DECISION TIME:

THE FISCAL EFFECTS OF EXTENDING THE 2001 AND 2003 TAX CUTS

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TEAM MEMBERS

Ingrid Schroeder, Director, Pew Fiscal Analysis Initiative
Scott S. Greenberger, Senior Officer
Sarah Nolan, Senior Associate
Ernest Tedeschi, Senior Associate
Douglas Walton, Associate
Evgeni Dobrev, Administrative Associate

John E. Morton, Managing Director, Pew Economic Policy Group
Douglas Hamilton, Deputy Director, Pew Economic Policy Group

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For additional information on the Pew Economic Policy Group and the Fiscal Analysis Initiative, please visit www.pewtrusts.org or email us at pfai-info@pewtrusts.org.

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EXECUTIVE SUMMARY

The income tax cuts of 2001 were enacted when the federal budget was running a surplus. The tax cuts of 2003, designed to boost the economy as it was showing signs of weakness, were approved before the federal debt rose to the top of the national agenda. Both sets of cuts are scheduled to expire at the end of 2010, and in the coming months Congress and the administration will have to decide whether to extend them at a time when the debt is climbing steadily but the economy remains fragile.

As the expiration date looms, several options are on the table. One option is to extend the tax cuts indefinitely, making them permanent for all taxpayers. Another is to limit the extension to individuals making less than $200,000 and married couples earning less than $250,000. In light of the continuing weakness in the economy, some have proposed extending the tax cuts for everybody for another two years. Finally, there is the option of allowing the cuts to expire as scheduled.

A new study by the nonpartisan Pew Fiscal Analysis Initiative examines each of these options, calculating their costs, with interest, and effects on the national debt. Pew's analysis assumes no other policy changes that would affect spending or revenue. Pew's analysis does not advocate for or against an extension. But it concludes that even an extension limited to individuals making less than $200,000 and married couples earning less than $250,000 would sharply increase the debt unless lawmakers cut spending to compensate for it. In contrast, allowing the tax cuts to expire as scheduled or extending them for only two years would lead to a significantly smaller debt in 2020 than would be the case under other options.

- Making the tax cuts permanent for all taxpayers, regardless of income, would cost $3.1 trillion over the next 10 years and inflate the national debt to 82 percent of GDP. This would be the highest level since 1948, in the aftermath of World War II, and well above the average debt-to-GDP ratio of the last 50 years of 37 percent. The current ratio is about 57 percent.
- Limiting the extension to individuals making less than $200,000 and married couples earning less than $250,000 would cost about $2.3 trillion in the next decade. Absent any offsets, this proposal would inflate the national debt to 78 percent of GDP by 2020.
- Extending the tax cuts for all taxpayers for only two years, as some have proposed in light of the fragile economy, would cost $558 billion over the next 10 years and increase the debt to 70 percent of GDP by the end of the decade.
- If the tax cuts are allowed to expire at the end of 2010, the debt-to-GDP ratio would rise, reaching 68 percent by 2020.

INTRODUCTION

In the spring of 2001 the first Harry Potter film had yet to arrive in theaters, September 11th was just another day in the calendar and the federal budget was running a surplus. Earlier in the year the Congressional Budget Office (CBO) had estimated that the nation's budget surplus would be $281 billion in fiscal year 2001, largely the result of several years of rapid economic growth. The public debt was expected to decline from its level of 35 percent of GDP at the end of fiscal year 2000 and to continue falling. The CBO noted some weakening in the economy, but predicted that after a short dip growth would pick up and by 2011 the budget surplus would approach $889 billion.[1]

It was in this context that Congress passed, and President Bush signed into law in June 2001, broad tax cuts that carried a $1.35 trillion 10-year price tag.[2] Two years later, in an effort to spur growth after the economy had weakened, they enacted a more narrowly focused set of tax cuts at an additional estimated cost of $350 billion.[3] Both laws are set to expire at the end of 2010. In the coming months, Congress and the president must decide whether to allow the cuts to expire as scheduled or extend some or all of them.

This decision will be made in a fiscal environment that is markedly different from the one in which the tax cuts were enacted. Instead of a surplus the federal budget had a $1.4 trillion deficit at the end of fiscal year 2009. National debt currently stands around 57 percent of GDP.[4] With no extension of the tax cuts or new spending initiatives, debt will continue to grow for the next two years and then level out, remaining above 60 percent of GDP for the rest of the decade. Pew's analysis shows that even a partial extension of the tax cuts, as proposed by the administration within its larger fiscal year 2011 budget plan, would inflate the national debt to 78 percent of GDP by 2020, the highest level since 1950.[5] A two-year extension of the cuts, with a sunset at the end of 2012, would raise debt to levels only slightly higher than with no extension.

BACKGROUND ON THE CUTS

The tax cuts were enacted as two separate pieces of legislation, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 and the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003.[6] The 2001 law contained a variety of tax cuts, including rate reductions in the top four brackets, the creation of a new 10 percent bracket for a portion of income previously taxed at 15 percent and a widening of brackets for married filers ("marriage penalty relief"). It also contained more targeted measures, such as increases in child-related tax credits, tax incentives for retirement savings and investments in education, a phase-out of the estate tax and changes to the gift tax. Most of the provisions were phased in gradually and are scheduled to expire at the end of 2010.

The 2003 law cut taxes on capital gains, dividend income and certain business expenses. It also accelerated the phase-in of a number of the income tax cuts in EGTRRA—for instance, moving full implementation of the income tax rate reductions from 2006 to 2003. Under JGTRRA, the dividend and capital gains tax reductions were scheduled to expire in 2008. However, subsequent legislation extended the expiration date for the capital gains and dividend cuts to the end of 2010 and extended other EGTRRA provisions. Those changes brought the total cost of the 2001 and 2003 legislation to $1.8 trillion.[7] (For additional detail on the various cuts, including estimates of the costs of the various components, see Appendix A.)

The provisions in the 2001 and 2003 tax cuts had widespread effects: A fifth of tax filers claimed a child tax credit in 2003, while 11 percent took an education credit or deduction for student loan interest.[8] But the income tax rate cuts were by far the most significant. They applied to taxpayers in every income bracket and constituted over half the total cost of the cuts. The first table in Appendix B compares the rates implemented by EGTRRA with those that would prevail if the tax cuts expire as scheduled. One analysis found that in 2006, shortly after implementation of the cuts, more than 90 percent of taxpayers with incomes over $40,000 paid less taxes.[9]

FISCAL EFFECTS OF EXTENDING THE 2001 AND 2003 TAX CUTS

The 2001 and 2003 cuts were approved and enacted with expiration dates, yet their extension is treated by many policy makers as all but inevitable. The fiscal year 2011 budget proposed by the Obama administration begins from a baseline that assumes that all the cuts will be extended. Likewise, when Congress enacted a law in early 2010 requiring that certain new spending or losses in tax revenue be offset, they exempted most of the 2001 and 2003 tax cuts from the requirement.[10]

In contrast, Pew's analysis treats a possible extension of the tax cuts for what it really is—a policy choice—and we measure the fiscal effects of this choice against a baseline that does not assume their extension. Looked at this way, a decision to extend the tax cuts is tantamount to enacting a new tax cut.

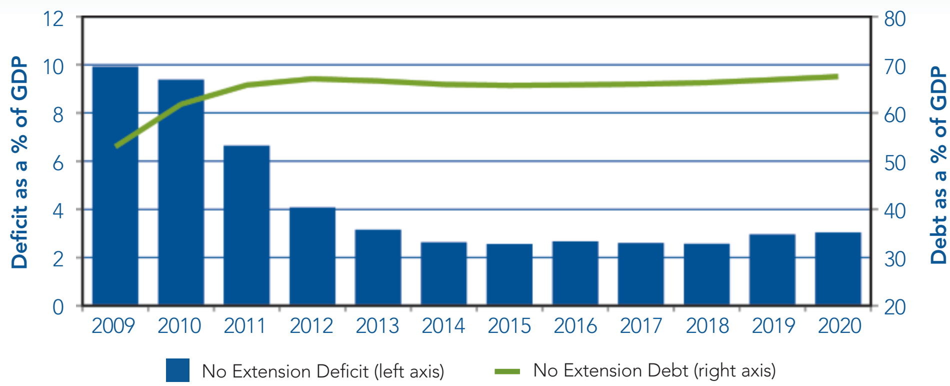
Starting in 2002 the U.S. budget has run a deficit each year. After the economy entered a recession the size of the deficit grew sharply, to 9.9 percent of GDP at the end of fiscal year 2009.[11] The government must finance annual deficits with new borrowing, which increases the national debt and requires larger annual interest payments, adding further to the size of annual deficits. This phenomenon is not unlike that experienced by someone who pays only the minimum charge on his credit card while continuing to add to the outstanding balance with additional spending and interest charges.

Rising debt threatens the country's economic well-being. Persistent high deficits can crowd out capital, reducing productivity and real wages. High debt also increases pressure on the Federal Reserve to purchase publicly-held debt, which could increase inflation. Thus it is important to consider the potential effect an extension of the tax cuts would have on future deficit and debt levels, in addition to looking at their costs.

No Extension of Tax Cuts

Pew's analysis starts with the CBO's March 2010 budget projections for fiscal years 2010 to 2020. This CBO baseline assumes that Congress will make no changes to current law and will allow the tax cuts to expire as scheduled.[12]

FIGURE 1: Federal Deficits and Debt: No Extension of Cuts



Source: Congressional Budget Office current law baseline projection

With no extension of the tax cuts, the CBO baseline projects deficits will be 6.6 percent of GDP in 2011 and then drop to 4.1 percent of GDP in 2012 (see Figure 1). By 2014 the deficit would be 2.6 percent of GDP, around the level experts identify as sustainable.[13] It would remain just below 3 percent for several years and then start to rise at the end of the decade. The CBO projects that debt will continue to rise over the next two years. It will then level off at about 66 percent of GDP for most of the next decade, rising slightly to 68 percent of GDP in 2020.

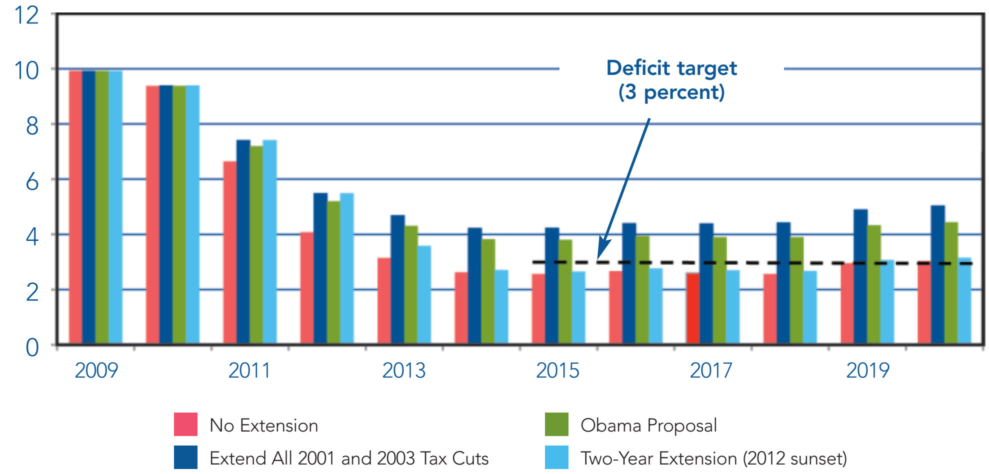
Extend All EGTRRA and JGTRRA Provisions

Extending all of the 2001 and 2003 tax cuts would cost $2.57 trillion over 10 years.[14] The cost increases to $3.1 trillion over the same decade when $580 billion in interest payments, as estimated by Pew, is added to the total (see Appendix C for an annual breakdown of projected direct costs and debt service payments).

An extension of all of the 2001 and 2003 tax cuts would raise future deficit and debt levels significantly. Figure 2 shows that extending all of the tax cuts would increase the size of the deficit to 4.2 percent of GDP or higher in each of the next 10 years. As Figure 3 shows, the effect on public debt would be even more striking—it would rise continuously, reaching 82 percent of GDP by fiscal year 2020.

FIGURE 2: Federal Deficits: Extension of the 2001 and 2003 Tax Cuts

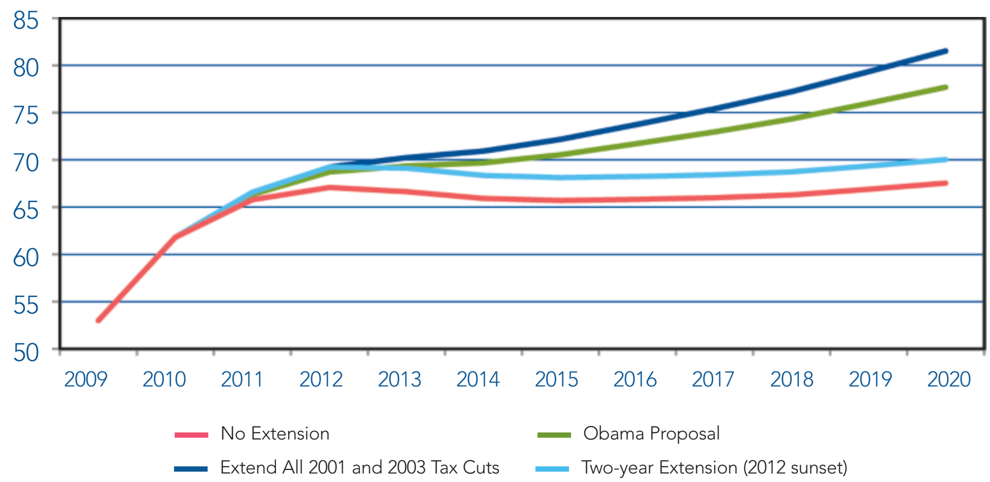
Percentage of Gross Domestic Product



Source: Pew projections based on Congressional Budget Office data
Note: "Obama proposal" reflects only the administration's proposals to extend the 2001 and 2003 tax cuts and not other proposed policy changes in the fiscal year 2011 budget.

FIGURE 3: Federal Debt: Extension of the 2001 and 2003 Tax Cuts

Percentage of Gross Domestic Product



Source: Pew projections based on Congressional Budget Office data
Note: "Obama proposal" reflects only the administration's proposals to extend the 2001 and 2003 tax cuts and not other proposed policy changes in the fiscal year 2011 budget.

President Obama's Proposal for a "Middle-Class" Extension

President Obama's fiscal year 2011 budget includes a complete package of spending initiatives and offsets. The Pew analysis isolates the provisions extending certain 2001 and 2003 tax cuts, but does not consider the full budget. The proposal Pew examines would extend tax cuts for the middle class, which the administration defines as single taxpayers with incomes under $200,000 and married taxpayers with incomes under $250,000, while allowing the cuts for taxpayers above that threshold to expire.[15] The proposal also would do the following:

- Expand the 28 percent tax bracket to include single taxpayers with incomes up to $200,000 and married couples making up to $250,000 who are currently in the 33 percent bracket and who would be in the 36 percent bracket if the tax cuts expire (see the second table in Appendix B).
- Extend the capital gains tax reductions and continue the elimination of limits on itemized deductions and exemptions for "middle-class" taxpayers.
- Restore the estate tax for all taxpayers, which was eliminated at the end of 2009, to the level that prevailed in 2009.

People with incomes above these "middle-class" thresholds would continue to pay lower rates on their earnings up to the thresholds (see Appendix B). This structural feature, along with the fact that relatively few people would be subject to the higher rates, does little to reduce the cost compared to a full extension. The cost of this partial extension would be $2.3 trillion over the next decade, including debt service costs.[16]

This proposal would result in deficits of over 3.8 percent of GDP throughout the decade, above the administration's own target of 3 percent of GDP (see Figure 2).[17] As Figure 3 shows, debt would rise to 78 percent of GDP by 2020, only four percentage points lower than with a full extension of the cuts.

TAX CUTS AND THE AMT INTERACTION

The Alternative Minimum Tax (AMT) forms a parallel income tax system under which taxpayers calculate their tax using a special AMT exemption amount instead of the standard exemption and most deductions. If their tax liability is higher under the AMT calculation than under the regular income tax calculation, taxpayers must pay the difference in the form of an AMT.

The AMT exemption amount is not indexed for inflation, and as incomes rose increasing numbers of taxpayers became potentially subject to the AMT. In 2010 one in six taxpayers will face the AMT under current law, compared to less than 1

Continued…

TAX CUTS AND THE AMT INTERACTION *...continued*

percent in 2000.[18] In response, Congress has regularly approved temporary adjustments to the AMT exemption amount that reduced the number of taxpayers subject to it. Each of these annual adjustments (or AMT "patches") has a cost that is equal to the amount of AMT revenue that is foregone as a result of the change in the exemption level.

Provisions that lower regular income tax liability will increase the number of people potentially subject to the AMT. Thus, extending the tax cuts and continuing to adjust the AMT exemption amount results in an interaction that adds an additional cost beyond the cost of either measure alone.

For example, the cost of the administration's limited tax extension proposal alone would be $2.3 trillion (including debt service costs) between 2011 and 2020. The cost of adjusting the AMT for inflation alone would be $704 billion (including debt service costs) for this period. Combining the two would add an additional $729 billion (including debt service costs) to the total cost because of the interaction between the two measures.[19]

These two changes, the administration's proposal and continued AMT adjustments, together would result in deficit levels above 4.4 percent throughout the decade. By 2020, debt would reach 84 percent, six percentage points higher than with the tax cut extension alone. Similarly, combining an AMT adjustment with a full extension of the 2001 and 2003 tax cuts would increase deficits to 4.8 percent or more and increase debt to 88 percent in 2020.

A Two-Year Extension of the Tax Cuts

Many who are concerned about the high cost of extending the tax cuts acknowledge that it would be unwise to let them expire while the economy is still fragile. One strategy would be to extend the cuts for two years, with a sunset at the end of 2012. The cost of a two-year extension would be $558 billion, including debt service, over the next 10 years.[20] A two-year extension would increase deficits significantly in fiscal years 2011 and 2012, but the cost would drop sharply in subsequent years. Starting in 2014 deficits would be about one-tenth of a percentage point higher than if there had been no tax cut extension (the difference is due to higher debt service costs attributable to the extension). Debt would rise to 70 percent of GDP by 2020, well below the debt to GDP ratio under both the Obama extension proposal and a full extension (see Figure 3).

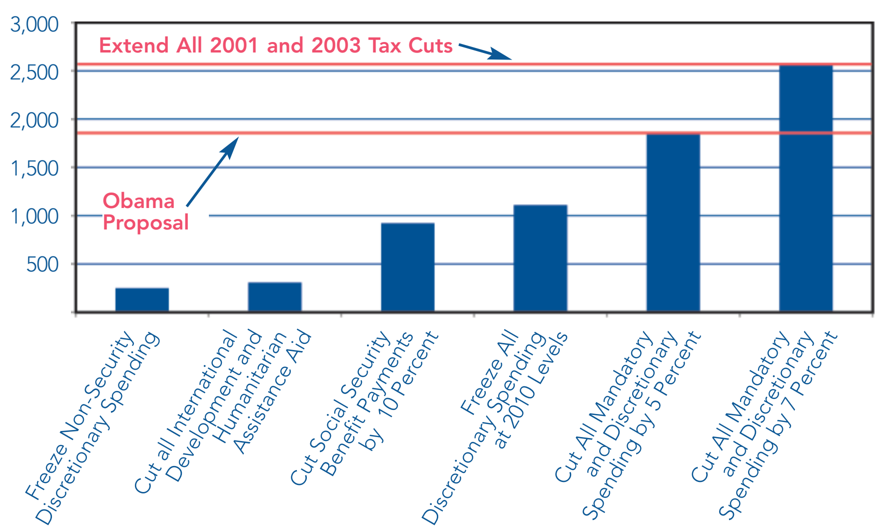
FINANCING THE CUTS

What would it take to extend the tax cuts without adding to the national debt? Figure 4 compares the savings that could be gained from certain spending reductions with the direct cost of extending the cuts (excluding debt service).[21] These are not proposals; rather they are examples chosen to illustrate the type of trade-offs that would be necessary to fully finance an extension of the cuts.

For example, eliminating U.S. international development and humanitarian aid over the course of the next 10 years would free up $307 billion, just 12 percent of the cost of a full extension of the cuts. Likewise, the three-year freeze in non-security discretionary spending (spending on programs other than defense and related programs) proposed in the administration's fiscal year 2011 budget pays for only about 10 percent of a full extension and 13 percent of the cost of its own proposal to extend the cuts for single taxpayers with incomes under $200,000 and joint filers with incomes under $250,000. Even freezing all discretionary spending, including defense, would offset less than half the cost of a full extension of the cuts.[22]

A 10 percent decrease in projected Social Security benefit payments over the next 10 years would be significant for recipients, for whom the average monthly payment is $1,067.[23] But such a cut would pay for just half of the Obama plan and only 36 percent of extending all the tax cuts.

FIGURE 4: Can Spending Cuts Pay for a Tax Cut Extension?
In Billions of Dollars



Source: Pew analysis based on Congressional Budget Office data; costs for International Assistance and Discretionary Spending Freeze are based on data in the President's fiscal year 2011 budget proposal.
Note: Cost estimates are for the ten-year cost (2011–2020) and exclude debt service.

However, paying for the tax cuts with a broad-based set of spending reductions could potentially cover the costs. Assuming cuts could be made to all mandatory and discretionary spending (excluding required payments on the debt), a cut of about 5 percent across the board would offset the ten-year cost of the administration's proposal. Likewise, a 6.8 percent across-the-board cut over 10 years (again, excluding payments on the debt) would offset the costs of a full extension of the cuts over the same period.

CAN THE TAX CUTS PAY FOR THEMSELVES?

The projections of tax cut costs in this paper are based on a conventional analysis that reflects certain assumptions about taxpayer behavior, but does not take into account potential increased macroeconomic activity that the tax cuts may induce. Some policy makers argue that analyses of tax cut proposals should take into account new economic activity that could occur when individuals and firms change their behavior in response to lower tax rates.

Tax cuts can stimulate the economy, leading to increased tax revenue that may offset some of the costs. However, the extent to which the increased revenue makes up for revenue lost from the cut is more difficult to determine and depends on a number of variables, including work behavior and savings and consumption decisions, as well as the particular type of tax that is cut. The stimulative effect also depends on how and when the tax cut is financed. Financing tax cuts with deficits can crowd out capital investment in plants and equipment and ultimately work to dampen the economy over time.

Two attempts at dynamic analysis looked at the extent to which tax cuts may pay for themselves. In a 2005 study, the CBO analyzed the effects of a 10 percent cut in all federal taxes on income (regular income, capital gains income, etc.) that was deficit-financed for the first 10 years.[24] The CBO found that the effects of such a change could offset between 1 and 22 percent of the costs over the first five years following the cut.

However, the CBO also found that the dynamic effects in the second five-year period were ambiguous. In some economic models, dynamic effects could reduce the costs of a tax cut by as much as 32 percent; in other models, dynamic effects could actually increase the costs of such a tax cut by 5 percent. Another study by the Department of the Treasury in 2006 also found ambiguous results.[25]

CONCLUSION

This analysis shows that a full extension of the 2001 and 2003 tax cuts without offsets would add significantly to U.S. deficits and raise federal debt in 2020 to the highest levels in 60 years. The more limited extension proposed by the Obama administration also would lead to substantial increases in the debt. Meanwhile, it would be difficult to pay for these extensions with spending cuts from any one program area. A two-year extension with a sunset in 2012 would result in a 2020 debt level only slightly higher than with no extension. While Pew's report makes no recommendations about what course of action should be chosen, it does provide an objective picture of what alternate scenarios would mean for spending, deficits and the debt, and it demonstrates the extraordinary challenges—and choices—that policy makers face as they consider our fiscal future.

APPENDIX A: Description of the 2001 and 2003 Tax Cuts

Item	Description	Billions of Dollars (through 2010)
EGTRRA (2001): INCOME-RELATED CUTS		
Income Tax Rate Cuts	Created a new 10 percent bracket. Reduced rates in top four brackets. **Expires: 12/31/2010**	**923.5**
Marriage Penalty Relief	Increased standard deduction for married couples. Allowed married filers with higher incomes to qualify for the Earned Income Tax Credit. **Expires: 12/31/2010**	**109.7**
Repeal of deduction and exemption provisions	Repealed limits on the use of itemized deductions and the personal exemption for upper-income taxpayers. **Expires: 12/31/2010**	**27.2**
Child Tax Credit	Increased the Child Tax Credit from $500 to $1000 and made it partially refundable. **Expires: 12/31/2010**	**241.6**
Other Child and Dependent Care Credits	Increased and made permanent the adoption credit. Increased the dependent care credit. Created new credit for employer-provided child care. **Expires: 12/31/2010**	**6.9**
Education Saving and Assistance Incentives	Provisions included an increase on the limit for tax-deductible contributions to education IRAs and a permanent exclusion for undergraduate tuition assistance from employers. Allowed wider use of pre-paid tuition plans and made most distributions from plans tax-free. **Most provisions expire on 12/31/2010**	**28.4**
Pension and IRA Provisions	Provisions included an increase in contribution limits and "catch-up" contributions for IRAs. Increased annual contribution and benefit limits for pensions. **Original 2010 expiration for provisions was repealed by the Pension Protection Act of 2006.**	**44.8**

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Item	Description	Billions of Dollars (through 2010)
EGTRRA (2001): ESTATE TAX		
Estate and Gift Tax	Increased exemptions for the estate tax and lowered the rate from 55 percent to 45 percent in 2009. Eliminated the estate tax starting in tax year 2010. Lowered the gift tax rate to 35 percent starting in tax year 2010. **Expires: 12/31/2010**	84.1
JGTRRA (2003)		
Capital Gains	Eliminated the 10 percent tax on most capital gains for taxpayers in the two lowest tax brackets and reduced the rate from 20 percent to 15 percent for taxpayers in higher brackets. **Expires: 12/31/2010**	29.6
Dividend Income	Made the tax rates on dividend income identical to the tax rates on capital gains; previously dividend income was taxed at regular income tax rates. **Expires: 12/31/2010**	139.0
Business Growth Incentives	Expanded the ability of businesses to immediately deduct some of the cost of new equipment, rather than claiming depreciation deductions over time. **Expired in 2004 and 2009 respectively, but subsequent legislation has extended and further expanded these provisions.**	26.0
TOTAL FROM ENACTMENT THROUGH 2010		1,661.0
	OUT-YEAR COSTS (2011 FORWARD)	145.1
TOTAL COSTS		1,806.1

Source: Pew analysis of cost based on Joint Committee on Taxation estimates
Note: Costs reflect the initial cost estimates of provisions contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), and also the cost estimates for provisions that accelerated or extended certain EGTRRA and JGTRRA cuts (the provisions were contained in the Working Families Tax Relief Act of 2004 and the Tax Increase Prevention and Reconciliation Act of 2006). Adjustments to the Alternative Minimum Tax that were included in this legislation are not reflected in estimates here. Out-year costs reflect the net effect of revenue reductions and increases that will occur after 2010 due to timing of revenue collections for certain taxes.

APPENDIX B: Income Tax Rates

Income Tax Rates: Current versus Rate with Expiration of 2001 Tax Cut

2010 RATES (WITH TAX CUTS)			2011 RATES (WITH EXPIRATION OF TAX CUTS)		
Single Filers	**Married Joint Filers**	**Current Rate**	**Single Filers**	**Married Joint Filers**	**Current Rate**
Up to $8,375	Up to $16,750	**10%**	Up to $34,850	Up to $58,200	**15%**
$8,375 to $34,000	$16,750 to $68,000	**15%**			
$34,000 to $82,400	$68,000 to $137,300	**25%**	$34,850 to $84,350	$58,200 to $140,600	**28%**
$82,400 to $171,850	$137,300 to $209,250	**28%**	$84,350 to $176,000	$140,600 to $214,250	**31%**
$171,850 to $373,650	$209,250 to $373,650	**33%**	$176,000 to $382,650	$214,250 to $382,650	**36%**
$373,650 and over	$373,650 and over	**35%**	$382,650 and over	$382,650 and over	**39.6%**

Source: Joint Committee on Taxation
Note: Table shows taxable income in each rate category for 2010 and the projected rate for 2011; income in these categories was lower when the 2001–2002 cuts were first enacted. Rate categories change annually to reflect inflation, but with an expiration of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provisions rate categories for some married filers change will also change to reflect the elimination of EGTRRA's "marriage penalty" relief provision. The change means that some married taxpayers would move into a higher rate category, as well as experiencing a rate increase.

Income Tax Rates: Current versus 2011 Rate Under Obama Proposal

2010 RATES (WITH TAX CUTS)			2011 RATES (WITH OBAMA PROPOSAL)		
Single Filers	**Married Joint Filers**	**Rate**	**Single Filers**	**Married Joint Filers**	**Current Rate**
Up to $8,375	Up to $16,750	**10%**	Up to $8,500	Up to $17,000	**10%**
$8,375 to $34,000	$16,750 to $68,000	**15%**	$8,500 to 34,550	$17,000 to $69,100	**15%**
$34,000 to $82,400	$68,000 to $137,300	**25%**	$34,550 to 83,700	$69,100 to $139,500	**25%**
$82,400 to $171,850	$137,300 to $209,250	**28%**	$83,700 to $174,600	$139,500 to $212,600	**28%**
$171,850 to $373,650	$209,250 to $373,650	**33%**	$174,600 to $194,050	$212,600 to $235,450	**28%**
			$194,050 to $379,650	$235,450 to $379,650	**36%**
$373,650 and over	$373,650 and over	**35%**	$379,650 and over	$379,650 and over	**39.6%**

Source: Joint Committee on Taxation, Urban-Brookings Tax Policy Center
Note: Table shows taxable income (after adjusting for exemptions and deductions) in actual rate categories for 2010 and projected categories for 2011. Under the Obama plan, a portion of income currently taxed at 33 percent would be included in the 28 percent bracket.

APPENDIX C: Cost Projections for Extensions

Cost of Tax Cut Extensions
In Billions of Dollars

		2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	TOTAL 2011–2020
Extend All 2001 and 2003 Cuts	Direct Cost	115	216	243	257	269	277	285	293	302	311	2,567
	Interest Cost	2	6	15	26	40	57	75	96	119	143	580
	Total	**116**	**222**	**258**	**283**	**309**	**334**	**361**	**389**	**421**	**454**	**3,147**
Obama Proposal	Direct Cost	83	171	182	190	198	202	205	207	209	212	1,859
	Interest Cost	1	5	11	20	30	42	56	71	87	104	428
	Total	**84**	**176**	**193**	**210**	**228**	**244**	**261**	**278**	**297**	**316**	**2,287**
Two-Year Extension (2012 sunset)	Direct Cost	115	216	61	—	—	—	—	—	—	—	391
	Interest Cost	2	6	12	15	17	19	21	23	25	27	166
	Total	**116**	**222**	**73**	**15**	**17**	**19**	**21**	**23**	**25**	**27**	**558**

Source: Pew projections based on Congressional Budget Office (CBO) data; totals may not add due to rounding
Note: Direct costs represents the increase in deficit that will occur if the tax cuts are extended without any offsets or spending decreases. Cost estimates are based on the following sources:
1) Cost estimates for a full extension of the 2001 and 2003 cuts come from Table 1-5 of the Congressional Budget Office's The Budget and Economic Outlook: Fiscal Years 2010 to 2020 (January 2010).
2) Cost estimates for the administration's proposed extension of "middle-class" cuts come from three sources: a) The decline in revenue comes from Table 1-3 of the Congressional Budget Office's An Analysis of the President's Budgetary Proposals for Fiscal Year 2011 (March, 2010). CBO's estimate includes both the extension of the 2001 and 2003 tax cuts and the interactive effect of indexing the AMT to inflation; and b) To isolate the cost of just the extension of the tax cuts, the model subtracts the cost of the interactive effect of indexing the AMT, which is estimated in Table 1-5 of the CBO's The Budget and Economic Outlook: Fiscal Years 2010 to 2020 (January 2010), from the total in (a); and c) Finally, the model adds the cost of the refundable portion of the 2001 and 2003 tax cuts, and these estimates come from footnote 2 of the Joint Committee on Taxation's Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal (March 2010).
3) Cost estimates for the two-year extension are based on data in Table 1-5 of the CBO's The Budget and Economic Outlook: Fiscal Years 2010 to 2020 (January 2010). For fiscal year 2013, the report assumes that one-quarter of the full cost is incurred, due to differences between tax and fiscal years (one-quarter of the 2012 tax year occurs in the federal government's 2013 fiscal year).

For more information on how Pew's model calculates interest costs, see Appendix D.

APPENDIX D: Technical Specifications of Budget Model

For all budget projections and simulations, Pew's analysis uses a basic budget model that projects the accumulation of federal debt over time. The model uses data from the Congressional Budget Office (CBO), Office of Management and Budget (OMB), and the Joint Committee on Taxation (JCT), and forecasts spending, outlays, deficit and debt at the end of each federal fiscal year.

Model Framework

Major components that are needed to calculate deficits and debt are spending, revenue, interest rate, net interest and Other Means of Financing (OMF). These component parts are described below.

Spending and Revenue

The basic primary spending categories are Social Security, Medicare net of offsetting premiums, federal Medicaid, other mandatory and total discretionary spending. The revenue categories include income tax, corporate tax, social insurance tax and other revenue. Data for these categories are drawn directly from CBO projections.

Interest Rate

This model uses the interest rates implied by the CBO baseline, which is found by dividing net interest by the average of debt held by the public at the beginning of the year and at the end of the year.

Net Interest

Pew calculates net interest under different policy scenarios by multiplying the interest rates described in the previous section by the average debt held by the public at the beginning of the year and at the end of the year.

Other Means of Financing

Other Means of Financing (OMF) includes various factors that reduce or increase the government's need to borrow. A sale of assets, for example, provides the government with additional funds and reduces its need to borrow to finance its deficit; this is recorded as a negative OMF value. Certain credit financing, however, increases the government's need to borrow. For instance, when the government issues a loan, the full amount of the loan is disbursed up front, even though the government anticipates that the loan will be paid back. While the budget reflects only the recorded outlay, which measures only the estimated cost for the loan subsidy and risk of default, the government must provide funds up front for the full amount of the disbursement. For this reason, many government loans, including small business and student loans, result in positive

OMF values in the period when the loan is disbursed, increasing the government's need to borrow, but result in lower OMF values in the period when the loan is repaid. For all projections, OMF is equal to the level specified in the CBO baseline.

Deficit and Debt Calculations

Future levels of deficit and debt can be derived from the model. The deficit is equal to total outlays, less total revenues. Debt held by the public is equal to debt at the beginning of the year, plus the deficit, plus OMF. This framework enables the model to calculate debt and deficit at the end of each fiscal year.

NOTES

1. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011* (January 2001), pp. 2-3; Table 1-1. In May the CBO lowered the surplus projection for 2001 slightly to $275 billion, noting some unanticipated weakness in revenue collections, but expressed continued confidence in the long-term economic projections; see *An Analysis of the President's Budgetary Proposals for Fiscal Year 2002* (May 2001), pp. 2-3; Table 1.
2. Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1836* (May 26, 2001).
3. Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 2, The "Jobs and Growth Tax Relief Reconciliation Act of 2003"* (May 22, 2003).
4. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011* (March 2010), Table 1-1, p. 2. Current debt as a percent of GDP is calculated using data from the Department of the Treasury (Monthly Statement of the Public Debt) and the Bureau of Economic Analysis in the Department of Commerce.
5. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2011* (March, 2010), Historical Tables, Table 7-1, p. 133. Following World War II public debt ranged from 109 percent of GDP in 1946 to 84 percent in 1948 and 80 percent in 1950.
6. EGTRRA was signed by the President on May 7, 2001 (Public Law 107-16); JGTRRA was signed on May 28, 2003 (Public Law 108-27).
7. See notes 2 and 3 for cost estimates for EGTRRA and JGTRRA. For cost estimates of provisions contained in subsequent legislation, see the relevant sections of the Joint Committee on Taxation's *Estimated Revenue Effects of the Conference Agreement for H.R. 1308, The "Working Families Tax Relief Act of 2004"* (September 23, 2004) and *Estimated Revenue Effects of the Conference Agreement for the "Tax Increase Prevention and Reconciliation Act of 2006"* (May 9, 2006). Cost estimates reflect both the loss in tax revenue and the increase in outlays for refundable tax credits. The $1.8 trillion estimate includes $1.66 trillion in costs through 2010 plus additional costs that occur after 2010 due to the timing of revenue collections.
8. IRS Statistics of Income (All Returns: Sources of Income, Adjustments, Deductions, Credits, and Tax Items) for 2003.
9. Leiserson, Greg and Rohaly, Jeffrey. *The Distribution of the 2001-2006 Tax Cuts: Updated Projections, November 2006* (Urban Institute and Brookings Institution Tax Policy Center, 2006), p. 3 Table 1; incomes are expressed in 2006 dollars. Note these are "taxpaying units"—tax filers, whether single or married, rather than individuals. As the report notes, a smaller percentage of taxpayers with incomes below $40,000 received benefits because many did not owe taxes.
10. Public Law 111-139, passed in January 2010, reinstitutes the so-called "pay-go" rules, but contains language exempting most of the EGTRRA and JGTRRA provisions.
11. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011* (March 2010), Table 1-1.
12. Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011* (March 2010). Legislation enacted after, and not reflected in, this analysis includes the *Hiring Incentives to Restore Employment Act* and *The Patient Protection and Affordable Care Act*.
13. In testimony before the Senate, Federal Reserve Chair Ben Bernanke said it was a "rule of thumb" that deficits should be around 2.5 to 3 percent in order to keep debt in control. (Christian Science Monitor, February 25, 2010, accessed at http://www.csmonitor.com/Money/2010/0225/Bernanke-to-Senate-If-you-want-to-fix-job-deficit-don-t-forget-budget-deficit).

14 Cost estimates for a full extension of the 2001 and 2003 cuts come from Table 1-5 of the Congressional Budget Office's *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (January 2010).

15 For a description of the income calculation see Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (February 2010), pp. 127-131.

16 Cost estimates for the administration's proposed extension of "middle-class" cuts come from three sources: a) The decline in revenue comes from Table 1-3 of the Congressional Budget Office's *An Analysis of the President's Budgetary Proposals for Fiscal Year 2011* (March 2010). CBO's estimate includes both the extension of the 2001 and 2003 tax cuts and the interactive effect of indexing the AMT to inflation; b) To isolate the cost of just the extension of the tax cuts, the model subtracts the cost of the interactive effect of indexing the AMT, which is estimated in Table 1-5 of the CBO's *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (January 2010), from the total estimate in (a); and c) Finally, the model adds the cost of the refundable portion of the 2001 and 2003 tax cuts, and these estimates come from Footnote 2 of the Joint Committee on Taxation's *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal* (March 2010).

17 Office of Management and Budget director Peter Orszag said last fall that "[I]n the medium term out in 2015, 2016, 2017, we need to get to something around 3 percent of the economy so that debt is no longer rising as a share of the economy." Bloomberg.Com, November 17, 2010, accessed at http://www.bloomberg.com/apps/news?pid=20601070&sid=ajXWeF_mSko0.

18 Congressional Budget Office, *The Individual Alternative Minimum Tax* (January 15, 2010), p.1. The increase in liability is due both to passage of the tax cuts and to inflation and income growth.

19 Pew's calculation of interactive AMT effect is based on data from the Congressional Budget Office's *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (January 2010), Table 1-5.

20 Cost estimates for the two-year extension are based on data in Table 1-5 of the CBO's *The Budget and Economic Outlook: Fiscal Years 2010 to 2020* (January 2010). For fiscal year 2013 the report assumes that one-quarter of the full cost is incurred due to differences between tax and fiscal years (one-quarter of the 2012 tax year occurs in the federal government's 2013 fiscal year).

21 The technical budget rules require that a true offset for a tax cut must come from a cut in a mandatory spending program or a tax increase, however this comparison includes discretionary spending items in order to illustrate the magnitude of the cost of a tax cut extension.

22 Ten-year estimate of outlays for international development and humanitarian aid comes from Table 26-14, Analytic Perspectives, *Budget of the U.S. Government, Fiscal Year 2011* (March 2010). Pew's estimate of savings from a three-year freeze on non-security discretionary spending is based on information contained in 2011 budget. For the estimate of savings from a freeze on all discretionary spending, see Congressional Budget Office, *The Budget and Economic Outlook: 2010-2020* (January 2010), Table 1-5.

23 Social Security Administration, *Monthly Statistical Snapshot*, March 2010, accessed at http://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/; estimates for savings from a 10 percent cut in Social Security spending are based on CBO projections; see Congressional Budget Office, *The Budget and Economic Outlook: 2010-2020* (January 2010), Table 3-1.

24 Congressional Budget Office, *Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates* (December 1, 2005).

25 Office of Tax Analysis, U.S. Department of the Treasury, *A Dynamic Analysis of Permanent Extension of the President's Tax Relief* (July 25, 2006).

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