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INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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THE PRESIDENT'S BUDGET SUBMISSION FOR FISCAL YEAR 2008

President Bush has submitted his proposed Federal Budget for Fiscal Year 2008. It forecasts a balanced budget by 2012, while extending the major elements of the Bush tax cuts. Achieving budget balance would depend on a continuation of the economic expansion and a reduction in the rate of growth of federal spending. One can disagree with specific spending recommendations, but the focus on spending restraint rather than tax increases is the right approach. Indeed, the task would be easier if spending had not been allowed to explode over the past few years. It is up by more than 50 percent, excluding debt service, between 2001 and 2007, which is nearly a third in real terms.

The President's budget includes permanent extension of the 2001 and 2003 tax cuts and expansion of tax-favored saving and education accounts. It includes a new standard deduction for people who purchase health insurance (offset by ending the tax exclusion of employer provided insurance). The budget provides for only a one year "fix" of the alternative minimum tax (extending the temporarily higher AMT exempt amount, adjusted for another year of inflation). Without it, the AMT would affect about 23 million taxpayers in 2007 instead of only 8 million. Beyond 2007, the number could jump to 29 million in 2008 and nearly 40 million in 2010. Revenues, which have been rising at double digit rates for two years, are projected to grow at only 5.6 percent going forward, in line with nominal GDP growth through 2012, and to hold steady at about 18.3% of GDP, roughly the 40 year average. This is a conservative assumption, given that real bracket creep would normally raise revenues a bit faster that GDP over time. It also assumes, perhaps too glumly, that we have already seen the full revenue feedback from the dividend and capital gains relief of 2003.

To achieve balance, the budget would hold the rate of federal spending growth below the rate of growth of GDP. Outlays would slip from 20.3 percent of GDP in 2006 to 18.3 percent in 2012. Discretionary non-defense spending growth would be held to less than the rate of inflation. The budget includes money for the wars in Iraq and Afghanistan for two years. It proposes steps to trim the expansion of Medicare, Medicaid, and SCHIP (state children's health insurance program). The Medicare proposals would eliminate about a quarter of the projected unfunded liability in that program, but much more work would remain.

Economic assumptions

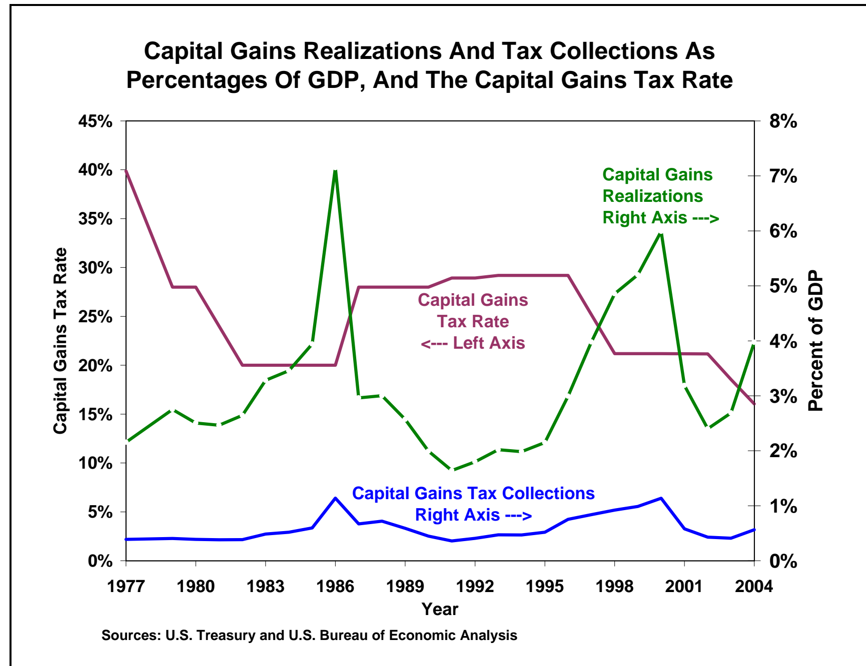
The budget outlook depends on its economic assumptions. The Administration assumes continued real economic growth averaging 3 percent (the most critical assumption) between 2007 and 2012 (dipping just below 3 percent in 2011 and 2012), with CPI inflation averaging 2.4 percent. The inflation assumption is higher than the Federal Reserve's "comfort zone". The 3-month Treasury bill interest rate is forecast to average 4.4 percent, and the ten-year Treasury bond rate to average 5.2 percent. By comparison, the CBO January forecast has a bit less real growth – 3 percent in 2008-2010, dropping to 2.7 percent in 2011 and 2012 – with inflation averaging 2.2 percent through 2012. The Blue Chip

Consensus falls in between. The three forecasts have roughly similar averages for long term interest rates, with slightly higher short term rates in the out years for the CBO and Blue Chip.

Threats to the forecast

None of the forecasts contains a recession, which would wreck all the numbers. It is very important to avoid an economic downturn.

All three real growth forecasts will prove to be too optimistic if the tax rate reductions and the 15 percent tax rate caps on dividends and capital gains are not extended. It was these provisions of the 2003 Act that turned investment in equipment around, triggered the surge in hiring that had been absent earlier in the recovery, boosted GDP and the stock market, encouraged dividend payouts, and resulted in a flood of tax revenues from capital gains and dividends. Failure to extend them would reverse the gains in investment and GDP, and lose the revenues associated with the dividend and capital gains surges.



We estimate that, if the tax cuts are allowed to expire, the required break-even rate of return on capital investment would jump by about 1.5 percentage points, enough to wipe out about 14 percent of the otherwise-viable capital stock. Disinvestment to shed the excess stock would cripple output and employment for several years. Real GDP would grow by 6 percent less than normal over a very short period, risking a recession in 2011, and throwing away two years of normal real growth. Thereafter, GDP would be on a permanently lower growth path, giving up future income worth about $25 trillion in present value, or about two year's national private sector output. Hours worked would be depressed by nearly 2 percent, and wages by above 4 percent, on a permanent basis.

The Administration assumes the 2001/2003 tax cuts will be extended, which is consistent with its growth forecast. The CBO forecast does not assume extension of the tax cuts. The CBO forecast assumes the real growth rate will slip by only three tenths of a percentage point after the tax cuts expire. This is wildly optimistic for such a wrenching increase in taxation of capital. The CBO static estimate of the cost of extending the tax cuts greatly exaggerates the real dynamic cost of doing so, and ignores the economic and budget danger of not extending the cuts. We can only explain the relatively sanguine Blue Chip forecast as being based on the feeling that some extension of the tax cuts will be achieved.

One key feature of the 2003 tax reduction was the lower, 15 percent tax rate on long term capital gains and qualified dividends. These would expire in 2011 under current law. In the past, increases in the tax rate on long term capital gains have been very damaging to revenues and growth. The capital gains differential was repealed in the Tax Reform Act of 1986 (effective in 1987). Capital gains realizations and tax revenues soared in 1986 as savers rushed to beat the rate hike. (See chart.) Realizations and

revenues then collapsed; realizations as a share of GDP fell below 1985 levels (below levels in effect before the 1986 surge) and stayed below their previous peak as a share of GDP until 1997 (when the capital gains rate was reduced once again). That 1986 rate hike lost capital gains revenues, and it also cost the economy and the budget billions of dollars more due to slower investment, capital formation, and growth of jobs and wages.

Treasury has recently reported details on capital gains realizations and tax collections for 2004. The 2003 tax rate reduction for long term capital gains resulted in more gains being realized, and a rise in capital gains revenues in spite of the rate reduction. This can be seen in the new data for 2004. Realizations were 2.95 percent of GDP in 2002, and rose to 4.26 percent of GDP in 2004. Taxes on capital gains are up by nearly half ($74 billion versus $51 billion). (Dividend payouts have also surged, and we believe future releases of tax details will show that they are largely offsetting the revenue effect of the rate cut.)

Earlier reductions in the capital gains rate, in 1978, in 1981, and in 1997, were followed by rising realizations and rising capital gains revenues, with additional gains in revenue from other sources as the economy improved. For decades, the revenue estimators at Treasury and CBO have underestimated these swings in realizations, and have ignored the resulting changes in the economy and other revenues.

Further cuts needed

Even if the tax cuts are extended, real growth rates may subside to the 2.5 to 3 percent range within a few years. The new tax treatment of capital in 2003 triggered a *level adjustment* in the capital stock, that is, the acquisition of additional capital was made profitable and sustainable by the change in the tax law. Investment has been higher than normal for a period, and will remain so until the new, higher desired capital stock is attained. That adjustment will have been completed by about 2008 for equipment, and will be winding down for structures between 2011 and 2013. Once the higher level of the capital stock is attained, investment and economic growth will return to a more normal level.

Maintaining a 3 percent-plus real growth rate for another decade will require either a further cut in the taxation of capital, stronger technological advances, or faster population growth. This is more important than merely fixing the AMT, although that should be taken care of as well (ideally, scrapped altogether!) because, in some cases, it raises taxes on capital income.

These tax reductions should be paid for by keeping a firm grip on government spending, in both the discretionary and entitlement sectors. Entitlement reform will be critical to keep deficits and taxes from soaring in the decades ahead.

Can the President's spending targets be met?

Technically, yes. But politically? Some of the spending targets are sensible and technically feasible, but would be politically difficult. For example, trimming farm subsidies for corporate agribusiness or the highest income producers makes a great deal of sense, especially as the ethanol provisions in the budget would send spending on corn through the silo roof. There is also no good reason for the SCHIP program to be giving insurance subsidies to families with incomes above twice the poverty level. Yet trimming either program would lead to howls from Congress. There is also too much new spending in the budget on politically "hot" items like global warming and energy independence (pun intended). Much of the energy program should be left to markets and the private sector.

Other spending targets are questionable. Squeezing payments to Medicare providers could, in theory, encourage them to try harder to eliminate wasteful tests and become more efficient. But the likelier outcome is to cause more providers to stop accepting Medicare patients. A better approach, empowering consumers to shop for insurance from competing private providers, involving the incentive

to make better medical care choices, is not in line with the political philosophy of the new majority in Congress.

There are many other programs being recommended for reduction or elimination, and many others that deserve to be cut. Spending restraint, enough to let the economy grow out from under the government, is surely the best and least costly way to solve the budget conundrum.

Why focus on spending?

Each dollar of government spending creates economic distortions that add to the direct cost of the outlay. Not only is government spending less efficient than private activity, but the dead weight economic costs of the tax represent lost income over and above the tax taken.

Suppose a dollar of spending is paid for, either now or in the future, by a dollar of taxes. If the tax is of the type that reduces at-the-margin incentives to save, invest, or work, it will reduce GDP and lose some portion of the projected revenue. The tax rate will have to be increased by more than indicated by the static revenue estimate to overcome the adverse effect on revenue from the reduction in GDP. The cost to the private sector of the added dollar of government spending is the tax revenue plus the reduction in income as the economy contracts.

When top income tax rates are raised, or added taxes are levied on business or capital income, the added costs are large. It is likely that each additional dollar of government spending costs the private sector between $2.50 and $3 in taxes and lost income. Government officials need to be aware that government outlays need to be more valuable than their direct cost would indicate to be worth pursuing.

Choosing between a balanced budget and tax cuts

Strictly speaking, having to choose between a balanced budget and tax cuts is a phony choice. Congress could balance the budget by restricting government spending to things that are truly essential for the national interest, and that can only be done on the national level. Everything else should be left to citizens acting in their private capacity, or through local or state governments.

However, we have a Congress that likes to please the public, and a public that too often thinks of government spending as a free good, paid for by someone else, and with little harm done. So we overspend. After awhile, we become afraid of the projected deficits.

Each Administration in such a situation eventually bows to the rhetorical concern over the deficits, and promises to submit a budget that will be in balance x years in the future. This result is rarely achieved. The last time that the budget moved into surplus, in the late 1990s, the surplus was a result of spending restraint, a reduction in the tax on capital, and strong economic growth.

We again have a federal budget submission that promises to balance the budget, this time in 5 years, with significant spending restraint starting three years hence (after a new President is inaugurated). Is this target really important? What if the spending targets are not met, and the deficit targets start to slip by a few years?

The United States has one of the lowest debt to GDP ratios in the developed world, and our figure is not high by historical standards. It would not take much spending restraint to set the ratio declining. There is room in this budget for some slippage on the spending side without damaging the economy, especially if the alternative is to allow tax rates on capital income and wages to rebound to old levels. The latter would weaken the economy and make balancing the budget more painful.

Suppose that spending does not fall to 18.3 percent of GDP by 2012, but only to 19.3 percent. That would add a static 1 percent to the 2012 deficit. If, in addition to extending the tax cuts, the AMT were "fixed" by making permanent the higher

temporary exempt amount and indexing it to inflation, then revenues would be lower by about a half a percent of GDP (static estimate). The result would be a deficit in 2012 of about 1.5 percent of GDP, well below the 40-year average of about 2 percent of GDP. A deficit of 1.5 percent of GDP or below in 2012, gradually declining to about 1 percent of GDP a few years later, would reduce the debt/GDP ratio (federal debt held by the public as a share of GDP). It would reduce the share of the budget devoted to interest payments over time. That is sufficient progress.

If the trade-off is between hitting the zero-deficit target and not extending the tax cuts, the correct choice is to accept a modest deficit (of as much as 1.5 percent of GDP). Not extending the tax cut would lead to a weaker economy, fewer jobs, lower incomes, and a lower revenue stream than in anyone's forecast, and larger deficits than the forecasts show. Controlling spending should be the real objective, even if it takes a bit longer to balance the budget as a result. That way, we can have a balanced budget and a strong economy, instead of a balanced budget and a mediocre economic outcome.

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President and Executive Director

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.