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Tax Cuts Are Still Not Driving the Budget Deficit: The Critics Fall Short

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With critics regularly blaming the 2001 and 2003 tax cuts for deficits caused more by runaway spending and a sluggish economy, The Heritage Foundation recently released "The Three Biggest Myths About Tax Cuts and the Budget Deficit"[1] to set the record straight.

This report contained three main points:

- The famous $5.6 trillion cumulative budget surplus that the Congressional Budget Office (CBO) once forecast for 2002 through 2011 is set to be replaced with a $6.1 trillion cumulative deficit. Conventional CBO data shows that the 2001 and 2003 tax cuts are responsible for just 14 percent of the difference[2];
- President Obama's claim that the deficits result mostly from the tax cuts, wars, and the new Medicare drug entitlement is untrue, even using the President's own faulty methodology; and
- Even if the tax cuts were extended, revenues are projected to rise above the historical average soon. The reason the 2020 budget deficit is projected to be 6 percent of GDP above its historical average is because spending will be 6 percent of GDP above its own historical average.

In response, the Center on Budget and Policy Priorities (CBPP) has released a report challenging Heritage's report.[3] CBPP's critique is based on faulty economic analysis and fundamental misrepresentations of the original report. Furthermore, even accepting CBPP's methodological arguments would not materially alter or refute Heritage's conclusions that the tax cuts play a relatively minor role in past budget deficits, and that future deficits are driven by soaring mandatory spending.

CBPP asserted the following four points:

1. **"Heritage ignores the fact that rapidly-rising interest costs—one of its 'culprits' behind rising outlays—result in significant part from the tax cuts and other fiscal policies of the Bush era."**

As stated above, the Heritage report uses CBO data to credit the 2001 and 2003 tax cuts with 14 percent of the swing from projected surpluses to actual deficits over the 2002–2011 period. Separately, the report assigns net interest costs—from all policies and economic factors, not just the tax cuts—responsibility for 12 percent of the swing. CBPP argues that these net interest costs should be split up and assigned to the respective policies that caused them.

While the tax cuts certainly contributed to rising net interest costs, the specific impact of a given policy on net interest costs is difficult to estimate.[4] Because CBO avoids such calculations, Heritage's analysis does as well.

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The larger question is whether the CBO's $1.7 trillion projection[5] accurately estimates the cost of the tax cuts. After all, this figure was not calculated with the benefit of hindsight. Rather it represents the tax cuts' estimated 2002–2011 cost as calculated by CBO when the policies were enacted (2001), expanded (2003), and extended (2004).

As CBPP suggests, excluding the tax cuts' impact on net interest costs may suggest that CBO understated their cost. On the other hand, CBO may have *overstated* the eventual cost of the tax cuts by:

- Not estimating the portion of lost tax revenues that would be recovered by the additional economic activity they generated. These revenue feedback effects were particularly strong between 2003 and 2006[6] (CBPP disputes this); and
- Projecting their long-term cost in 2001 within a CBO budget baseline that overestimated the 2009–2011 gross domestic product (GDP) by approximately $4 trillion. The lower actual GDP reduced incomes and therefore reduced the eventual impact of tax rate reductions (CBPP does not challenge this point).

Thus, the CBO projections could be accused of both overestimating and underestimating the eventual budget impact of the tax cuts. In order to prevent bias one way or the other, the Heritage report reflects the CBO figures unaltered.

Note that CBPP misrepresents Heritage's claim by adding "other fiscal policies of the Bush era" to its critique of the cost of the tax cuts. Yet Heritage's 14 percent figure specifically referred to the 2001 and 2003 tax cuts. The net interest costs of President Bush's "other fiscal policies" (i.e., runaway spending) have absolutely nothing to do with the cost of those tax cuts.

Most important of all is the fact that even accepting the CBPP tax cut critique, the essential reported results remain valid. The CBO figures already exclude all economic growth impacts on tax revenue, and are based on an inflated GDP between 2009 and 2011. Even generously assigning one-third of all added net interest costs over the decade to the tax cuts would merely raise their responsibility from 14 percent of the overall budget swing to 18 percent—still a small portion.[7]

2. "Heritage ignores the fact that the share of deficits accounted for by the Bush-era tax cuts will grow in future years as the impact of the economic downturn on deficits diminishes."

In both this quote and in Figure 1 of its report, CBPP commits the same methodological fallacy perpetrated by President Obama—an error pointed out in the Heritage report. By asserting that ending the tax cuts could reduce the 2019 deficit by 60 percent, CBPP implies that the tax cuts would otherwise *cause* 60 percent of the 2019 deficit. Of

1. Unless otherwise noted, all data in this paper comes from Brian Riedl, "The Three Biggest Myths About Tax Cuts and the Budget Deficit," Heritage Foundation *Backgrounder* No. 2423, June 21, 2010, at *http://www.heritage.org/Research/Reports/2010/06/The-Three-Biggest-Myths-About-Tax-Cuts-and-the-Budget-Deficit.*
2. The CBO updates its budget baseline three times annually. The updates specify the legislative, economic, and technical changes that altered the baseline. The evolving 2002–2011 budget baseline was calculated by beginning with the January 2001 CBO baseline, and then aggregating the 28 subsequent CBO baseline updates through March 2010.
3. Kathy A. Ruffing and James R. Horney, "Critics Still Wrong on What's Driving Deficits in Coming Years," Center on Budget and Policy Priorities, June 28, 2010, at *http://www.cbpp.org/cms/index.cfm?fa=view&id=3036* (August 2, 2010).
4. Assigning net interest costs by policy depends on the date each policy was enacted, as well as interest rate trends.
5. The $1.7 trillion figure is based on 2002–2011 projected cost of the tax cuts, which CBO included in its January 2002, August 2003, and January 2005 budget baseline updates.
6. See Myth #9 at Brian Riedl, "Ten Myths About the Bush Tax Cuts," Heritage Foundation *Backgrounder* No. 2001, January 29, 2007, at *http://www.heritage.org/Research/Taxes/bg2001.cfm.*
7. Given that the 2001/2003 tax cuts cost only one-sixth as much as the new spending, stimulus, economic/technical factors, and other tax cuts over the 2002–2011 period, assigning them one-third of the net interest cost is disproportionately large. However, it takes into account that the tax cuts occurred earlier in the decade, and had more years to add to the interest tab. One-third of the 12 percent net interest tab comes to 4 percent.

course, with Washington projected to spend $5.6 trillion and tax $3.9 trillion in 2019, one could single out *any* group of federal policies that cost $1.7 trillion and blame it for the entire budget deficit. By CBPP's logic, one could also blame the entire 2019 budget deficit on the $1.7 trillion in projected discretionary spending.

Furthermore, even if all tax cuts are extended, 2020 tax revenues are still expected to exceed their historical average of 18.0 percent, while spending is set to surge 6 percent of GDP above its historical average.

3. **"In constructing its baseline, Heritage partly assumes its own conclusion…(by) assum[ing] that regular discretionary spending (other than war costs and stimulus funds) will grow at the same rate as the GDP over the next 10 years."**

CBPP asserts that a proper current-policy budget baseline should freeze discretionary spending at today's inflation-adjusted levels (which translates to about 3 percent annual growth). In the Heritage report, discretionary spending is frozen as a percentage of GDP (approximately 5.5 percent annual growth). CBPP points out that CBO's yearly budget baseline uses CBPP's standard, while ignoring that CBO's long-term budget outlook uses Heritage's standard in its alternative fiscal scenario.[8] Given that discretionary spending has risen approximately 7 percent annually over the past decade, assuming 5.5 percent annual growth seems more realistic than 3 percent.

Either way, this is a minor distinction. Using CBPP's discretionary spending figures would merely reduce projected 2020 spending from 6 percent of GDP above the historical average to 5 percent. Once again, allowing for CBPP's criticism would not alter the central point that there is no long-term revenue decline, and therefore rising long-term deficits are driven entirely by above-average spending.

4. **"It was not a sudden spurt of growth in Social Security, Medicare, and Medicaid that turned projected budget surpluses into deficits…. Indeed, CBO had already projected that this would eventually occur when, in 2001, it projected significant budget surpluses through 2011 and years beyond."**

The original January 2001 CBO budget baseline assumed that nominal spending on Social Security, Medicare, and Medicaid would nearly double between 2001 and 2011, from $798 billion to $1,506 billion.[9] However, it also assumed—unrealistically—that these enormous costs could be absorbed by a permanent tax revenue bubble; an unprecedented drop in discretionary spending to 1930s levels; and the absence of any recessions, wars, terrorist attacks, and natural disasters over the decade. Indeed, the failure of those unrealistic projected offsets to materialize does not take Social Security, Medicare, and Medicaid off the hook for their rapid growth.

As for future budget deficits, tax revenues are projected to soon reach their historical average. As spending surges to 6 percent of GDP above its historical average by 2020, Social Security, Medicare, and Medicaid (along with net interest) are the moving variables responsible for the vast majority of this growth.

A Fundamentally Flawed Analysis. The Center on Budget and Policy Priorities' report fails to counter The Heritage Foundation's report while offering only a showing of distracting chaff. Not content with providing its own fundamentally flawed analysis, CBPP misrepresents Heritage's analysis as well. Further, even accepting CBPP's critique in detail would still not alter Heritage's overall conclusions that the tax cuts played a relatively small role in past deficits, and that rising long-term deficits are driven entirely by soaring spending.

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8. Congressional Budget Office, "The Long-Term Budget Outlook," June 2010, p. 12, at *http://www.cbo.gov/ftpdocs/115xx/doc11579/06-30-LTBO.pdf* (August 2, 2010). Page 14 states that "many budget analysts believe that the alternative fiscal scenario presents a more realistic picture of the nation's underlying fiscal policy than the extended-baseline scenario does..."
9. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2002–2011," January 2001, at *http://www.cbo.gov/doc.cfm?index=2727&type=0.*