration tax cuts	2.3% to 2.7%	$12.1 trillion to $14.2 trillion
Social Security actuarial deficit*	0.73%	$3.8 trillion
Medicare Hospital Insurance actuarial deficit	1.11%	$6.2 trillion
Combined Social Security and Medicare HI deficit*	1.84%	$10.0 trillion

* Assumes level of GDP and interest rates projected by Social Security actuaries.
Source: William G. Gale and Peter R. Orszag, "The Real Fiscal Danger," Tax Notes, April 21, 2003.
http://www.brook.edu/views/articles/gale/20030421.pdf

Appendix Table A

Conference Agreement on the Jobs and Growth Tax Relief Reconciliation Act of 2003: Distribution of Income Tax Change by AGI Class, 2003[1]

AGI Class (thousands of 2002 dollars)[2]	Tax Units[3]			Percent Change in After-Tax Income[3]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Income Tax Rate[4]	
	Number (thousands)	Percent of Total	Percent with Tax Cut				Current Law	Proposal
Less than 10	32,978	23.7	0.7	*	*	-1	-9.7	-9.7
10-20	23,022	16.6	45.2	0.3	1.2	-53	-3.9	-4.3
20-30	18,524	13.3	87.8	0.8	3.5	-189	3.5	2.8
30-40	13,431	9.7	92.6	1.0	4.4	-323	6.9	6.0
40-50	10,627	7.6	95.2	1.1	4.8	-451	8.6	7.6
50-75	18,039	13.0	98.9	1.2	12.8	-703	9.9	8.8
75-100	9,518	6.8	99.9	2.1	15.4	-1,611	12.4	10.5
100-200	9,196	6.6	99.8	2.2	23.2	-2,506	16.1	14.2
200-500	2,174	1.6	99.3	2.2	11.0	-5,015	23.2	21.5
500-1,000	359	0.3	98.5	3.5	6.3	-17,307	28.1	25.6
More than 1,000	184	0.1	98.7	4.4	17.3	-93,530	29.2	26.0
All	138,959	100.0	63.9	1.8	100.0	-715	13.3	11.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).
* Less than 0.05 percent. ** Less than $1 in absolute value.

(1) Calendar year. Baseline is current law. Includes the following provisions: increase child tax credit to $1,000; expand size of the 10-percent bracket to $7,000 for singles and $14,000 for married couples; expand 15-percent bracket for married couples to twice that for singles; increase standard deduction for married couples to twice that for singles; reduce top four tax rates to 25, 28, 33, and 35 percent; increase AMT exemption by $9,000 for married couples and $4,500 for others; reduce the tax rate on qualifying dividends and long-term capital gains to 15 percent (the rate for individuals in the 10 and 15-percent tax brackets would be 5 percent; preferential rates would not apply to income that, under current law, is reported as dividends on tax returns but represents distributions of interest income from mutual funds; lower capital gains rate apply to qualifying assets sold on or after May 6, 2003).
(2) Tax units with negative AGI are excluded from the lowest income class but are included in the totals.
(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.
(4) After-tax income is AGI less individual income tax net of refundable credits.
(5) Average income tax, net of refundable credits, as a percentage of average AGI.

804 HART SENATE OFFICE BUILDING
PHONE: (202) 224-0372 FAX: (202) 224-5568
INTERNET: WWW.SENATE.GOV/~JEC/DEMOCRATS