# *Federal Tax Policy at a Crossroads*

By Frank Mauro, Executive Director, Fiscal Policy Institute
September 21, 2010

The United States Congress is currently considering what action to take regarding a range of income tax cuts that were enacted at the behest of President George W. Bush in 2001 and 2003, and which are currently scheduled to expire at the end of the current calendar year, 2010. Most media coverage of this debate has focused on whether or not the portions of those tax cuts that are specifically targeted at the wealthiest two to three percent of taxpayers should be allowed to expire as President Obama is recommending.

Specifically, President Obama is sticking with his 2008 campaign pledge to make the Bush income tax cuts permanent for single taxpayers with adjusted gross income (AGI) below $200,000 and for married taxpayers with AGI below $250,000, and to allow the Bush tax cuts that were specifically targeted for taxpayers with higher incomes to expire.

In addition to the income tax provisions of the 2001 and 2003 tax cuts, the future of the estate tax is also on the table. The Bush tax cuts provided for the gradual reduction of the estate tax over the course of the decade until this year when this tax is completely eliminated—only to pop back into place in 2011 at its 2001 exemption level ($1 million per spouse) and rate (55 percent of the taxable portion of the estate over the exemption level). President Obama has proposed a plan (with a $3.5 million per spouse exemption level and a 45 percent rate) that is estimated to produce about half the revenue that would be generated if the 2001 law were to take effect once again.

President Obama is also proposing to make permanent two modifications of the Bush tax cuts. These modifications were enacted in February 2009 as part of the American Recovery and Reinvestment Act and are extremely helpful to those taxpayers that need tax relief the most—low- and moderate-income working families. These modifications of the 2001 and 2003 tax cuts expanded the Child Tax Credit[1] and the Earned Income Tax Credit[2] in ways that effectively "make work pay."

The main Republican alternatives involve making all of the income tax cuts enacted under President Bush permanent while eliminating even more of the federal estate tax. This is the thrust of S.3773, which was introduced last week by Senate Minority Leader Mitch McConnell and 25 other Republican Senators. This bill would establish a $5 million per spouse estate tax exemption and a 35 percent rate, but would allow the 2009 expansions of the Child Tax Credit and the Earned Income Tax Credit to expire.

There are also some deficit hawks that depart from both the Obama and the main Republican positions and call for letting all of the tax cuts expire. And there may be people at the opposite end of the spectrum who would make all of the tax cuts on the table permanent and add some others for good measure. The President's former Budget Director, Peter Orszag, has recently taken the position that repealing the Bush tax cuts is so important for the long term viability of the U.S. economy that it would be worth extending them all for two years, if that were the price of a compromise under which they would be eliminated in two years. But others who are calling for a two-year extension, such as House Minority Leader John Boehner, still have permanentization as their ultimate goal.

Table 1, which presents the results of a recent analysis by the Institute for Taxation and Economic Policy using its tax model, compares the distributional impacts on New York taxpayers of President Obama's plan and the Republican alternative as laid out in the Senate Republican leadership's S.3773. The following important points can be made by a review of this table:

- Overall, and on average, the taxpayers in each of the first three quintiles of the income distribution, all do better under President Obama's plan than under the Republican plan. The taxpayers in these three income groups, taken together, would pay $104 more, on average, under the Republican plan than under the President Obama's plan.
- The difference for taxpayers in the first three quintiles would be even greater if the President's proposal for extending the Making Work Pay Credit were included in the analysis. It is not included, however, since the President is proposing to extend it for only one year, through 2011.
- The taxpayers in the top 5 percent of the income distribution, and particularly those in the top 1 percent, do much better under the Republican plan than under President Obama's plan.
    - Under the Republican plan, the richest 1 percent of New York taxpayers would pay $80,546 less in 2011, on average, than they would under President Obama's plan.
    - Under the Republican plan, the richest 1 percent of New York taxpayers would receive 44 percent of all the tax cuts going to New York taxpayers. Under President Obama's plan they would still do very well, still receiving 20 percent of all the tax cuts going to New York taxpayers.
- While the New York taxpayers in the top 1 percent not do as well under the President's plan than they would do under the Republican plan, they still do extremely well, with an average tax cut of $49,180.

If President Obama is proposing to let the tax cuts for taxpayers with incomes above $250,000 expire, then why do New York taxpayers in the top 1 percent of the income distribution (with an average income above $2 million dollars a year) receive a larger tax cut, on average, than middle income New Yorkers, under his plan? As the Center on Budget and Policy Priorities notes, the answer lies, in part, with the system of marginal rates on which the federal income tax system is based:

> This is because the 2001 tax law's reductions in the lower tax brackets benefit not only people whose incomes fall within the lower brackets but also those whose incomes exceed those brackets. In fact, high-income people actually receive much larger benefits in dollar terms from the so-called "middle-class tax cuts" than middle-class people do.[3]

**Why the Bush tax cuts for the wealthy should be allowed to expire as scheduled—
And the modifications of those tax cuts enacted as part of the Recovery Act
should be made permanent**

1. Extending the tax cuts for the wealthy would cost over $800 million over the next ten years. The 10-year cost of extending the Bush income tax cut for taxpayers with AGI over $200,000 for single individuals and over $250,000 for married couples is estimated to be about $700 million. The cost of the deeper estate tax cut proposed by the Senate Republicans is approximately $100 million.

2. Extending the Bush tax cuts for the rich would limit the resources available to create jobs and improve the economy. The Congressional Budget Office (CBO) ranked making permanent the Bush tax cuts for all taxpayers (including the rich) as the least effective policy option for creating jobs over the next couple of years.

3. Extending the 2001 and 2003 tax cuts for the rich will perpetuate many unfair aspects of the federal tax system. Three fourths of capital gains income goes to the richest one percent of taxpayers. Continuing very low rates of taxation on capital gains and dividends allows very wealthy taxpayers to pay federal income taxes at lower effective rates than middle-income people whose income takes the form of wages and salaries.

4. Many middle-income and low-income taxpayers would pay more in taxes under the Republican plan than under President Obama's plan. This is because the President's plan would make permanent the ARRA's temporary changes in the rules governing the Child Tax Credit (CTC) and the Earned Income Tax Credit (EITC) while the Republican plan would allow those changes to expire. If the improvements in the CTC and EITC are not made permanent, the lowest income three fifths of New York taxpayers would lose $104 of tax cuts, on average.

5. Making the Bush tax cuts for the wealthy permanent would limit the resources available for funding successful federal programs with proven track records. As the Center on Budget and Policy Priorities' analysis of Minority Leader Boehner's recent plan for a 2-year extension of the Bush tax cuts for the wealthy demonstrates, important programs and services will be at risk. The CBPP analysis concludes that the Boehner plan would require an average cut in all non-security domestic discretionary spending of 21.1 percent against the CBO baseline for FY 2010 adjusted for inflation or 21.7 percent against the President's proposed appropriations for FY 2011. See Table 2 for examples of the impact of such a 21.7 percent cut in the funding levels of affected programs.

| Table 1 | | | | | | |
|---|---|---|---|---|---|---|
| **Impact on New Yorkers of Competing Tax Cut Proposals** | | | | | | |
| **New York Taxpayers** | | **President Obama's Plan** | | **Senate Republicans' Plan** | | **Republican Plan vs. Obama's Plan** |
| Income Group | Average Income | Average Tax Cut | Share of Tax Cut | Average Tax Cut | Share of Tax Cut | |
| Lowest 20% | 10,685 | (182) | 1.80% | (49) | 0.40% | 133 |
| Second 20% | 24,911 | (572) | 5.80% | (450) | 3.30% | 122 |
| Middle 20% | 44,161 | (887) | 9.00% | (829) | 6.00% | 57 |
| Fourth 20% | 73,184 | (1,603) | 16.20% | (1,600) | 11.70% | 3 |
| Next 15% | 131,700 | (4,091) | 31.00% | (4,106) | 22.40% | (15) |
| Next 4% | 316,604 | (7,801) | 15.80% | (8,398) | 12.20% | (598) |
| Top 1% | 2,283,486 | (40,180) | 20.30% | (120,726) | 44.00% | (80,546) |
| ALL | 84,538 | (1,947) | 100.00% | (2,704) | 100.00% | (757) |
| Bottom 60% | 26,585 | (547) | 16.60% | (443) | 9.70% | 104 |

Source: Institute on Taxation and Economic Policy (ITEP) Tax Model, September 2010.

Notes: While the calculations in this table are for 2011, the table does not include the Making Work Pay Credit since President Obama has proposed to extend it for only one year (2011). If the Making Work Pay Credit were included, the value of the tax cuts under President Obama's plan would be greater than shown.

Table 2

**The Boehner Plan: What Extending the Tax Cuts for the Wealthy Could Mean for Important Programs and Services**

Amounts in Millions of Dollars

| **Program** | **President's Proposed FY2011 Funding Level** | | **The Boehner Cut to These Programs** | |
|---|---|---|---|---|
| | **US** | **NY** | **US** | **NY** |
| Women, Infants & Children (WIC) | 7,603.0 | 469.1 | (1,649.9) | (101.8) |
| Title I Education Grants | 14,492.4 | 1,241.3 | (3,144.9) | (269.4) |
| Vocational Rehabilitation | 3,141.5 | 151.4 | (681.7) | (32.9) |
| Special Education | 11,755.2 | 768.7 | (2,550.9) | (166.8) |
| Adoption Assistance | 2,534.1 | 258.5 | (549.9) | (56.1) |
| Child Care & Development Block Grant | 2,927.1 | 136.0 | (635.2) | (29.5) |
| Child Care Entitlement - Mandatory and Matching | 3,717.7 | 245.7 | (806.7) | (53.3) |
| Child Support Enforcement | 5,288.0 | 282.3 | (1,147.5) | (61.3) |
| Consolidated Health Centers | 2,480.0 | 123.4 | (538.2) | (26.8) |
| Head Start | 8,224.0 | 519.9 | (1,784.6) | (112.8) |
| Low-Income Home Energy Assistance Program (LIHEAP) | 5,300.0 | 250.8 | (1,150.1) | (54.4) |
| Substance Abuse and Prevention Block Grant | 1,798.6 | 115.9 | (390.3) | (25.2) |
| Community Development Block Grant | 3,990.1 | 374.5 | (865.9) | (81.3) |
| Community Services Block Grant | 700.0 | 60.5 | (151.9) | (13.1) |
| EPA - Clean Water | 2,000.0 | 216.3 | (434.0) | (46.9) |
| EPA - Drinking Water | 1,287.0 | 83.0 | (279.3) | (18.0) |
| Bridge Replacement and Rehabilitation | 4,362.4 | 436.2 | (946.6) | (94.7) |
| Interstate Maintenance | 5,105.4 | 183.3 | (1,107.9) | (39.8) |
| National Highway System | 6,234.6 | 208.1 | (1,352.9) | (45.1) |
| Highways - Equity Bonus | 9,743.6 | 240.1 | (2,114.4) | (52.1) |
| Surface Transportation Program | 6,566.0 | 247.3 | (1,424.8) | (53.7) |

---

ENDNOTES

[1] The ARRA made the Child Tax Credit more accessible to low income working families by allowing more of this credit to be refundable. While the 2001 Act gradually increased the maximum value of the credit from $500 to $1,000, the refundable portion of the credit was limited to 15 percent of the taxpayer's earnings above a threshold which had been set at $10,000 in 2001 and which had been inflation adjusted to $12,050 by 2008. In 2008, the Congress reduced the threshold to $8,500 for the 2008 tax year only, and in 2009, the ARRA set it at $3,000 for 2009 and 2010. If Congress allows this provision of the ARRA to expire, the threshold will be around 12,850 in 2011 and it will increase each year thereafter with inflation. For a parent, working full time at the current $7.15 per hour minimum wage, not extending the Recovery Act's 3,000 threshold would reduce the value of the credit for one child from $1,000 to $311. It is estimated that making this provision of the Recovery Act permanent would cost $83.1 billion over the next ten years.

[2] The ARRA made two important changes in the Earned Income Tax Credit (EITC). Prior to the ARRA, the EITC had three credit rates for reaching the maximum credit level for a worker's status: 7.65 percent of earnings for childless adults; 34 percent for one child; and 45 percent for two or more children. The ARRA added a 45 percent rate for families with three or more children. The second enhancement to the EITC made by the ARRA was to provide additional "marriage penalty" relief by increasing from $3,000 to $5,000 the difference between the beginning of the credit phase-out range for married taxpayers with children filing jointly and other taxpayers with children. Making these two expansions of the EITC permanent is estimated to cost cost $30.1 billion over the next ten years.

[3] Marr, Chuck and Gillian Brunet, High-Income People Would Benefit Significantly from Extension of "Middle-Class" Tax Cuts, Center on Budget and Policy Priorities, August 13, 2010, http://www.cbpp.org/files/8-13-10tax.pdf . Other factors involved in explaining the magnitude the tax cuts for the wealthiest taxpayers under President Obama's plan include the continuation of portions of the Bush era changes to the estate tax and the taxation of income from stock dividends.

*The Fiscal Policy Institute (www.fiscalpolicy.org) is an independent, nonpartisan, nonprofit research and education organization committed to improving public policies and private practices to better the economic and social conditions of all New Yorkers. Founded in 1991, FPI works to create a strong economy in which prosperity is broadly shared.*