Abstract - Even after passage of the 2001 legislation, federal taxes as a share of gross domestic product will fall well within the narrow range that has prevailed since the end of World War II. The bill brought to light the danger of bifurcating the tax and expenditure sides of the budget, and conflicts over progressivity and marginal tax rates could not be resolved without drawing expenditures into the analysis and the bill itself. Finally, whether taxes in the long run go up or down is to a large extent still to be determined by the future direction of entitlement programs.

INTRODUCTION

Let me try to give a somewhat different, longer-term perspective on the meaning of this tax cut. I want to address three issues. The first is the size of the bill relative to others in recent history and relative to total tax collections. The second is the way that this bill makes clearer than ever the arbitrariness of considering tax and expenditure issues in isolation. For many analyses, consistent thinking is only possible by looking at both sides of the budget. Two prime examples played out in the recent legislation were over progressivity and marginal tax rates. Finally, I will suggest that the bigger tax issue for the long run likely is not whether provisions of this bill will be fully implemented but, instead, what happens to entitlements.

TAXES: SOME HISTORICAL COMPARISONS

Figure 1 shows taxes as a percentage of gross domestic product with and without the 2001 tax cut. The tax cut itself as finally enacted turned out to be a bit smaller than what the President had initially proposed—but not necessarily smaller if all of its provisions are extended fully into the future. The traditional way of making sense out of the long-term change in direction is to take something like costs in a distant year as a percentage of GDP. By that time, the notion is that everything is fully implemented. Such an assumption is difficult in the current context since Congress technically put a lot into the tenth year and then wiped out all changes in the 11th, enacted some changes for only a few years, and failed to index the child credit even for inflation. In any case, one can play around with the numbers in a variety of ways, but, roughly speaking, it
appears that a fully implemented bill like this would eventually cost annually about 1 1/2 percentage points of GDP.

How does that compare with tax increases and decreases historically? The biggest increases and decreases in the last 50 or 60 years have been associated with World War II and the Korean War. Once past the Korean conflict, total federal revenues as a percentage of GDP display a remarkable constancy. It is even hard to find President Reagan’s tax cuts in Figure 1. Still, the Reagan tax cuts, if fully implemented, would have been about 4 percentage points of GDP. Relative to the economy, they were about 2 1/2 times bigger than the Bush tax cut, at least as originally enacted.

Of course, many qualifications are required. The tax code wasn’t indexed for years before 1985 (that indexing provision was added by the Congress in 1981, not proposed by the President), so there was some bracket creep between 1981 and 1984. In 1982, the Congress also passed a bill that actually stopped implementation of some of the long-run changes made in the Reagan tax cut. So, to say the Reagan cuts were 2 1/2 times as big as the Bush cuts could overstate the case; on the other hand, we won’t know for a few years how much of the Bush cuts will be continued, increased, or pared either.

Rather than simply ask what happens in the years after a cut is enacted, it is also worthwhile examining what happened in the prior years. Even historians tend to focus extraordinary attention on the size of the Reagan tax cuts without ever noting that in the late 1970s there were tax increases almost as large. These tax increases were not legislated so much as the result of very large amounts of bracket creep that took place in the late 1970s when inflation rates sometimes exceeded 10 percent. The increases in marginal tax rates were especially large for families at about twice the median income.

By way of comparison, revenues as a percentage of GDP also rose in the period prior to the 2001 tax cut. A moderate portion of this was due to the 1993 Tax Act, but a great deal of it was the result of large increases in capital gains realizations, not all of which are projected to continue under either Treasury or Congressional Budget Office (CBO) estimates. There is also significant movement of many upper-middle-income and richer families into higher brackets, sometimes due to the increasing prevalence of two-earner
couples where both spouses have good wages. And, finally, average rates also increased simply because there was a continuation toward a more unequal distribution of income (a trend that started in the late 1970s).

From this type of historical perspective, the Bush tax cut is neither very large nor very small—it is of a moderate size. You may like it; you may not. You may think there are other needs of society that could have been met with these taxes. You may think that tax rates cause large distortions in the economy and that the cut is not large enough. But, from a historical perspective, the numbers tell us that total tax collections will remain well within their post–World War II range.

TAXES AND SPENDING

A second issue brought to light by this tax cut is whether one can adequately measure what is going on the tax side of the budget separately from expenditures. Consider the debate over the progressivity of the tax cut. The discussion itself is hampered by the simple fact that we tend to use inconsistent measures of progressivity on the tax and expenditure sides of the budget. From the tax side, we tend to measure it by the rate of tax. Is the system proportional (an average rate measure), less than proportional, or more than proportional? Alternatively, does the marginal rate of tax increase or decrease as income increases? On the expenditure side, the tendency has been to measure progressivity by whether more dollars are given to higher or lower income people. For instance, a bill that gives more to the rich than to the poor is considered regressive as measured by absolute dollars.

These standards are inconsistent. We see this when we look at Social Security. Using the definitions above, the Social Security tax is regressive because the marginal rate and the average rate are essentially proportional up to a given income level, then decline. Expenditures, in turn, are regressive because higher earners get more dollars of benefits on average than do lower earners. Yet most believe that the system as a whole is progressive. In other words, on an overall basis, it is meant to provide a net redistribution from richer to poorer people—a redistribution that is possible with taxes that are regressive and expenditures that are regressive by inconsistent measures.¹

Now consider the recent income tax cut. The Administration proposed an income tax cut that gave larger percentage cuts at the bottom than it did at the top. In the 1970s, we would have considered that type of proposal modestly progressive by the traditional tax definition. The complication, of course, is that from a broader budgetary perspective, cutting taxes means something has to give on the expenditure side. Measuring across both sides of the budget, the change may not be progressive at all. I once suggested that in most cases, larger government—at least modern government dominated by social expenditures—is almost always, on net, progressive and redistributive toward lower income classes. Even a regressive tax—regressive by the traditional tax definition—is likely to take more dollars from the rich than the poor and to return to the poor (rich) more (less) in the way of expenditures than they contributed in taxes.

Take the simple case of a proportional tax and an expenditure that is exactly the same for each person. On net, there is redistribution from richer to poorer. Cut back on the tax in a proportionate manner and the amount of redistribution is liable to be reduced.

By this type of calculus, almost any attempt to create a smaller government is

¹ I dodge the issue of whether this redistribution actually occurs given the design of many other features of the system and differences in mortality rates. See, for instance, Cohen, Steuerle, and Carasso, 2001.
going to reduce net redistribution (I don't address the efficiency and growth issues here, which often are the primary justification for most government action in any direction). By a consistent measure of progressivity, then, almost any cutback in government can be attacked as "regressive," whether the reason is that government has become bloated, that a society wants to move away from communism or socialism, that revenues increased unexpectedly beyond what was necessary, that inefficiency rises exponentially as government becomes larger, or that such a move would be growth-enhancing.

How did this issue play out in 2001? Partly because we have gone a long way toward removing lower income people from the tax rolls, it was hard to have an income tax cut that did much for those at the bottom of the income scale. But think about it more closely. The argument really is not that the government should give lower income persons a disproportionate share of an income tax cut. The argument, instead, is that lower income individuals deserve more expenditures.

The 2001 tax bill resolved some of these distributional issues by doing just that—adding in expenditures for households at moderate income levels. For the most part, the refundable portion of expanded earned income tax credits and of child credits are not income tax cuts at all. Even the budget counts these as expenditures, though administered by the IRS. The issue could not be resolved or even compromised within the tax system alone. Mixing and matching across both sides of the budget were required.

A second area where taxes and expenditures cannot be treated separately is in determining the appropriate marginal tax rate schedule. Figure 2 shows marginal tax rates for a married couple with two children under the old tax law (prior to the passage of the 2001 legislation). The figure counts rates from both the regular income tax and the earned income tax credit (EITC). At a little over $20,000 of income, the marginal rate jumps up toward about 36 percent. This combined marginal rate derives from a 21 percent tax rate due to the phase-out of the EITC, plus the 15 percent marginal tax rate that formerly represented the first bracket of the income tax. Through a combination of increasing the child credit and creating a 10 percent bracket, the Administration tried to move out the point at which these low-income families first faced direct individual income tax rates to just beyond where the

Figure 2. Marginal Tax Rates for a Married Couple with 2 Children: Old Law
EITC phased out. The goal clearly was to reduce the marginal tax rate for these low-to-moderate income families. Once again, the EITC in much of this range is really an outlay program although it is administered by the tax system.

LONG-TERM DETERMINANTS OF TAX LEVELS

If we would similarly take account of other outlay programs such as Food Stamps, Medicaid, and housing allowances, it turns out that a large portion of moderate income families face very high rates, usually about 60 or 70 percent. One of the arguments to make more of the child credit refundable in the 2001 legislation was to try to reduce these marginal rates in outlay programs. In effect, the tax bill used an outlay program to offset some of the tax effects of other outlay programs!

Once again, one can’t solve the issue of how to set tax rates unless the tax and spending sides of the budget are analyzed together. We have moved to a world in which it is increasingly harder to separate tax and spending issues. The recent debate over progressivity and marginal tax rates itself was confusing because it often failed to work through these issues in a consistent manner.

Finally, one might ask about the direction of tax rates over the long haul. In the long-run, the present value of taxes equals the present value of expenditures. From that perspective, the ultimate driver of tax rates in the current budget is less the delayed tax cuts and more the scheduled increases in entitlement spending as a percentage of gross domestic product (GDP). Figure 3 shows past and projected Social Security, Medicare, and Medicaid spending—in comparison to federal revenues—growing by as much as six or seven percentage points of GDP over the next few decades. And the growth rate is inexorably upward. This entitlement growth is much larger than the scheduled decline in taxes, so from sheer size, one can speculate that it is putting more pressure to raise the size of government than are the tax cuts to reduce the size of government. The budget remains on a collision course, but what wins out in the end remains to be seen.

Figure 3. Total Federal Revenues vs. Long-Term Mandatory Spending
CONCLUSION

In summary, at least by comparison, the 2001 tax cut is moderate in size and keeps taxes within their historical range as a percentage of GDP. The debate over progressivity and marginal tax rates demonstrated the danger of bifurcating analysis of the tax and expenditure sides of the budget. And, finally, whether taxes in the long run go up or down is to a large extent still to be determined by what we as a nation decide to do with our entitlement programs.

Acknowledgment

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