

Federal Tax Policy & the Future: Challenges & Opportunities

Aviva Aron-Dine
Center on Budget and Policy Priorities
March 20, 2008

2009-2010: Watershed Years for Federal Tax Policy

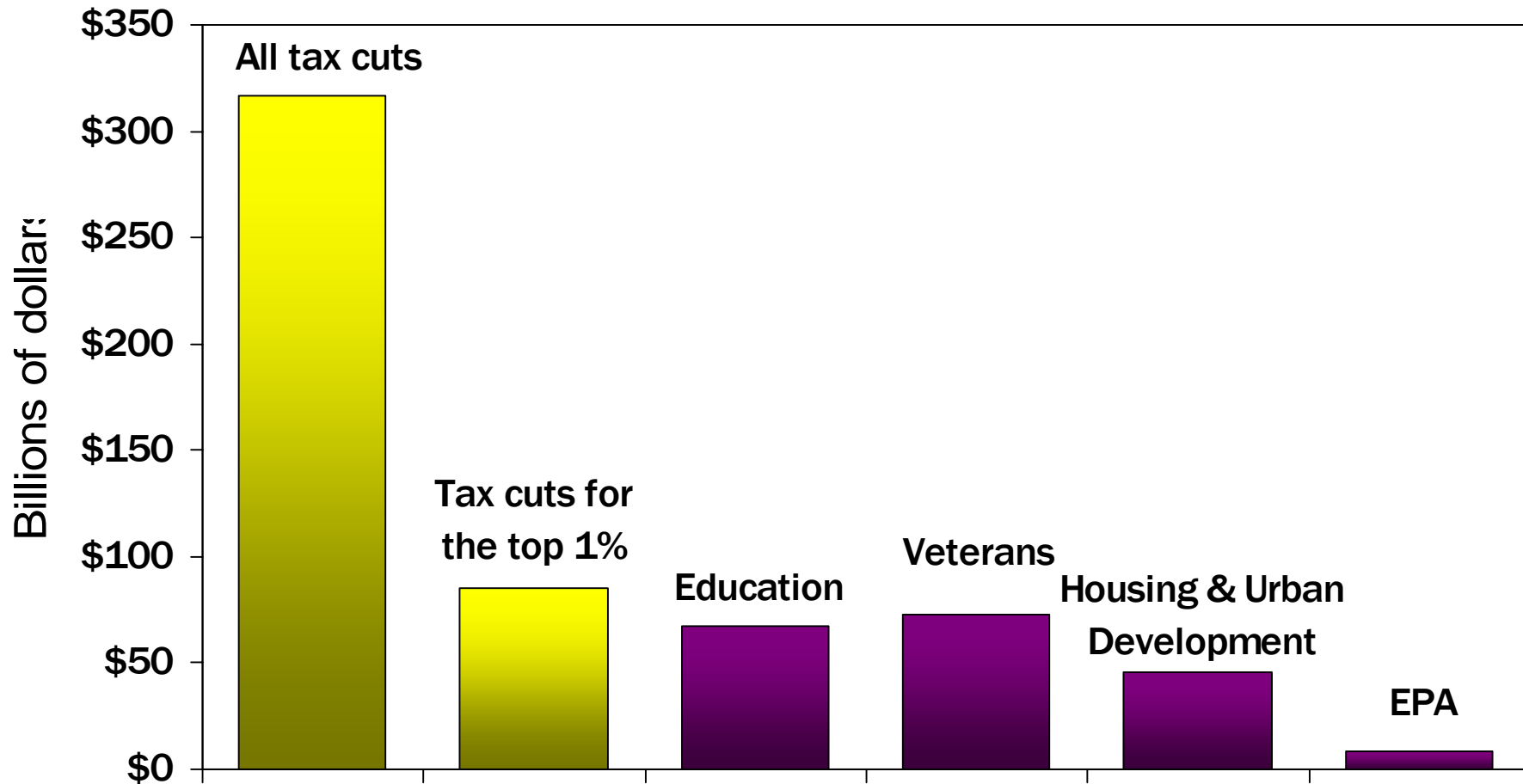
- The 2001 & 2003 Tax Cuts: About 10% of federal revenues are in play.
- The Alternative Minimum Tax is likely to be addressed.
- Efforts by some to put corporate tax reform or corporate rate cuts on the table.
- Might be opportunities to improve tax credits for low-income working families.

The 2001 and 2003 Tax Cuts: An Overview

- **Components**
 - Reduced income tax rates for top 4 brackets
 - Cut capital gains and dividend rates
 - Phased out and repealed estate tax
 - Provided temporary Alternative Minimum Tax relief
 - Child Tax Credit, 10 percent tax bracket, “marriage penalty” relief
- **Cost: About 2 percent of the economy (GDP) or 10 percent of all federal revenues annually**
- **Key Feature: Expire at the end of 2010**

How Much Do These Choices Matter?

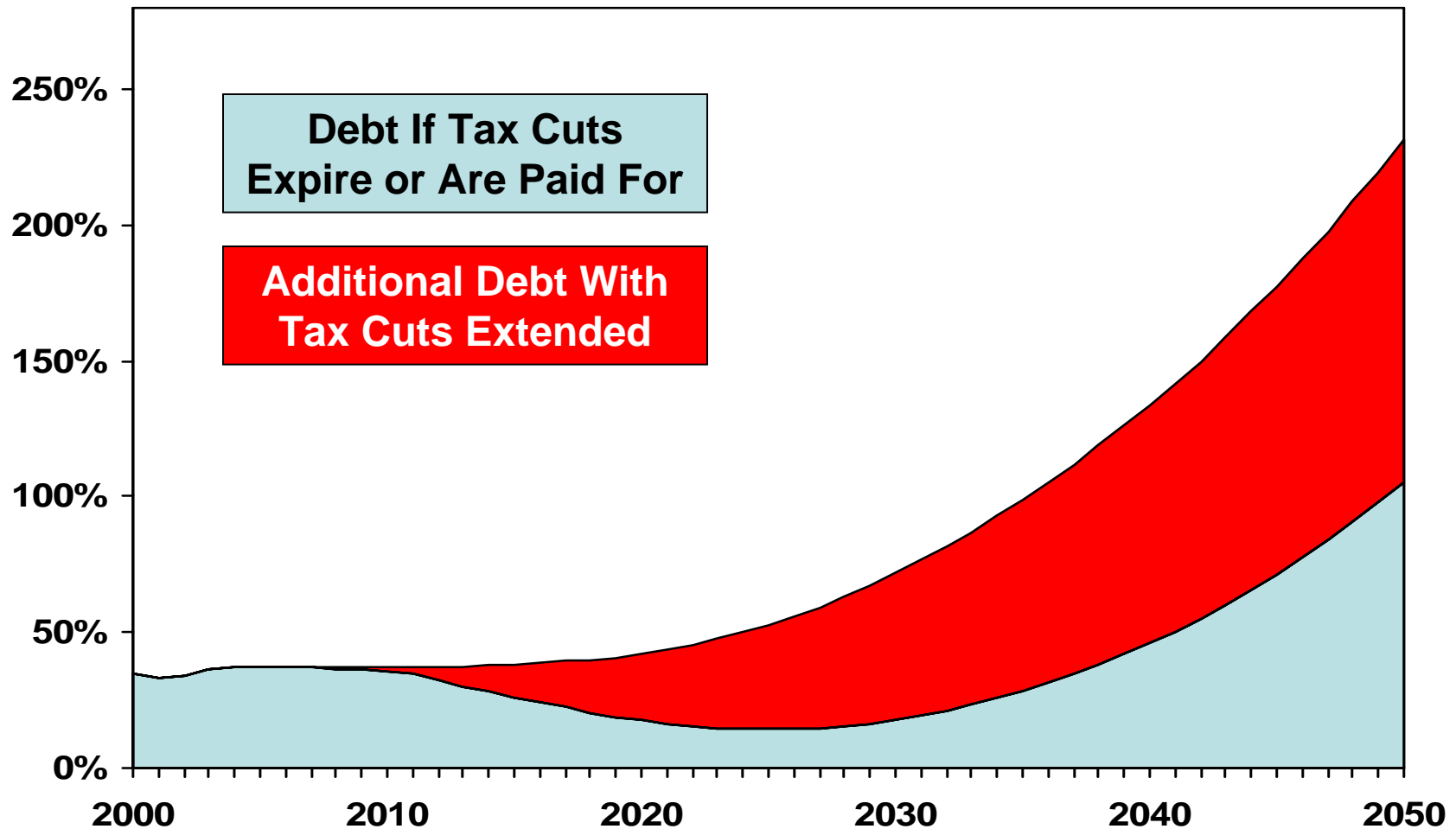
2007 Agency Budgets, Tax Cuts if Fully in Effect in 2007



Source: CBPP calculations based on CBO and OMB data

Long-Run Impact of Upcoming Tax Decisions Could Be Huge

Debt as a Share of the Economy



Source: CBPP calculations based on CBO data

Part 1:
Debates Over
High-Income Tax Cuts

Some Major Provisions of 2001 & 2003 Tax Cuts Clearly High-Income Tax Cuts

- **Top two marginal rates**
 - Married couple with 2 kids need income of at least \$225,000 to benefit AT ALL
 - More than 85% of benefits go to households with incomes over \$500,000
- **Capital gains and dividends**
 - Average tax cut of \$20 for middle-income households, \$32,000 for households w/incomes over \$1 million
- **Estate tax repeal**
 - Under current estate tax law, exemption is \$4 million per couple; only 1 in 200 estates owes ANY estate tax

How These Tax Cuts Are Defended

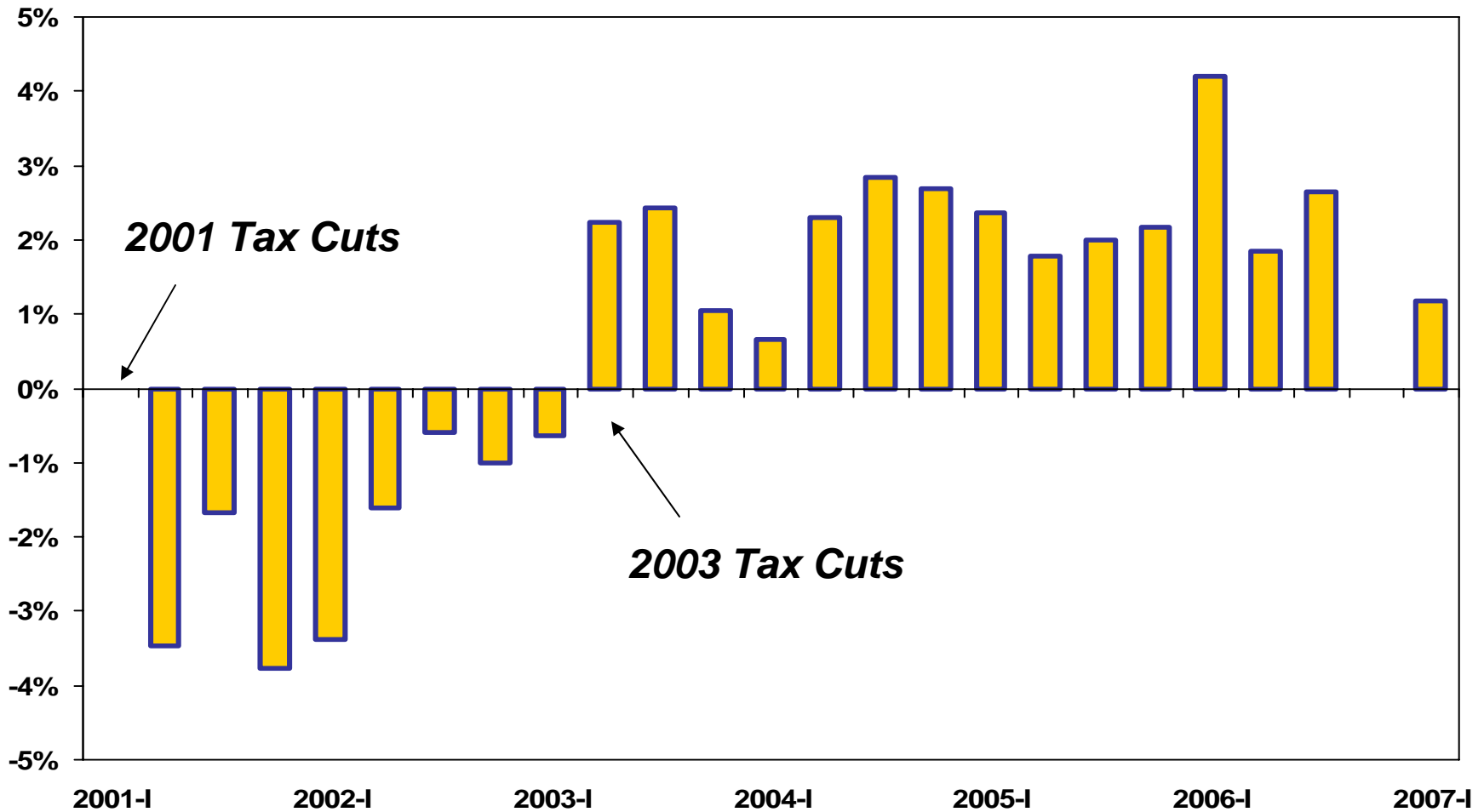
- **Typically not “highest-income people need more money.”**
- **Instead, “tax cuts for high earners and investment income will help the economy.”**

Tax Cuts and the Economy

- **Tax cuts often promoted with exaggerated claims about economic effects**
- **Difficult to actually establish effects of taxes and tax cuts on the economy**
- **Three main approaches**
 - **Historical and cross-country studies**
 - **Studies of work and savings decisions**
 - **Economic simulations**

Investment Increased Following the 2003 Tax Cuts...

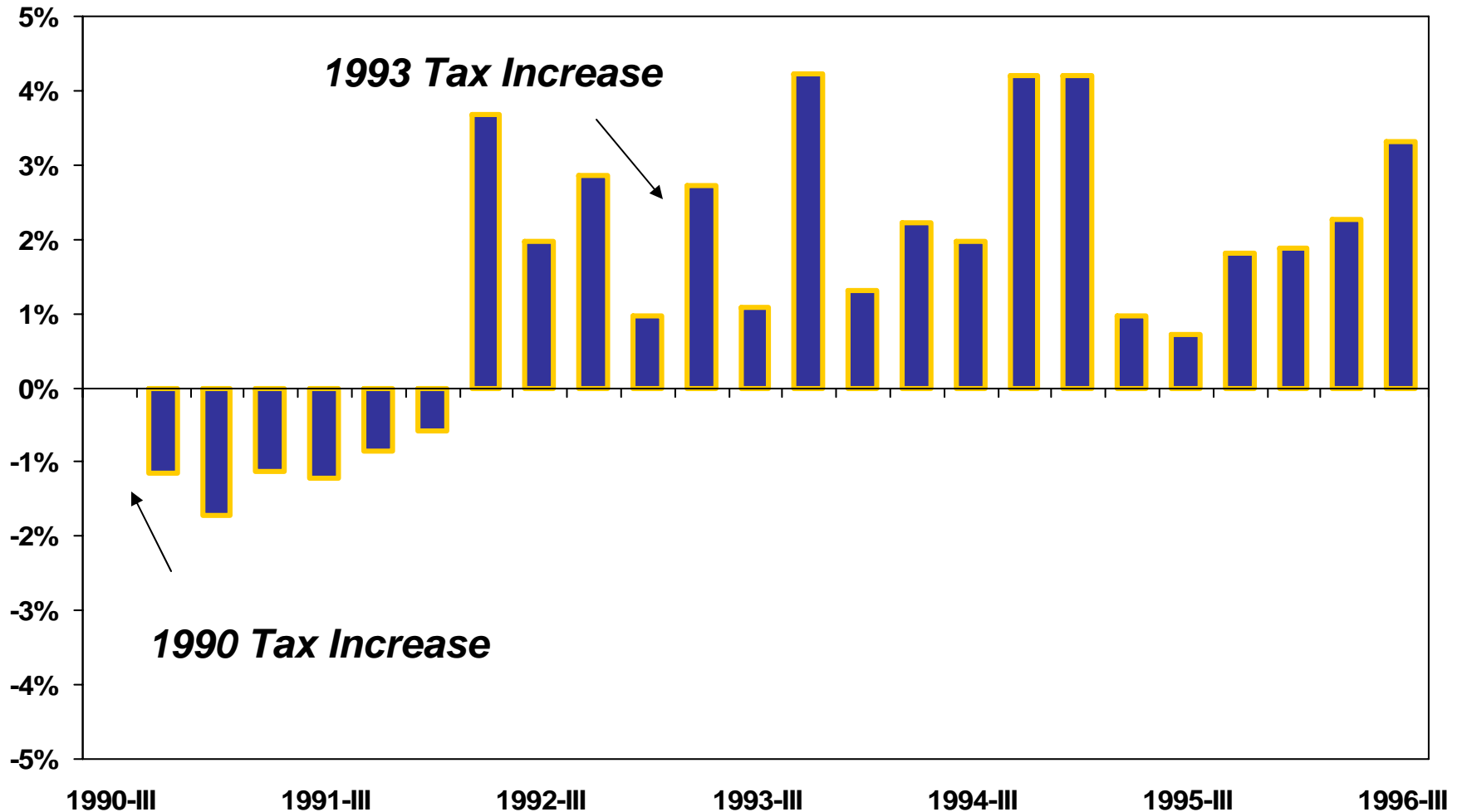
Quarterly Percent Growth in Non-Residential Investment



Source: CBPP calculations based on Commerce Department data

... But Increased More Following the 1993 Tax Increase

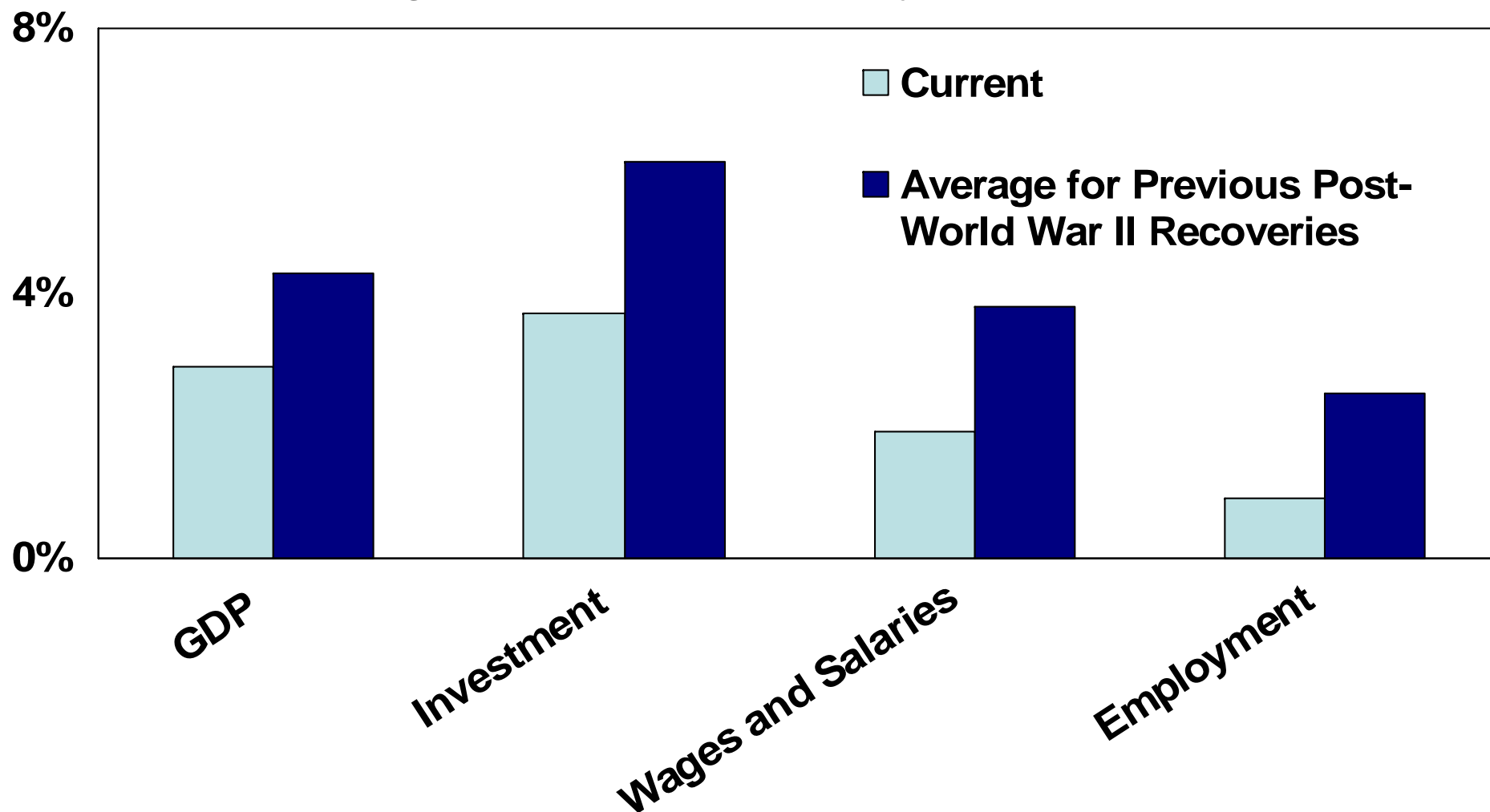
Quarterly Percent Growth in Non-Residential Investment



Source: CBPP calculations based on BEA data

Economy's Overall Performance Weaker Than Average in This Expansion

Average Annual Growth Rate, Adjusted for Inflation



Source: CBPP based on BEA & BLS

Taxes and the Economy: Work and Saving Decisions

- **Empirical studies consistently find little effect on work effort of primary earners.**
- **Private saving probably not very responsive to taxes.**
 - **Congressional Research Service: “Most empirical evidence seems to point to little savings response.”**
- **Revenue levels influence government savings.**
 - **Deficits = government dissaving**
 - **National saving = private + public saving**

Adding to Deficits Likely Worse for the Economy Than Letting Tax Cuts Expire

"Growth effects [of individual and corporate income tax rate cuts] eventually become negative without offsetting fiscal policy [i.e. if not paid for]... because accumulating Federal government debt crowds out private investment"

-- Joint Committee on Taxation

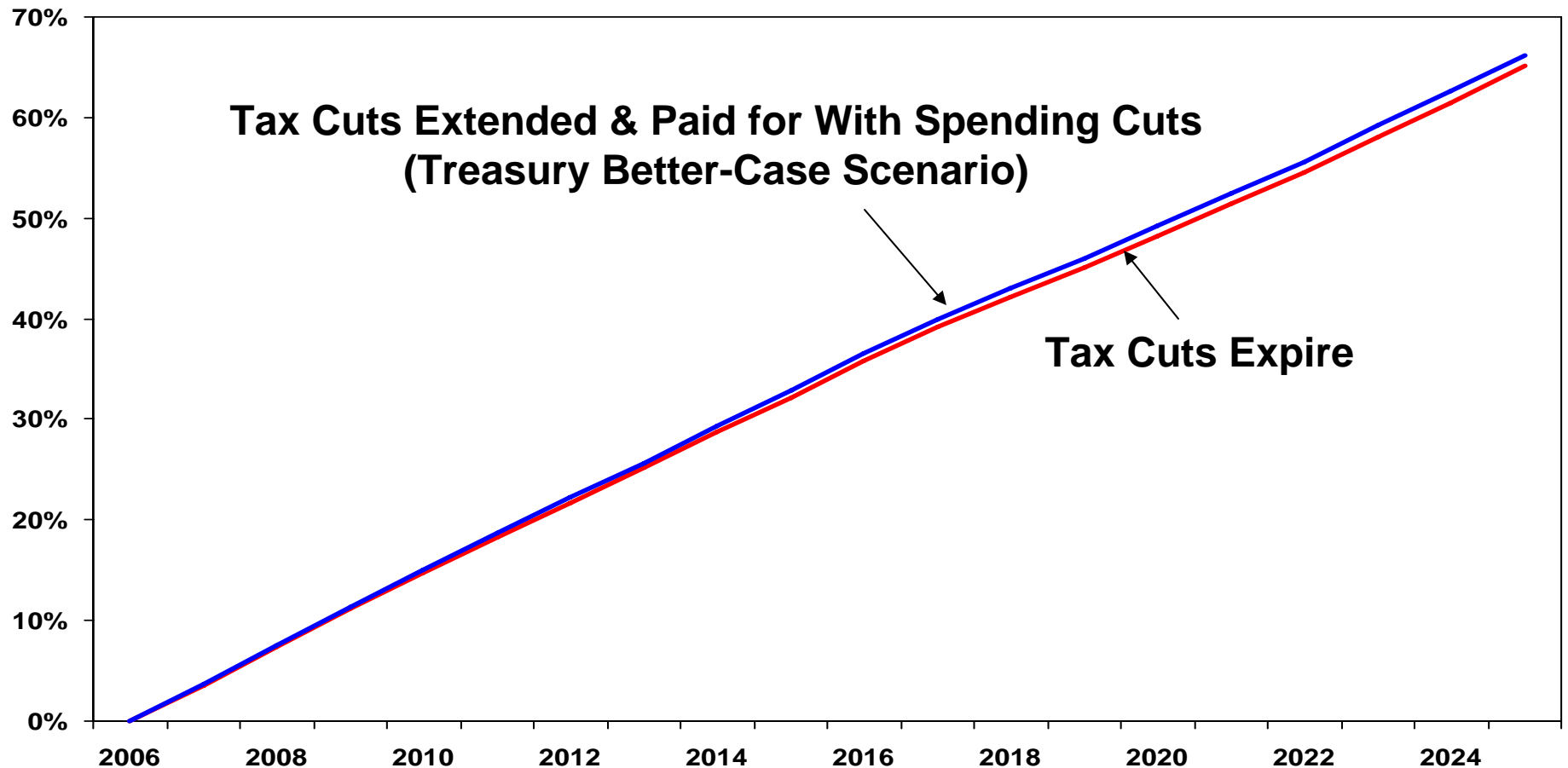
"Making the 2001 and 2003 tax cuts permanent would raise the cost of capital for new investments, reduce long-term investment, and reduce economic growth."

**-- William Gale, Brookings Institution; and
Peter Orszag (formerly of the Brookings Institution,
now director of Cong. Budget Office)**

Studies by **Federal Reserve economists, the Congressional Research Service, the Congressional Budget Office**, and other noted experts have produced similar findings regarding the effects of unpaid for tax cuts.

Treasury Simulations: Effects of Even Paid-For Tax Cuts Are Small

Percent Increase in Real GDP through 2025



Note: Treasury did not provide year-by-year numbers to the specific annual path is illustrative only.

Putting It All Together: “Dynamic Distributional Analysis”

- Want to integrate direct and indirect benefits and costs of tax cuts so we can see the whole picture
- Example: Consider Treasury Department’s simulation of extending the 2001 & 2003 tax cuts
 - Found 0.7 percent boost to national income
 - Higher growth offset aprox. 10% of tax cuts’ costs.
 - Required tax cuts be paid for by program cuts equal in size to the combined budgets of the Departments of Education, Homeland Security, HUD, Veterans’ Affairs, State, and EPA.

Impact of the 2001 & 2003 Tax Cuts Under These Assumptions

| | Direct Tax Benefit | Income Change* | Finance Cost** | Total After-tax Income Change |
|-----------------|---------------------------|-----------------------|-----------------------|--------------------------------------|
| Bottom Quintile | \$73 | \$61 | -\$1,576 | -\$1,442 |
| Middle Quintile | \$792 | \$314 | -\$1,576 | -\$470 |
| Top 1% | \$81,615 | \$10,543 | -\$1,576 | \$90,581 |

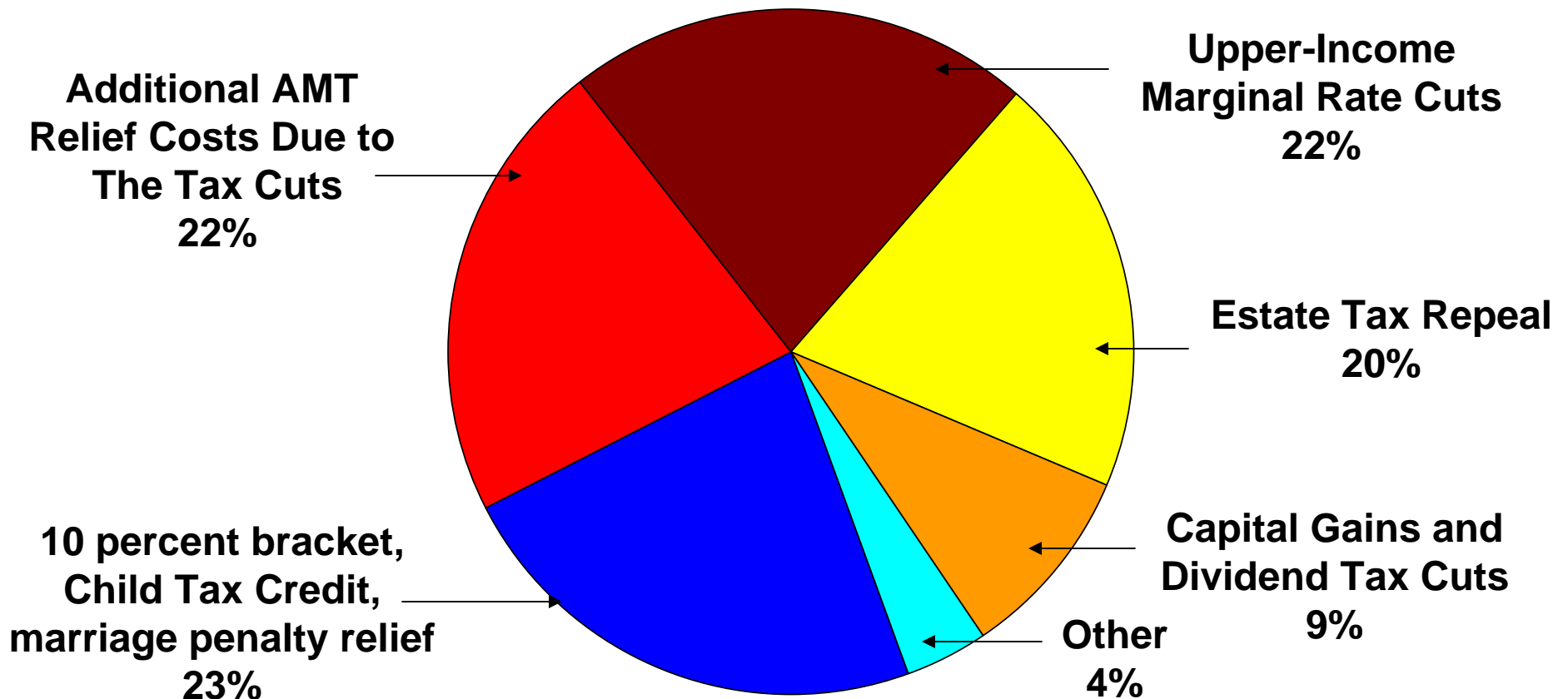
* Assumes increase in national income distributed in proportion to income.

** Assumes program cuts impose equal per-household costs.

**Part 2:
Middle Class –
& “Middle Class” –
Tax Cuts**

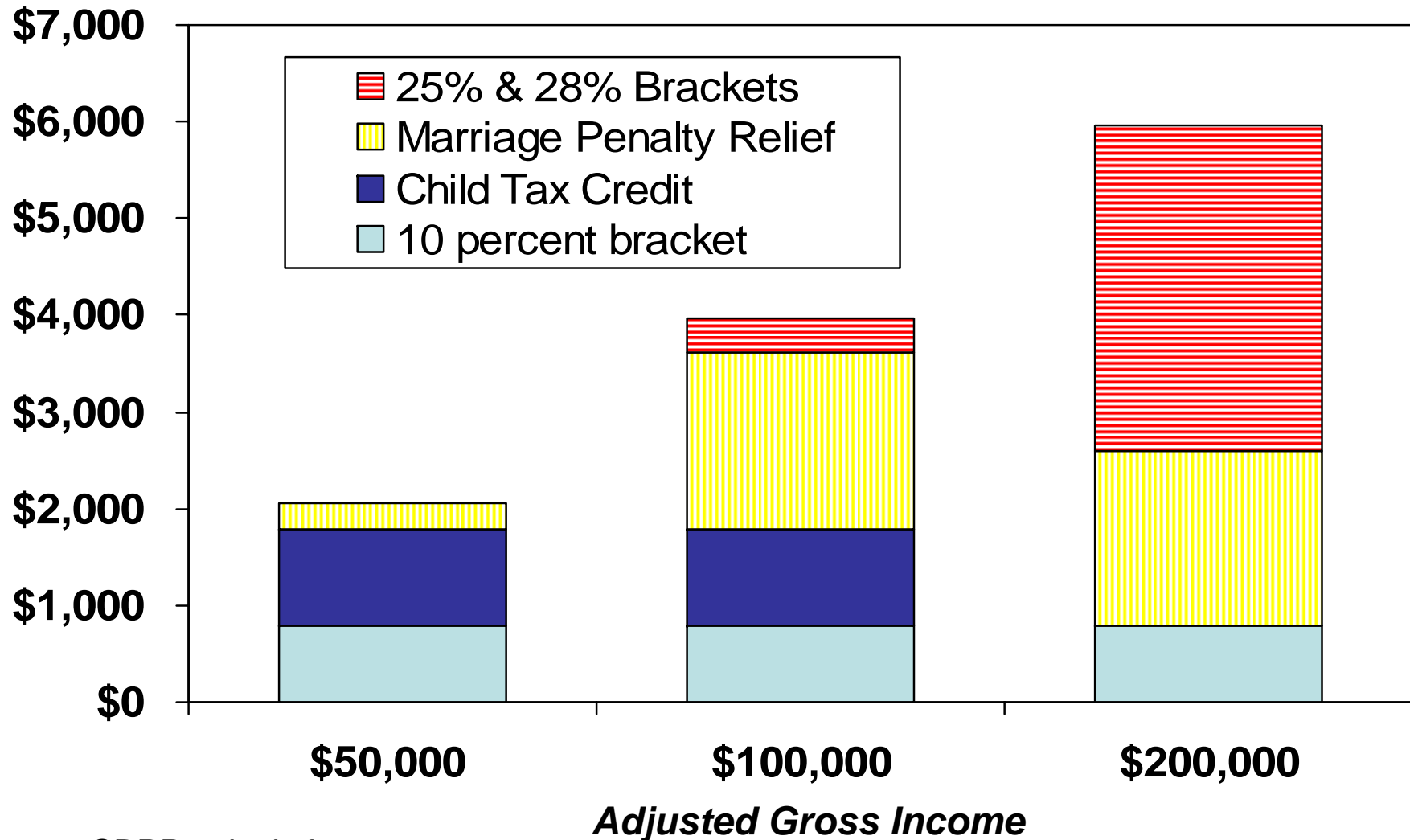
Provisions of the 2001 and 2003 Tax Cuts

Share of Annual Cost When Fully in Effect



Which Tax Cuts Are Middle Class?

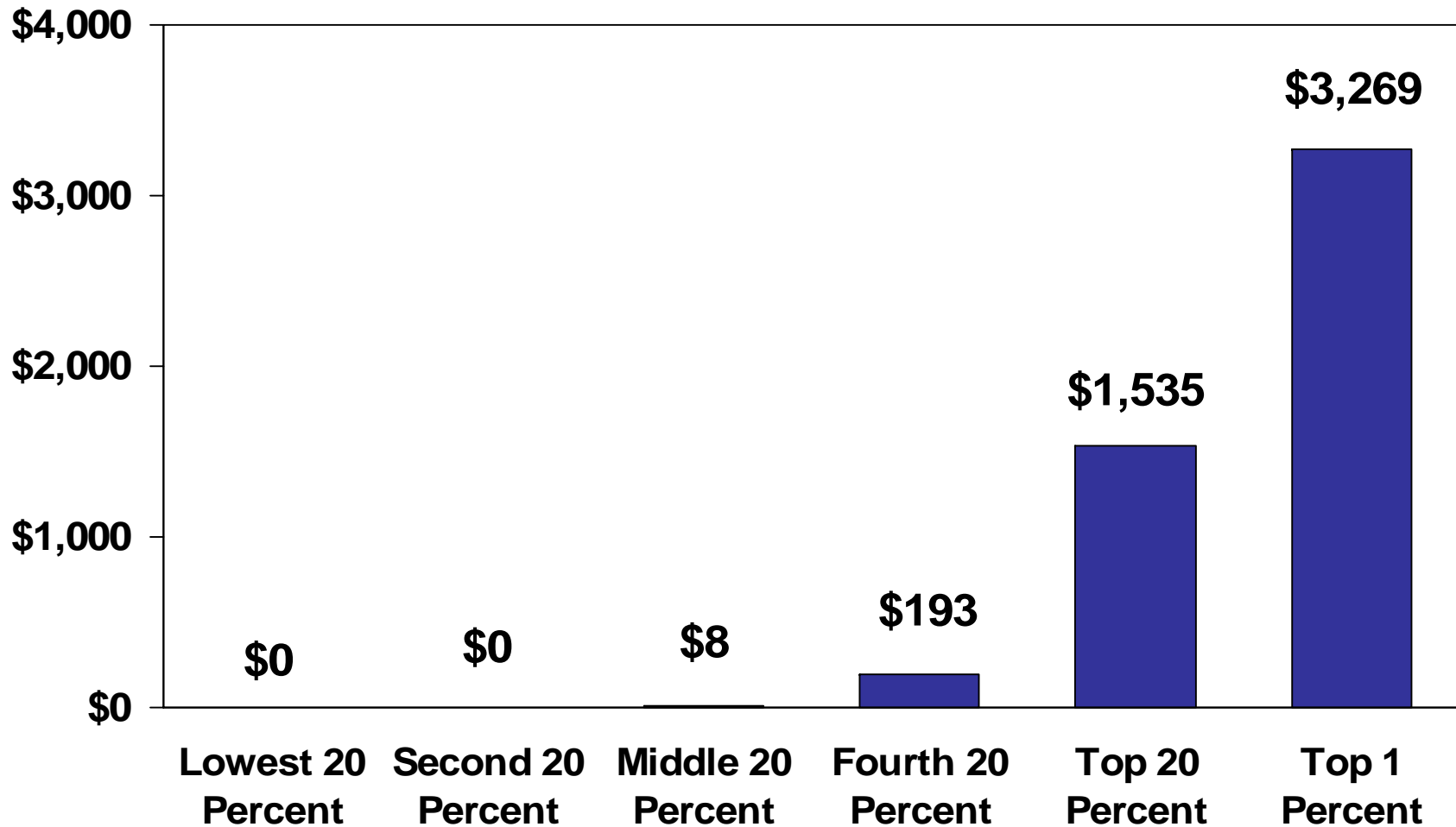
Value of 2001 & 2003 Tax Cuts in 2007, Married Couples With 2 Children



Source: CBPP calculations

Which Tax Cuts Are Middle Class?

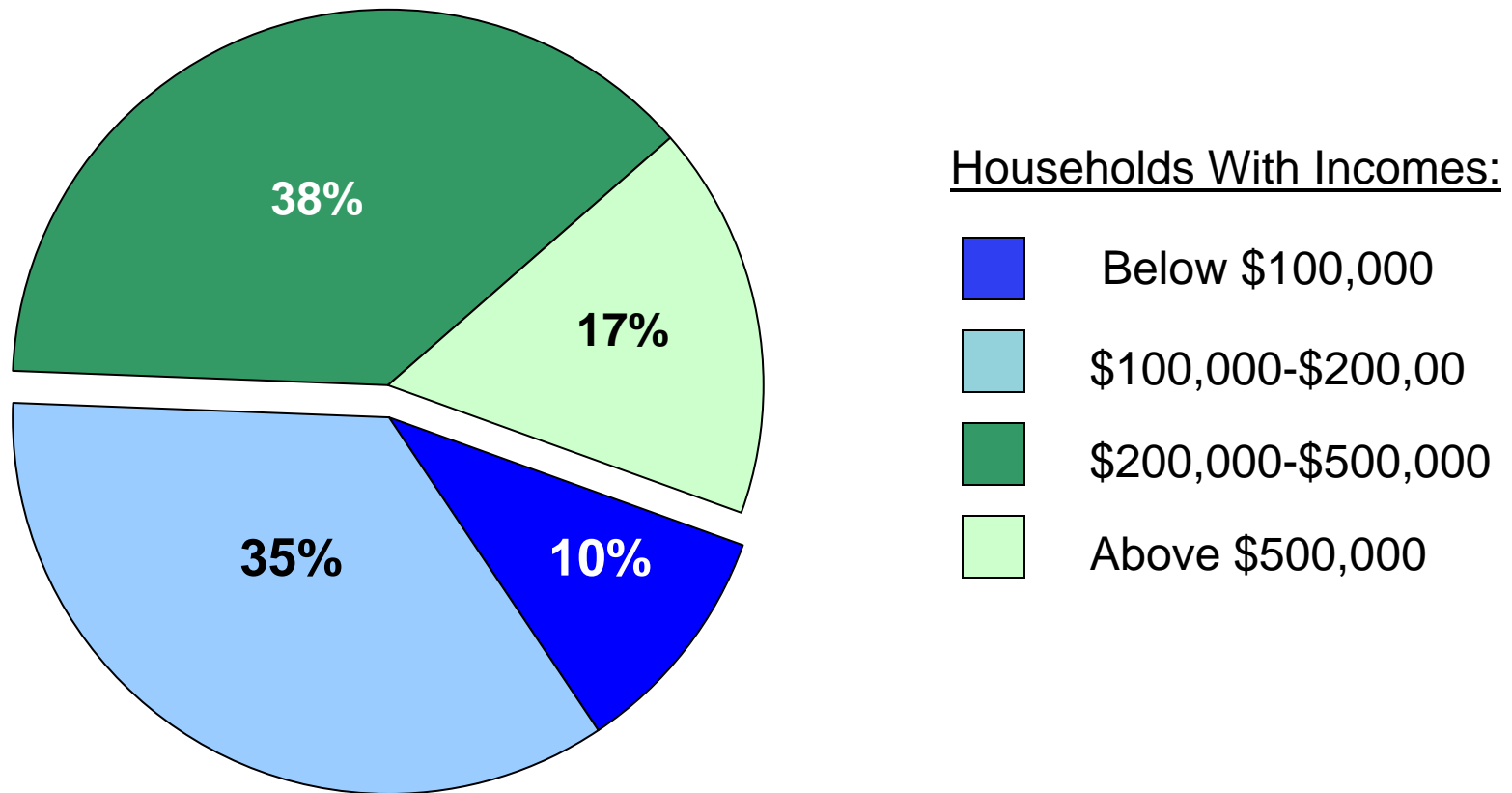
Average Tax Cuts from the 25 and 28 Percent Brackets Rate Reductions, 2010



Source: Urban-Brookings Tax Policy Center

Which Tax Cuts Are Middle Class?

Distribution of AMT Tax Revenue



Source: Urban-Brookings Tax Policy Center. Estimates are for 2007 *without* an AMT patch.

Even Extending Just Middle Class Tax Cuts Is Costly

Revenue Loss From Extending Tax Cuts, 2009-2018

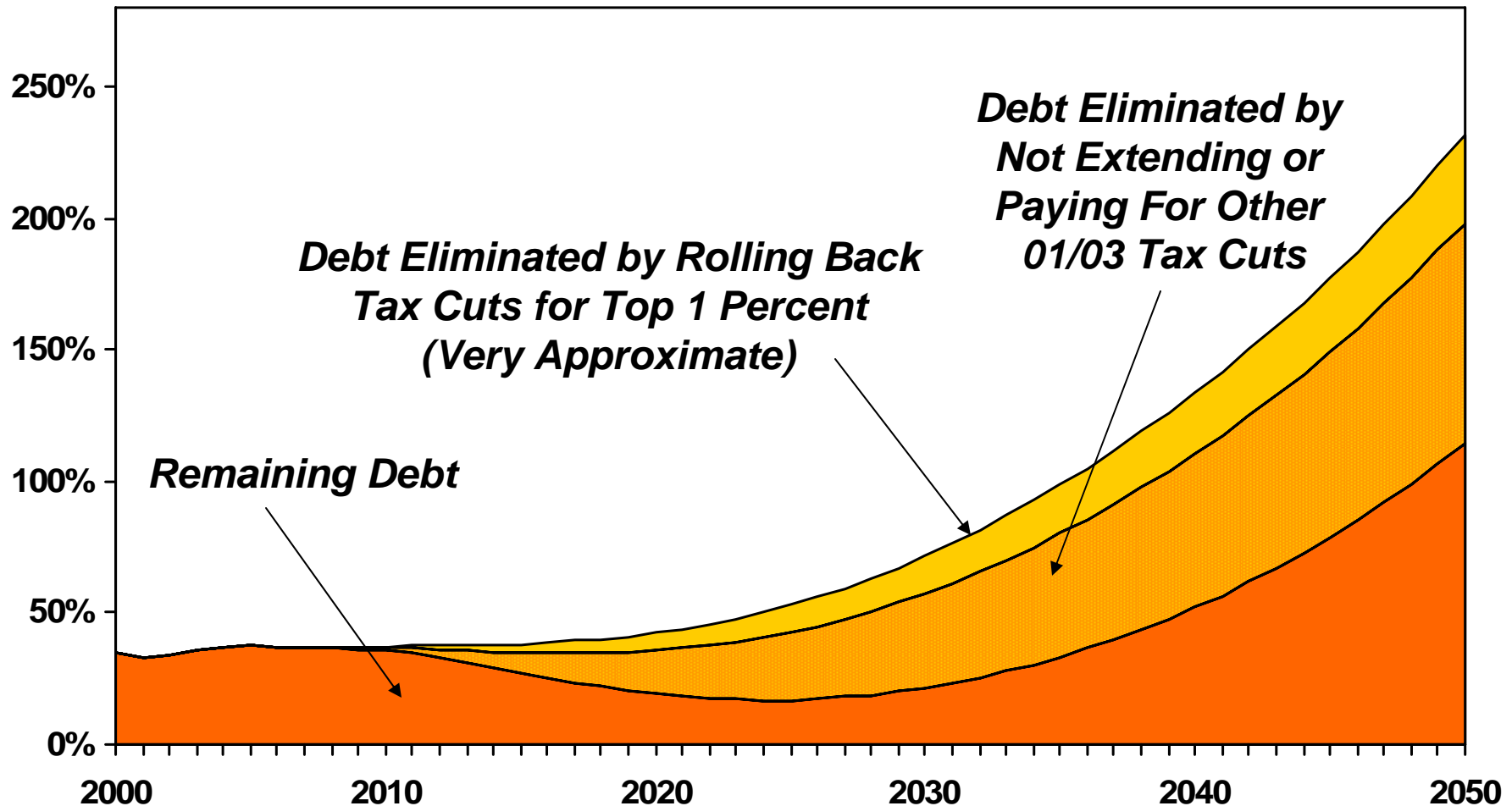
| | |
|--|-----------------------------|
| 10 percent bracket | \$343 billion |
| Child Tax Credit | \$252 billion |
| Marriage penalty relief | <u>\$59 billion</u> |
| <i>“Middle Class” Tax Cuts Subtotal</i> | <i>\$654 billion</i> |

Extending Higher-Income Tax Cuts Adds Substantially to Costs

- **In addition to extending the 10 percent bracket, Child Tax Credit, and marriage penalty relief, some policymakers would also extend the 25 and 28 percent brackets, which primarily benefit high-income households.**
- **If these additional tax cuts are also extended, the price tag jumps to about \$800 billion (2009-2018).**
- **Extending the AMT “patch” for another ten years would cost between \$700 billion and \$1.3 trillion.**
- **If all provisions of the 2001 and 2003 tax cuts are extended, along with AMT relief, the cost reaches \$3.6 trillion (2008-2017), or \$4.3 trillion with interest if deficit financed.**

Rolling Back Tax Cuts For the Very Top Won't Even Fund Existing Programs & Commitments

Debt as a Share of the Economy



Source: CBPP calculations based on Congressional Budget Office data.

Part 3:
Tax Policies Affecting Low-
Income Households

Federal Tax Policy & Poverty: The Earned Income Tax Credit & Child Tax Credit

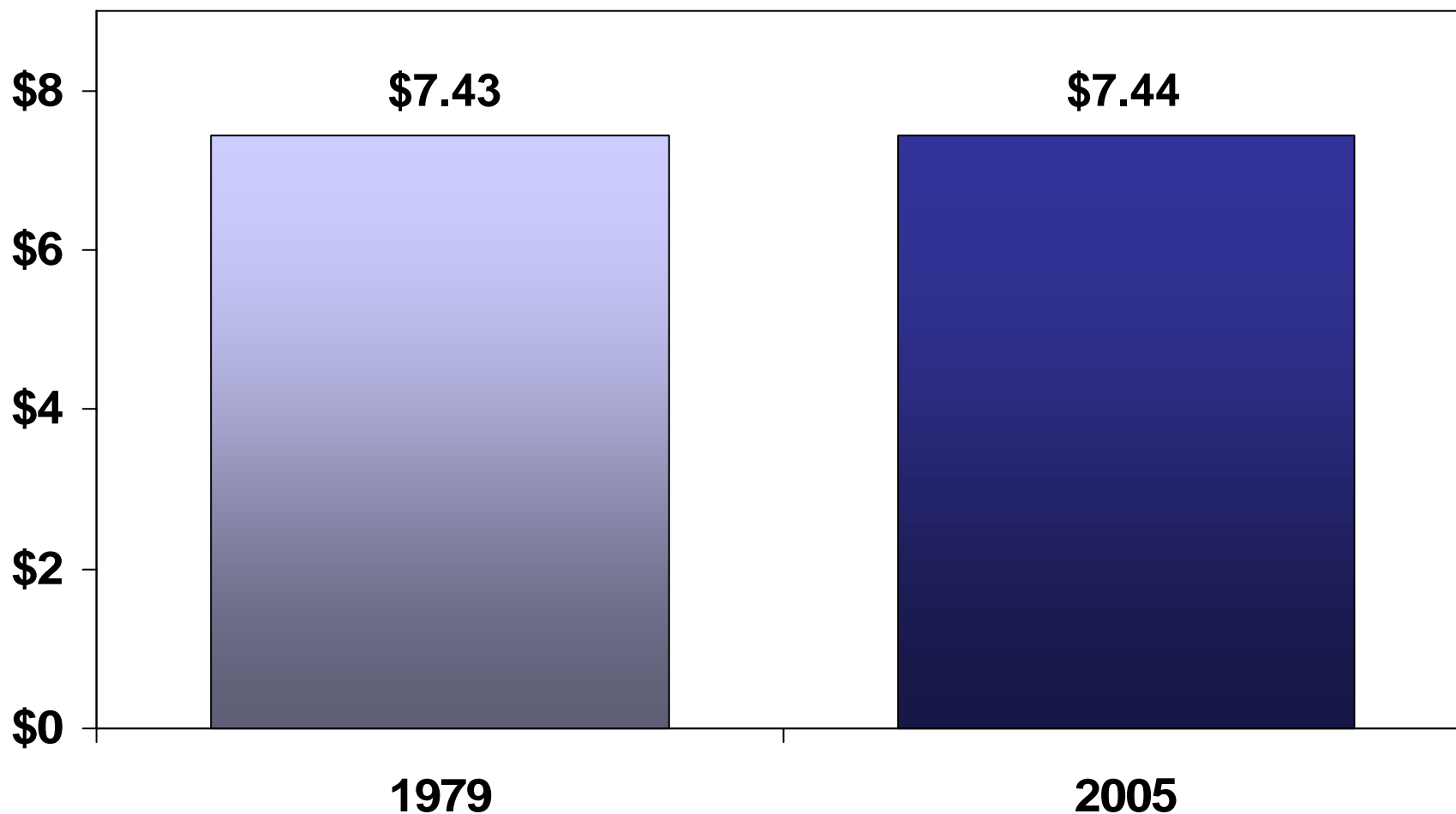
- **The EITC is a refundable tax credit; the CTC is partially refundable.**
 - **Refundable credits are available to people with incomes too low to owe taxes.**
- **The EITC lifts more children out of poverty than any other federal program.**
- **Studies have found that the EITC boosts employment among single mothers.**
- **The refundable CTC also has a significant anti-poverty impact.**

Large Tax Bills Could Be Vehicles for Improvements

- Large budget/tax bills should reflect our national priorities
- Deficit reduction/responsible budgeting & investments in key areas can go hand in hand
 - Major EITC expansions in 1990 and 1993 were included in deficit reduction packages
- Practically speaking, packages with lots of moving pieces can create opportunities

Defining Feature of Labor Markets Since Late 1970s Is Wage Stagnation at the Bottom

Tenth Percentile Hourly Wage, 2005 Dollars



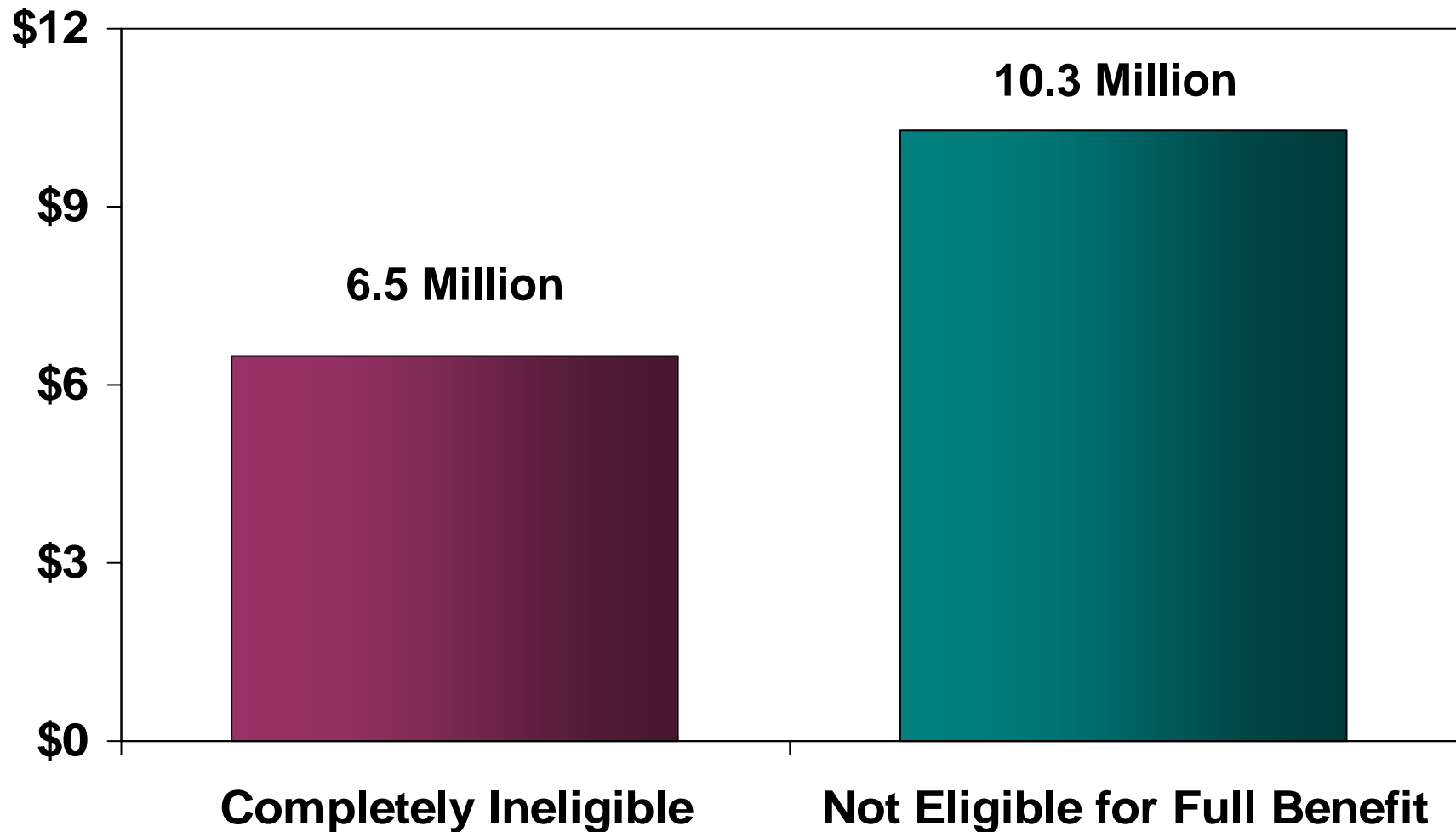
Source: Congressional Budget Office

Improving the EITC for Workers Without Qualifying Children

- EITC for these workers currently tiny
 - Maximum of \$438, v. \$2,917 for parent w/1 child
- EITC does not even fully offset federal income taxes for workers at the poverty line
- Phases out at such a low income level that a full-time minimum wage worker in CA is ineligible
- Many experts think a significant expansion could help combat declining employment rates

Millions of Children in Low-Income Working Families Are Ineligible for the Child Tax Credit

2008



Source: Urban-Brookings Tax Policy Center

Improving the Refundable Child Tax Credit

- In order for low-income families to benefit from a tax credit, it needs to be *refundable*
 - Refundable credits are available to families with incomes too low to owe income taxes
- Child Tax Credit is *partially* refundable
 - A parent with two children needs earnings of \$12,050 to benefit at all and more than \$20,000 to benefit in full
- Bipartisan support for proposals to expand refundability