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March 26, 2009

TESTIMONY OF ROBERT GREENSTEIN
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before the
SENATE COMMITTEE ON FINANCE

I appreciate the invitation to appear before the Committee today. I am Robert Greenstein, Executive Director of the Center on Budget and Policy Priorities, a policy institute that focuses on fiscal policy issues and issues affecting low- and moderate-income families.

This testimony makes the following points:

- As the Congressional Budget Office report issued last Friday shows, the nation faces serious mid-term and long-term fiscal problems. Strong action will be needed on both the revenue and spending sides of the budget.

- It seems clear that the tax cuts enacted in 2001 and 2003 affecting people with incomes up to $250,000 will be made permanent, without their costs being offset. The major question regarding the 2001 and 2003 tax cuts concerns the disposition of the tax cuts for people making over $250,000 (over $200,000 for single filers).

- Given the nation's fiscal position, extending the upper-income tax cuts would be unwise for both the budget and the economy. Research suggests that extending these tax cuts without paying for them would likely reduce long-term economic growth because of the corrosive effects of the increased debt. This is a conclusion that emerges from the work of the Congressional Budget Office, the Joint Committee on Taxation, and other leading economists and fiscal policy experts.

- President Obama's tax proposals, which would allow some (but not all) tax cuts for households over $250,000 to expire at the end of 2010, have been criticized as producing a "high-tax" government and imposing crushing tax burdens on high-income Americans in general and on small business owners in particular. These criticisms do not withstand scrutiny.

- Regarding the charge that these proposals would produce high levels of taxation, the Congressional Budget Office finds that under President Obama's proposals — including his proposal to cap itemized deductions at a 28% deduction rate for people making over $250,000 — total federal revenues would average 18.4% of GDP over the next ten years, just about the average level for the last 30 years, and would not exceed 18.9% of GDP in any year. These are not high levels of taxation. Indeed, there were only four years in the last 30 when the federal budget was balanced, and in every one of them, revenues were between 20% and 21% of GDP.

- Nor would the Obama proposals result in crushing tax burdens on affluent Americans. Data from the respected Urban Institute-Brookings Institution Tax Policy Center show that *average tax burdens on virtually every income group — including the top 1 percent of Americans — would be lower than they were in the 1990s, a period when the economy boomed.* An often overlooked fact is that people at the top of the income scale would still gain from the extension of the 10 percent tax bracket, marriage penalty relief, reduction in tax rates in the tax brackets below the top two brackets, and the halving of the top tax rate on dividends from 39.6% in the 1990s to 20% under the Obama proposal. Indeed, high-income households would gain *more on average* than they would lose from the proposed itemized deduction cap, with the result that they would pay a smaller percentage of their income in federal taxes than under the pre-Bush policies.

Effective Tax Rates
(average federal tax rate, 2012)

Household Income Group	Current law with AMT relief extended (2001/03 tax cuts expire)	Obama Proposal
Poorest fifth	5.7%	0.8%
Next-to-bottom fifth	12.5%	8.4%
Middle fifth	18.2%	15.2%
Next-to-top fifth	20.9%	18.1%
Top fifth	27.7%	26.0%
Top 2 to 5 percent	26.9%	25.3%
Top 1 percent	32.8%	32.6%

Source: Tax Policy Center

- Nor would these proposals oppress small businesses. To the contrary, most people with small business income would be net gainers. Tax Policy Center data indicate that only 2.2 percent of people with small business income would be in the two top tax brackets — and hence be affected by the proposal to allow the rate reductions in those brackets to expire for filers with incomes over $250,000 (over $200,000 for single filers). (A higher figure that has recently been cited has been misunderstood and misapplied, and is not the correct figure.) The number of small business owners who would benefit from the "middle class" tax cuts that would be extended or from new tax-cut measures that the Administration has proposed would dwarf the number who would face tax increases. Indeed, one little known fact is that ten times as many small business owners receive the Earned Income Tax Credit as are in the top two income tax brackets.

- Moreover, there is little evidence for the claim that a return to Clinton-era rates of taxation at the top of the income scale would seriously injure small businesses and damage U.S. job growth. If this were true, the experience of the last two decades would show that small-business job growth was considerably faster in the years when the Bush tax cuts were in effect than in the Clinton years when the top tax rates were higher. *Yet the opposite is true.* The average rate of small business job growth was twice as high in the Clinton years as under President Bush before the current recession set in.

- Policymakers also should consider the disturbingly large growth in recent years in inequality of after-tax income, especially between those with very high incomes and other Americans. CBO

data show that between 1979 and 2005 (the years for which CBO has compiled these data), the after-tax income of the 20 percent of Americans in the middle of the income spectrum grew an average of $8,700 — or 21 percent — after adjusting for inflation, while the average income of the poorest 20 percent of Americans grew by $900, or 6 percent. In contrast, the average income of the top 1 percent of households increased by $745,000, or 228 percent. And other data show that in 2006, the top 1 percent of Americans secured a larger share of all pre-tax income than in any year since 1928.

The 2001 and 2003 tax cuts exacerbated this trend. CBO data show that these tax cuts further widened inequality. And the Tax Policy Center has estimated that in 2010, households with incomes of over $1 million will receive an average tax cut from the 2001 and 2003 tax changes of *$158,000 each* — as compared to $810 for households in the middle of the income scale. It is difficult to see how the nation can continue to afford providing such massive tax cuts to those at the pinnacle of the income scale.

Finally, this testimony covers two related issues:

- It finds strong merit in the Administration's proposals to extend the expansions in the child tax credit, the EITC, and the American Opportunity Tax Credit that were enacted on a temporary basis in the recent economic recovery legislation, and to pay for those extensions. If paid for, these extensions should better reward work among low-income parents, increase educational attainment and productivity, and reduce child poverty, without enlarging the deficit.

- The nation also needs to address climate change and can do so without imposing a large middle-class tax increase. This can be accomplished if emissions permits under a cap-and-trade system are auctioned and the principal (though not the only) use of the auction proceeds is to offset the increased energy costs that low- and middle-income families will incur, primarily through a refundable climate tax credit created for this purpose.

I now examine these issues in more detail.

DEFICIT-FINANCED TAX CUTS HAVE ADVERSE ECONOMIC EFFECTS OVER THE LONG RUN

In recent years, various respected institutions and experts have examined the impact of permanent deficit-financed tax cut on the long-run health of the economy. Their findings are sobering.

- In a 2005 study, the Joint Committee on Taxation examined the economic effects of reductions in individual and corporate tax rates and an increase in the personal exemption. It found that "Growth effects eventually become negative without offsetting fiscal policy [i.e., without paying] for each of the proposals, because accumulating Federal government debt crowds out private investment."[1]

- In another 2005 study, Brookings economist William Gale and then-Brookings economist (now OMB director) Peter Orszag examined the effects that extending the 2001 and 2003 tax cuts

[1] Joint Committee on Taxation, "Macroeconomic Analysis of Various Proposals to Provide ($500 Billion in Tax Relief," JSCX-4-05, March 1, 2005, http://www.house.gov/ct/x-4-05.pdf.

without paying for them would have on incentives for investment. They found that, under most plausible assumptions, extending the tax cuts without paying for them would reduce incentives for investment. In a separate analysis, Gale and Orszag concluded that making the 2001 and 2003 tax cuts permanent without offsetting their cost would be "likely to reduce, not increase, national income in the long term."[2,3]

- Finally, in 2005, the Congressional Budget Office examined the economic effects of a 10 percent across-the-board cut in income-tax rates. It found that, if deficit-financed, the rate reduction could potentially reduce economic output. CBO considered the claim that tax cuts generate sufficient economic growth to boost revenues by enough to pay for themselves. It found, instead, that the increased deficits resulting from the tax cuts might be enough of a drag on the economy that the tax cuts actually would *lose more revenue* than if one assumed they had no effect on the economy. In other words, deficit-financed tax cuts could be even more expensive than officially "scored," rather than less expensive.[4]

In short, making the tax cuts for people above $250,000 permanent without offsetting the cost would not only enlarge debt and inequality but also would likely reduce long-term economic growth because of the corrosive effects of the higher levels of debt.

TAX BURDENS ON HIGH-INCOME HOUSEHOLDS WOULD BE THE SAME OR LOWER THAN IN THE 1990S

Some who attack the Obama tax proposals portray them as "soak the rich" proposals that would impose high and enormously damaging tax burdens on those at the top of the income scale. These charges are uninformed.

The best way to measure tax burdens is to examine *effective tax rates* — i.e., how much people pay in federal taxes as a share of their incomes. A comparison of effective tax rates on high-income people under the policies in effect in the late 1990s to the effective rates that would prevail under the Obama tax proposals shows the following (all of these data come from the Tax Policy Center):

- Under current law (except for the continuation of AMT relief) — that is, under tax law if the 2001 and 2003 tax cuts are allowed to expire —the average effective tax rate in 2012 for the top one percent of households would be 32.8 percent. In other words, this group, which has average income of $1.6 million a year, would pay an average of 32.8 percent of its income in federal taxes.

- Under the Obama plan, the effective rate for this group would be *32.6* percent, or slightly lower. This means that the average tax burden for very high income people would be slightly

[2] William Gale and Peter Orszag, "Deficits, Interest Rates, and the User Cost of Capital: A Reconsideration of the Effects of Tax Policy on Investment," Urban-Brookings Tax Policy Center Discussion Paper No. 27, August 2005, http://www.urban.org/UploadedPDF/311211 TPC DiscussionPaper 27.pdf.

[3] William Gale and Peter Orszag, "Bush Administration Tax Policy: Effects on Long-Term Growth," Tax Notes, October 18, 2004, http://www.dbo.gov/ftpdocs/69xx/doc6908/12-001-10Percent TaxCut.pdf.

[4] Congressional Budget Office, "analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income tax Rates," December 1, 2005, http://www.cbo.gov/ftpdocs/69xxdoc6908/12-01-10Percent Tax Cut.pdf.

less under the Obama plan than under Clinton-era policies.

- Furthermore, the size of the reduction in tax burdens under the Obama proposals, as compared to tax burdens under the pre-Bush tax policies, grows significantly larger even if one goes only a small way down the income scale. For example, the most affluent 2% to 5% of households (that is, the households in the top 5 percent of the income distribution, except for those in the top 1%) would face an effective federal tax rate of 25.3% under the Obama proposals, compared to 26.9% under a return to pre-2001 law with AMT relief extended. And for those right in the middle of the income scale, the total federal tax burden would be 15.2 percent of income under the Obama proposals, compared to 18.2 percent under the policies of the 1990s.

Some who hear these figures may be surprised. They may assume that when one couples the Obama proposal to roll back tax cuts at the top of the income scale with the Obama proposal to limit itemized deductions for high-income households to a 28% deduction rate, the result is *higher* tax burdens on affluent people than under the policies of the 1990s. But that is not the case. Many of the 2001 tax-cut provisions that would become permanent under the Obama plan benefit high-income households, including the creation of the 10 percent tax bracket, marriage penalty relief, and the reduction in tax rates in what used to be the 28 and 31 percent brackets and now are the 25 percent and 28 percent brackets.

Furthermore, the benefit to high-income individuals from the Obama proposal to set the top tax rate on dividends at 20 percent — or about *half* the 39.6 percent tax rate on dividends that prevailed in the 1990s — is especially large. According to the Tax Policy Center, the lower rate on dividends would provide an average tax cut of $10,408 to the top one percent of households.

I would add that the itemized deduction proposal is hardly a radical one. The Tax Policy Center's analysis finds that it would affect only 1.4 percent of households. It would mean that the subsidy the federal government provides to these households for their deductible expenditures would be *a little less than double* the subsidy the tax code provides for the same expenditures when middle-class households make them (a subsidy of 28 cents per dollar of deductible expenditure for those at the top of the income scale, as compared to a 15 cent subsidy for people in the 15 percent tax bracket), rather than being *more than* double the subsidy. Moreover, the 28 percent deduction rate would be the same as in the final years of the Reagan Administration. The Bush Administration's tax reform panel actually proposed to go further, recommending in 2005 that the value of the mortgage interest deduction be set at 15 percent for everyone.

I also would note that the much-talked about impact on charitable contributions would be modest. The best data and research indicate that total charitable contributions would be expected to decline by about 1.9 percent. If such a change were part of a package with health care reform that achieved universal coverage and cost containment, the charitable sector as a whole would come out ahead, due to the reduction that would ensue in the burdens placed on the sector to provide charity health care and the relief that that would go to small nonprofits that currently pay high costs to insure their employees because they must buy coverage in the small-group insurance market. (Moreover, if one is concerned about the tax policy incentives for charitable giving, the estate tax warrants primary focus. CBO has estimated that repealing the estate tax would reduce bequests by 16 to 28 percent and charitable giving during life by 6 to 11 percent.)

WOULD THESE TAX BURDENS DAMAGE THE ECONOMY?

Some also argue that the tax burdens on people over $250,000 that would result from the President's proposals would damage economic and job growth, by depressing incentives for the highest-earning Americans to work, save, and invest. To sustain this claim, critics must show that such results marked the Clinton years. And in fact, they did not.

The economy did well in those years. And high-income people did even better, greatly increasing both their pre-tax and after-tax incomes. They clearly worked hard and invested substantial sums. According to CBO, the average after-tax income of people in the top 1 percent of the population grew 78 percent between 1992 and 2000, after adjusting for inflation, or six times the 13 percent increase that people in the middle of the income spectrum secured.

EFFECT ON SMALL BUSINESSES

There has been considerable discussion of the effects of the Obama tax proposals on small business. There may be more misunderstanding on this issue than any other.

Some claim that most small business owners would be affected by allowing high-income tax cuts to lapse. But Tax Policy Center data show that only 2.2 percent of people with small business income would be in the two top tax brackets in 2012 if the top two rates revert to their pre-2001 levels.[5] The number of small business owners who would benefit from extending the middle-class tax cuts and the proposed expansions of the EITC and the saver's credit dwarfs the number who would be affected by allowing the tax cuts at the top to expire.

In addition, some criticisms of the Obama tax proposal imply that the investments that small business owners make in staff or equipment are made out of *after-tax* income, with the income tax being applied to small business receipts *before* such expenses are taken into account. That is incorrect. Business owners pay tax on the profit that a firm produces after such expenses are taken into account, *not* on the receipts the firm takes in. And the Obama proposals would not limit or reduce the deductions that business owners claim for business expenses (which are above-the-line" deductions).

Moreover, if the Obama proposals really would damage small-business job growth seriously, such job growth should have suffered grievously in the Clinton years and rebounded smartly in the Bush years, after the top income tax rates were cut. The economy's response to changes in tax policy since the enactment of increases in the top rates in 1993 provides something of a natural experiment to test this thesis. What the data show are that the rate of small business job growth was twice as

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[5] Some filers have incomes over $250,000 but are in a lower tax bracket or are subject to the AMT, which has a 28 percent top rate. Some of these filers would be affected by the Obama proposal to set the top rate on capital gains and dividends at 20 percent for filers with incomes over $250,000. Tax Policy Center data show that 5.6 percent of small business filers would be affected by this provision.

Average Annual Small Business Job Growth (20-499 Employees)				
	Base	**End**	**Ave. % Growth**	**Ave. Job Growth**
Clinton	31,245,872	36,536,659	2.3%	755,827
Bush	36,780,814	38,614,220	1.0%	366,681

Source: Small Business Administration, U.S. Census Bureau
Clinton Base Year: 1993, End Year 2000; Bush Base Year: 2001, End Year 2006 (latest available)
Note: An analysis of job growth for all small businesses with less than 500 employees shows a similar disparity, with the pace of job growth during the Clinton years being twice the pace from 2001 to 2006. Firms with 20-499 employees are highlighted here because critics of the Obama proposal have focused on this group. See Taxing Success: President Obama's Tax Increases on Small Business are Bad for Job Creation, Senate Republican Policy Committee, March 17, 2009.

large in the Clinton years, when the top tax rates were higher, as in the Bush years (prior to the onset of the current recession).

Finally, small businesses should benefit substantially from health care reform. Today, many small firms either cannot afford to purchase health insurance for their employees or must pay much higher premiums than large corporations do. They thus are placed at a competitive disadvantage. Well-designed national health care reform can address these problems, which would be very beneficial for small business.

EXTENDING CERTAIN TAX PROVISIONS INCLUDED IN THE RECOVERY LEGISLATION AND PAYING FOR THEM

The 2001 and 2003 tax cuts are not the only tax cuts affecting lower-and middle-income households that are scheduled to expire at the end of 2010. The expansions of the child tax credit, the EITC, and the American Opportunity Tax Credit included in the recently enacted recovery legislation also are scheduled to expire at that time. The President's budget proposes to extend these measures and to offset the cost of doing so. The budget also would expand the Saver's Credit, originally enacted in 2001 due in no small part to the efforts of Chairman Baucus, and pay for that reform as well.

These are excellent proposals, and I urge their adoption. Making the child tax credit improvement permanent would benefit nearly 16 million children in low-income working families, reducing poverty among children who constitute an important part of the workforce of the future. It also would better reward the work effort of their parents, with 80 percent of the benefit going to the children of hard-working parents who make between $10,000 and $30,000 a year and otherwise would receive only a partial child tax credit or no child tax credit at all.

It is instructive to examine who the affected parents would be. They include large numbers of preschool and kindergarten teachers, child care workers, nursing home workers, home health aides, janitor and custodians in schools or office buildings, cashiers, waiters, waitresses, kitchen workers in restaurants, agricultural workers, and the like.

Our analysis of Census data yields another noteworthy finding as well — the child tax credit and EITC provisions in the economic recovery legislation will lift 800,000 children — and 1.4 million people of all ages — out of poverty. We ought not to slide backward on that front.

In addition, the expansion of the American Opportunity Tax Credit included in the recovery legislation will help 4 million low-income students go to college who previously were shut out of this

INCREASED INEQUALITY AND FEDERAL TAX POLICY

The increase in income inequality in recent decades provides some important context for discussions of tax policy. From the end of World War II through the mid-1970s, the gains from economic growth were broadly shared across the U.S. population. Congressional Budget Office data show that in recent decades, however, this has changed. Since the 1970s, income inequality has grown sharply, and the bulk of the gains from economic growth have accrued to those high up on the income scale.

The CBO data, which cover the years from 1979 through 2005, show that after adjusting for inflation, the average after-tax income of those in the middle of the income scale rose by $8,700 — or 21 percent — over the 26 years from 1979 to 2005. For those in the bottom fifth of the population, average income was only $900 — or 6 percent — higher in 2005 than in 1979. (Note: This measure of income counts food stamps, housing assistance, and various other means-tested benefits, as well as the EITC.) In contrast, the average income of the top 1 percent of households soared by $745,000 — or 228 percent — between 1979 and 2005.

Data compiled by economists Thomas Piketty and Emanuel Saez and based on IRS data on pre-tax income extend one year further, into 2006. These data show that the share of pre-tax income going to the top 1 percent of households was greater in 2006 than in any year since 1928, and that just between 2005 and 2006, average pre-tax income rose by almost $60,000 (or 5.8 percent) for the top 1 percent of households, after adjusting for inflation, while rising by less than $450 (or 1.4 percent) for the bottom 90 percent of the population.

To be sure, we are likely to see a temporary decline in the concentration of income over the next year or so, given the sharp decline in the stock market. But there was a similar development when the dot.com bubble burst a few years ago — income at the top of the income scale fell sharply — and it turned out to be just a speed bump. Incomes at the top more than made up the lost ground from 2004 to 2006. The long-term trend toward increasing inequality has been quite strong.

The Role of the 2001 and 2003 Tax Cuts

The 2001 and 2003 tax cuts exacerbated the trend toward growing inequality. Economists generally agree that the single best measure of whether a change in tax policy is regressive is whether it increases after-tax income by a larger percentage for those at the top of the income scale than for those at the middle and bottom. A policy that does so further widens after-tax income inequality. This is precisely what the 2001 and 2003 tax cuts did.

Some have tried to argue that the 2001 and 2003 tax cuts were progressive because the share of taxes that people at the top pay has increased. This share increased, however, *not* because the tax code has become more progressive but because the share of total income that households at the top get increased sharply. The income gains at the top were so large that high-income households pay a larger share of the taxes *even though* they have received much larger tax cuts, measured as a share of their income, than anyone else and *even though* the percentage of income they pay in federal taxes went down by more than it declined for anyone else.

Finally, in light of the daunting budget deficits the nation faces and the increase in inequality it has experienced, the magnitude of the tax cuts for those at the very pinnacle of the income scale is breathtaking. The Tax Policy Center has estimated that when the 2001 and 2003 tax cuts are phased in fully in 2010, households with annual incomes of more than $1 million will receive tax cuts that average $158,000 apiece, compared to an average tax cut of $810 for Americans in the middle of the income scale. It is difficult to see how our nation can continue to afford such munificent tax cuts for those who are at the apex of American society and are far better off than everyone else.

tax credit. For our future competitiveness, we need to lessen financial barriers to college attendance among children from low-income families. We will need the best educated workforce possible in order to compete in an economy that is going to continue to become even more global.

Finally, the improvements in the Saver's Credit that the President's budget proposes would not only help millions of middle- and low-income workers in retirement but would also benefit the economy by boosting national savings.

Accordingly, I recommend that Congress move these provisions, and the offsets to pay for them, together with the legislation to make the 2001/2003 "middle-class" tax cuts permanent. Both sets of measures are slated to expire at the end of 2010, and they should be considered and move as a package.

CLIMATE CHANGE LEGISLATION AND MIDDLE-CLASS TAX BURDENS

Lastly, there is the question of whether cap-and-trade legislation would constitute a "tax increase" because an emissions cap would raise prices of fossil-fuel energy and energy products. As CBO has explained in various reports, how low- and middle-income households are affected under an emissions cap depends primarily on the decisions that policymakers make on two key policy questions: whether emissions permits are given away free or are auctioned, and if they are auctioned, what is done with the auction proceeds. Simply stated, auction proceeds can be used to compensate low- and middle-income consumers for the average increase in costs they will incur for energy and energy-related products. As a recent Center on Budget and Policy Priorities' paper concludes, the optimal approach is to auction the permits and to devote a substantial share of the proceeds to a new refundable climate tax credit that offsets the increase in energy costs for low- and middle-income households, supplemented by other mechanisms for those who do not file income tax returns, such as many Social Security beneficiaries and people at the bottom of the income scale.

Suffice it to say, the notion that cap-and-trade legislation necessarily imposes a tax increase or its equivalent on poor and average families is mistaken. Well-designed climate legislation should not have that effect.