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REVISED HOUSE TAX-CUT BILL SWELLS DEFICIT AND CONTINUES LESS FAVORABLE TREATMENT OF LOWER-INCOME COUPLES

By Joel Friedman

The House of Representatives passed on April 28 by a vote of 323-95 a tax-cut bill that will make permanent all of the "marriage-penalty relief" tax cuts originally enacted in 2001. Originally, the bill made permanent only the provisions benefiting middle- and upper-income couples enacted in 2001, and failed to make permanent the provision for low- and moderate-income families enacted that year. Faced with growing criticism over this omission, the House Republican leadership modified the bill before bringing it up for a vote and made the low-income marriage penalty relief provision permanent as well.

In addition, the bill would make the middle- and upper-income "marriage-penalty relief" provisions fully effective after 2004, continuing the acceleration of their full implementation that was enacted in 2003 and that is scheduled to expire on December 31 of this year. The bill does not provide for any acceleration of the tax breaks enacted in 2001 for lower-income couples, which are phasing in gradually and will not be fully effective until 2008. As result, even the modified bill continues to treat the low-income provision — a modest expansion of the Earned Income Tax Credit — somewhat less favorably than the provisions that benefit married couples at higher income levels. Speeding up implementation of the EITC provision, so it becomes fully effective in 2005, would cost less than $3 billion.

Despite the fact that the bill now makes permanent all three "marriage-penalty relief" provisions enacted in 2001, including the EITC provision, the bill still is of primary benefit to higher-income couples. In 2010, when all three of the provisions for married couples enacted in 2001 — including the low-income provision — will be fully in effect, approximately 58 percent of the tax-cut benefits from these provisions will flow to the 31 percent of couples with incomes above $100,000, according to Urban Institute-Brookings Institution Tax Policy Center estimates. Eight percent of the benefits will go to the 31 percent of couples with incomes below $40,000. (See Table 1.)

Nevertheless, the bill's principal flaw lies elsewhere — in its failure to include any offsets to pay for its tax cuts. The Joint Committee on Taxation estimates that the bill will cost $105 billion between 2005 and 2014. This estimate, however, is artificially low. It assumes that relief from the Alternative Minimum Tax that is now in effect but is scheduled to sunset on December 31 will not be renewed, that the number of families subject to the AMT consequently will explode into the tens of millions, and the swollen AMT will cancel out *about half* of the tax cuts for married couples the bill would otherwise provide. Joint Tax Committee estimates show that if, as most observers expect, AMT relief is continued, the bill's provisions would cost $204 billion over ten years, rather than $105 billion (see box on page 2).

Cost of Bill Artificially Low Due to Alternative Minimum Tax

The tax cuts in the revised bill cost $105 billion between 2005 and 2014, according to Joint Committee on Taxation estimates. These costs would add to the deficit and the debt, and thus would result in higher interest payments on the debt. The interest costs would amount to $16 billion over the ten-year period, bringing the bill's overall impact on the deficit to $121 billion.

These official estimates assume that millions of married couples will receive no tax cut or only a partial tax cut under the bill because of the Alternative Minimum Tax. Current AMT relief is scheduled to expire on December 31, 2004. If this AMT relief is allowed to expire, the Joint Committee on Taxation estimates that the bill will cause 3 million additional married couples to be subject to the AMT in 2005. Moreover, the total number of taxpayers subject to the AMT will balloon from about 3 million today to over 30 million by 2010, if AMT relief is not extended, reflecting the effects of the tax cuts enacted since 2001 and flaws in the design of the AMT.

To avoid this explosion in the number of AMT taxpayers, virtually everyone expects the current relief from the AMT to be continued. If this is done and the AMT does not cancel out some or all of the tax cuts for these married couples, then the total cost through 2014 of the House marriage-penalty bill rises to $204 billion, according to Joint Committee on Taxation figures. When the cost of the increased interest payments on the debt also is included, the likely cost of the measure rises another $33 billion to $237 billion over the next ten years.

Since the bill contains no offsets, the bill would worsen the deficit. It would constitute yet another piece of legislation that passes its cost on to future generations and makes still more difficult the challenge of coping with the fiscal consequences of the baby-boomers' retirement.

Tax Cuts for Married Couples in the 2001 Act

The tax code can impose a penalty on married couples when both spouses work and they end up paying more income tax as a married couple than they would pay if they remained single. The tax cuts for married couples enacted in 2001 were designed to reduce or eliminate such penalties. As enacted, the provisions also give tax breaks to married couples that do *not* face such penalties. As a result, these provisions also substantially increase the number of married couples that receive a marriage "bonus."

The 2001 tax-cut package included three provisions specifically aimed at married couples. Estimates prepared by the Urban-Brookings Tax Policy Center that examine the effects of these provisions on different income groups in 2010, when the three tax breaks for married couples in the 2001 law will all be fully in effect, show that these three provisions will have the following effects:[1]

[1] The Tax Policy Center estimates also assume that the current relief from the Alternative Minimum Tax, indexed for inflation, is provided in 2010.

Table 1

Impact in 2010 of Tax Cuts for Married Couples Enacted in 2001*
(all estimates for married couples only)**

Cash Income***	Increase Standard Deduction	Widen 15 Percent Bracket	Expand EITC	Total, All Three Provisions
		Percentage of Tax-Cut Benefits Going to Each Income Group		
Less than $40,000	16%	0%	95%	8%
$40,000-$100,000	63%	27%	4%	34%
More than $100,000	21%	73%	0%	58%
All married couples	100%	100%	100%	100%
Addendum:				
Married couples receiving a tax cut (millions)	21.2	23.2	3.0	39.0

*Measured relative to a baseline that assumes the current level of AMT relief, indexed for inflation.

**The Tax Policy Center estimates that there will be 63 million married couples in 2010, representing about two-fifths of all households.

***Income levels expressed in 2003 dollars. Cash income includes various forms of taxable income as well as non-taxable income, the employer share of payroll taxes, and employer contributions to pension plans.

Source: Urban-Brookings Tax Policy Center

- **Widening of the 15 percent tax bracket for married filers** — One of the three provisions increases the income level at which the 15 percent tax bracket ends for married filers and the 25 percent tax bracket begins. This measure — the largest of the three provisions by far — provides a tax break to those married couples whose combined income is high enough to have otherwise placed them in the 25 percent bracket or a higher bracket. (Couples who are in the 15 percent bracket or a lower bracket, therefore, receive no benefit from this tax cut.) The provision favors high-income households the most; 73 percent of the benefits of this provision will flow to the 31 percent of couples with incomes over $100,000.[2]

- **Increase in the standard deduction for married filers** — Another of the three provisions sets the standard deduction for married filers at twice the standard deduction for single filers. This provision primarily benefits middle-income married families. Upper-income families typically itemize their deductions and do not use the standard deduction. Low-income families who owe no income tax

[2] This estimate is sensitive to the assumption about extending AMT relief. If AMT relief were not extended, the AMT would cancel a significant portion of the benefits of this tax cut, particularly for couples with incomes over $100,000.

(but may pay significant amounts of payroll tax) do not benefit from this provision either. This provision thus targets the middle class; 63 percent of the benefits of this provision will flow to the 38 percent of couples with incomes between $40,000 and $100,000.

- **Increase in the Earned Income Tax Credit for married filers —** The third provision modestly enlarges the EITC for low- and moderate-income married couples. Virtually all of the benefits of this provision — 95 percent — will flow to the 31 percent of couples with income under $40,000. This provision is, by far, the least costly of the three.

Although each of these provisions is directed to somewhat different income groups, the majority of the combined benefit of these three provisions flows to couples with higher incomes. This is the case because widening the 15 percent bracket costs more than twice as much as the other two provisions combined. In total, the Tax Policy Center analysis shows that 58 percent of the tax-cut benefits of the three provisions will go to couples with incomes above $100,000, while only eight percent of the benefits will flow to couples with incomes below $40,000.

Table 2

Marriage Provisions To Be Made Permanent (including EITC relief)

Income group	Average tax cut for couples*
Less than $40,000	$117
$40,000 to $100,000	$385
More than $100,000	$827

*Reflects provisions when fully in effect in 2010; expressed in 2004 dollars. See notes in Table 1 for more details.

Source: Urban-Brookings Tax Policy Center

Table 2 also illustrates the point that the tax cut for upper-income couples is larger, as it shows that those with incomes above $100,000 would receive average tax cuts substantially larger than other groups.

Changes Since 2001

Under the 2001 tax-cut legislation, all three of these provisions were slated to phase in over a number of years, becoming fully effective later in the decade. In 2003, however, as part of the stimulus package enacted that year, the increase in the standard deduction for married couples and the widening of the 15 percent tax bracket for married couples were made fully effective immediately. The 2003 legislation did *not* accelerate the EITC provision for low-income married couples. A proposal to include the EITC provision so that all three of the tax-relief provisions for married couples would be accelerated was offered on the Senate floor by Senator Jim Jeffords but was defeated by a vote of 51-49.

The provisions enacted in 2003 that accelerated implementation of the tax cuts for middle- and upper-income married couples are slated to expire at the end of 2004. After that, these tax cuts return to their original phase-in schedules. All of these tax cuts are then scheduled to sunset at the end of 2010.

Effects of the Revised House Bill

The House-passed bill would repeal the December 31, 2004, sunset date so that the accelerations of the tax cuts for middle- and upper-income couples do not expire at the end of this year. The bill does not speed up implementation of the third provision for married couples enacted in 2001 that modestly enlarges the EITC for low- and moderate-income working couples. "Marriage-penalty relief" for these poorer married couples will not become fully effective until 2008. Currently, only one-third of the relief provided under that provision is in effect. Starting in 2005, two-thirds of the relief will be in effect.

The Marriage Penalties that Lower-Income Working Families Face

The provision enlarging the EITC for married filers is particularly important because the EITC can produce quite severe marriage penalties for lower-income families. Accordingly, many institutions and analysts from across the political spectrum have called in recent years for addressing the marriage penalties in the EITC. For example, the Heritage Foundation called for addressing EITC marriage penalties "to ensure that low-income families do not lose their EITC benefits simply because they are married."[3]

The EITC serves as a work incentive, offsetting payroll taxes, effectively supplementing low wages for some low- and moderate-income workers, and helping to make low-paid work more remunerative than welfare. For couples with two or more children, the credit rises with earnings until a family's income reaches about $10,750 in 2004. Working couples with two or more children that have incomes between about $10,750 and $15,040 receive the maximum EITC. The credit then gradually phases out between income of $15,040 and about $35,460. Due to the structure of this phase-out, families that receive the EITC can face sizeable marriage penalties.

For example, two individuals, each with one child and earnings of $10,000, would face a marriage penalty in 2004 of more than $1,000, or five percent of their combined income, if they were married rather than single.[4] They would face this marriage penalty in 2004, even with the part of the EITC expansion enacted in 2001 that is now in effect. That provision modestly reduced EITC marriage penalties by increasing, for married filers only, the income level at which the EITC begins to phase down as a filer's income rises. That income level has been increased by $1,000 so far; it is scheduled to be increased by another $1,000 in 2005 and a further $1,000 in 2008, so that the income level at which the EITC starts phasing down will eventually be $3,000 higher for married filers than for non-married filers.

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[3] Rea S. Hederman, Jr., "Why Congress Should Renew Its Efforts to End the Marriage Penalty," Heritage Foundation Backgrounder, March 28, 2001.

[4] If these individuals were not married, each would receive $2,604 in federal income tax benefits in 2004 due to the EITC, for a combined income tax benefit of $5,208. If the two individuals were married, their combined income tax benefits would be reduced to $4,180 (including both the EITC and the refundable child tax credit), due to the phaseout of EITC benefits.

Conclusion

The House of Representatives adopted a bill on April 28 to make permanent the three "marriage-penalty relief" provisions enacted in 2001. This bill has two flaws. First and of primary importance, it includes no offsets for its tax cuts; as a result, they would increase the deficit and worsen the fiscal outlook. Second, the bill does not accelerate the provision enacted in 2001 to reduce marriage penalties among low- and moderate-income working couples, who face some of the most serious marriage penalties in the tax code. By contrast, the bill continues the acceleration of the two marriage-penalty relief provisions enacted in 2001 that benefit middle- and upper-income couples. This disparate treatment is difficult to justify.