Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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SENATE AND HOUSE RECONCILIATION TAX PACKAGES: NEARLY $100 BILLION IN TAX CUTS ARE ON THE TABLE

By Joel Friedman

The Senate passed its reconciliation tax-cut package on November 18, and the House passed its version on December 8. Although the Senate and House measures include a number of similar provisions (see the box on page 6), they differ in key respects, particularly regarding relief from the Alternative Minimum Tax, extension of the capital gains and dividend tax cuts, and the use of revenue-raising offsets. Notably, the House extended the capital gains and dividend tax cuts in reconciliation, while the Senate did not. Further, the House chose to address AMT relief outside of reconciliation, passing a separate bill on December 7. The House and Senate are expected to begin the process of resolving differences between these tax-cut bills when Congress reconvenes for the second session of the 109th Congress.

- **Total Cost**: Both the House and Senate reconciliation tax-cut packages would cost just under $60 billion over the five years, from 2006 through 2010. But this total understates the full cost of the tax cuts under consideration. The total cost of all tax cuts included in either the House or Senate bills is more than $96 billion over five years (see Table 1). Even when the revenue-raising offsets in the Senate bill are included, the net five-year total of all the different provisions would still be $77 billion.

  Thus, the tax cuts under consideration — both as part of reconciliation and potentially outside reconciliation — exceed the five-year $40 billion savings generated by the program reductions in the budget-cut reconciliation bill that the Senate passed on December 21 and that the House is expected to take up immediately upon its return from recess. Consequently, the combined impact of the tax-cut and budget-cut bills will be to increase the deficit, making it clear that the budget cuts in reconciliation — many of which disadvantage low- and moderate-income families — are being used *not* to reduce the deficit but to offset a portion of the cost of tax cuts, over three-quarters of which would benefit households with incomes over $100,000.

- **Capital Gains and Dividends**: The House bill includes a two-year extension of the capital gains and dividend tax cuts, which expire in 2008. This two-year extension costs $51 billion, of which $21 billion would occur in the five years covered by reconciliation (2006-2010). The Senate bill does *not* extend these tax cuts.

- **Alternative Minimum Tax**: The Senate measure provides relief for one year from the Alternative Minimum Tax. Current AMT relief expired at the end of 2005. The Senate bill would extend the higher AMT exemption level, adjusting it for inflation plus an additional amount in order to prevent the number of AMT taxpayers from growing, at a cost of $31

billion. The House reconciliation bill includes no comparable provision; however, the House passed a separate bill outside of reconciliation that would provide AMT relief. This House measure would increase the AMT exemption level only to reflect inflation and thus is slightly less generous than the Senate provision.

Table 1: Provisions in House and Senate Tax Reconciliation Bills That Could Be Part of a Conference Agreement (in billions of dollars)

	5-year cost	Status
Tax Cuts:		
AMT exemption level	-$30.5	Senate
Capital gains and dividends	-20.6	House
R&E credit	-9.9	Both
Small business expensing (Section 179)	-7.3	Both
Charitable giving	-0.5	Senate
Other tax cuts in both bills	-12.9	Both
Other tax cuts, House only	-6.2	House
Other tax cuts, Senate only	-8.4	Senate
Subtotal, tax cuts	**-96.2**	
Revenue-raising offsets	**+18.8**	Senate
Total (net)	**-77.5**	
Addendum:		
Enacted Katrina relief*	-7.8	Enacted

*Katrina relief was originally part of the Senate reconciliation bill, but the House passed it as a separate measure, and it was subsequently enacted on December 22. As a result, it is no longer a factor in the reconciliation conference agreement.

Note: Where Joint Tax Committee estimates for similar House and Senate provisions differed, the table above reflects the Senate estimate.

Source: Joint Committee on Taxation

- **Revenue-Raising Offsets**: The Senate measure includes revenue-raising offsets that total nearly $19 billion over five years. A number of the provisions seek to close corporate tax loopholes and to clarify when certain transactions are not valid for tax purposes because they lack "economic substance." Another Senate provision would affect how large integrated oil companies account for their inventories of oil for tax purposes, raising $4.3 billion over five years. The House bill includes no revenue-raising offsets.

- **Katrina-related relief**: The Senate bill includes $7 billion in Katrina-related tax reductions. The House passed this relief separately, outside of reconciliation. The House and Senate then agreed on a five-year $7.8 billion package of tax assistance, which was adopted and then signed into law by President Bush on December 22 (PL 109-135).

Resolving the House and Senate Differences

It is unclear how the House and Senate will resolve these large differences in conference. For instance, Senate conservatives have indicated they are unlikely to support a final package that does not include the extension of the capital gains and dividend tax cuts, and Senate Majority Leader Bill Frist has announced he will insist on the inclusion of these tax cuts in the final bill that comes out of conference. At the same time, the House has previously rejected many of the offsets in the Senate bill, and Ways and Means Committee Chairman Bill Thomas has stated he believes it is inappropriate to include revenue-raising measures in reconciliation. The White House has also declared its opposition to the major revenue-raising provisions in the Senate bill.

Which provisions would be included in the reconciliation bill will ultimately depend on the total amount of tax cuts that are allowed in the measure without triggering a point of order under Senate rules. The budget resolution limits tax reconciliation to a five-year cost of $70 billion. But the Senate's "pay-as-you-go" rules may only allow for tax cuts totaling $60 billion over five years; tax cuts costing more than that could trigger a 60-vote point of order.[1] Consequently, both the House and Senate bills were limited to $60 billion. There are a range of issues surrounding the interpretation of the Senate's pay-as-you-go rules, however, including whether enactment of the budget-cut reconciliation bill would permit the full $70 billion of tax cuts to be included in the tax reconciliation bill. These issues likely will have to be resolved by the Senate Parliamentarian.

Even if the higher, $70 billion total is permitted under Senate rules, there still is likely to be pressure to enact more tax cuts than can be accommodated within this limit. As a result, Congressional leaders are likely to follow the lead of the House and move some of the tax cuts under consideration separately, outside of reconciliation. Tax cuts moved outside of reconciliation would likely be subject to a 60-vote point of order in the Senate, but certain tax cuts that have broad bi-partisan support — such as extension of AMT relief and the research and experimentation tax credit — might well garner this higher vote total. With some tax cuts that can command broad support moving separately, the more controversial tax cuts, such as the capital gains and dividend tax measures, could all be packaged into the reconciliation conference agreement. If this scenario is adopted, the end result will be a larger total volume of tax cuts — and higher deficits.

Who Benefits from the House and Senate Tax-Cut Packages?

Both the House and the Senate reconciliation tax-cut packages would primarily benefit upper-income taxpayers. Under both bills, more than three-quarters of the gains from the major provisions in the bill would go to people with incomes over $100,000 a year, according to the Urban Institute-Brookings Institution Tax Policy Center.[2]

Yet the House package is substantially more skewed to the very highest-income taxpayers than the Senate measure. Some 8 percent of the gains from the Senate bill would go to people with incomes above $1 million. By contrast, *40 percent* of the benefits of the House would go to people with incomes that high. Correspondingly, while 41 percent of the gains

Table 2: Distribution of Major Provisions in the House and Senate Tax-Cut Reconciliation Packages

	Percent Distribution of Tax Cut Benefits	
	Senate	House
Less than $100,000	23.0%	21.3%
$100,000 — $200,000	41.0	16.3
$200,000 — $500,000	25.5	13.9
$500,000 to $1 million	2.4	8.1
Over $1 million	8.0	40.1
Total	100.0	100.0

Source: Urban-Brookings Tax Policy Center. Estimates are for the distribution of the tax cuts when they are fully in effect.

[1] The Senate pay-as-you-go scorecard cited in the budget resolution allows for $75 billion in deficit-increasing legislation over five years. With the enactment of the energy bill and several smaller measures, which have a combined cost of about $15 billion over 5 years, the amount on the scorecard dropped to $60 billion.

[2] These estimates do not include the Katrina-related provisions or the revenue-raising offsets in the Senate-passed bill, or various minor provisions in both the House and Senate measures.

from the Senate package would go to people with incomes between $100,000 and $200,000 a year, only 16 percent of the gains from the House package would.

The primary reason for the House measure's far more skewed distribution is that it extends capital gains and dividend tax cuts but *not* AMT relief. The Senate measure does the opposite.

High-Income Households Receive Overwhelming Share of Benefits from Extending Capital Gains and Dividend Tax Cuts

The House bill's concentration of tax-cut benefits among households with incomes over $1 million undercuts the claims of many supporters of capital gains and dividend tax cuts who have misleadingly sought to characterize these tax cuts as providing benefits that are widely distributed. Those making these assertions point to the *number* of taxpayers who receive a benefit of *any* amount from the capital gains and dividend tax cuts. These claims ignore the fact that many of the middle-income taxpayers who are affected receive very small tax-cut benefits while a highly disproportionate share of the benefits go to households at extremely high income levels.

- According to Tax Policy Center estimates, about 26 million households will receive some benefit from the extension of capital gains and dividend tax cuts in 2009, or about 17 percent of all households. Supporters of extending the tax cuts emphasize that of those receiving a tax cut, 22 percent have incomes below $50,000, and 56 percent have incomes below $100,000.

- But while a substantial number of middle-income families may receive some tax cut, the benefit they receive is small. Households with income of less than $50,000 would receive an average tax cut in 2009 of *less than $11* from the capital gains and dividend measures, according to the Tax Policy Center. Households with incomes of less than $100,000 would receive an average tax cut of $29. In contrast, the average tax cut for households with income of more than $1 million would be *$32,000* in 2009.

- Consequently, households with income under $50,000 would receive only 4 percent of the benefits of the capital gains and dividends tax cuts in 2009, and those with income under $100,000 would receive only 14 percent of the benefits. In contrast, households with incomes of more than $1 million would receive close to half — 45 percent — of the benefits of these tax cuts, even though they will constitute only 0.3 percent of the households in the nation in 2009.

Capital Gains and Dividends Tax Cuts More Skewed to the Top of the Income Spectrum Than AMT Relief

Supporters of the capital gains and dividends tax cuts also have tried to characterize them as offering benefits that are more broad-based that AMT relief. While both AMT relief and the capital gains and dividend rate reductions primarily benefit upper-income households, their impact within this "upper income" category in quite different. Households with the very highest incomes would receive far greater benefit from the capital gains and dividend tax cuts than from the extension of the AMT relief.[3] According to Tax Policy Center analyses:

[3] Note that the Tax Policy Center estimates for AMT relief are for the impact of extending the current AMT exemption level. The Senate proposal would slightly increase the exemption level so as to prevent the number of AMT taxpayers from increasing. This difference would only have a modest impact on the distributional estimates presented above.

- While about 87 percent of the benefits of extending AMT relief in 2006 would flow to households with incomes over $100,000, virtually all of these benefits would be concentrated on households with incomes between $100,000 and $500,000. And more than half of the benefits of AMT relief would go to households with incomes between $100,000 and $200,000. *Less than 1 percent* of the benefits of the AMT relief would go to households with incomes in excess of $500,000.

- Households with incomes of more than $100,000 would receive a similar share of the benefits from the capital gains and dividend tax cuts — about 86 percent of the total benefits in 2009. But only 31 percent of the benefits would go to households with income between $100,000 and $500,000. Some 55 percent of the benefits go to households with income *over* $500,000, and 45 percent of the benefits would flow to households with incomes of more than $1 million.

Impact of Capital Gains and Dividend Tax Cuts on the Economy

Supporters of extending the capital gains and dividend tax cuts claim these tax cuts have had a positive effect on the economy and will continue to provide economic benefits over the long run. There is little evidence, however, to back-up these assertions.[4]

The potency of the capital gains and dividend tax cuts in the short run is questionable, particularly given the relatively lackluster performance of the economy in the past several years. When the current economic recovery is examined using a wide range of economic indicators, this recovery is consistently found to be weaker than the average recovery in the post-World War II period. In the current recovery, the economy has *underperformed* in terms of GDP growth and growth of investment in non-residential buildings and equipment. Its performance has been particularly poor in terms of employment and wage growth. Given the below-average recovery, there is little reason to believe that the costly capital gains and dividend tax cuts are critical to the economy's health.

The lack of impact of these tax cuts over the short run should not be surprising. Most economists believe that if these tax cuts were to have a positive impact on the economy, it would occur over the long run, not over the short run. In addition, even this potential positive long-term impact — which, in theory, would come from more saving and investment — is mitigated by the fact that these tax cuts add to the deficit. All else being equal, deficits lower national saving, thus lowering national investment and reducing long-run economic growth.

The Joint Committee on Taxation estimates that the proposed two-year extension of the capital gains and dividend tax cuts would reduce revenues by $51 billion between 2006 and 2015. Supporters of these tax cuts would like them to be made permanent, which would cost still more — $162 billion over the next ten years (and $189 billion when the added interest costs on the debt are included).

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[4] For further discussion, see Joel Friedman and Aviva Aron-Dine, "Economic Evidence for Extending Capital Gains and Dividend Tax Cuts is Weak," Center on Budget and Policy Priorities, November 9, 2005; and Aviva Aron-Dine, "Capital Gains and Dividend Tax Cuts and Investment," Center on Budget and Policy Priorities, November 14, 2005.

Other Tax Cuts in the Reconciliation Bills

The House- and Senate-passed tax reconciliation bills include a range of tax cuts beyond those examined in this report. Most of the additional provisions extend tax cuts that expired at the end of 2005, although a few provisions of the bills extend tax cuts slated to expire in years after 2005. Both the House and Senate measures also include some new tax cuts.

- Both bills would extend a number of business tax cuts. For instance, both would extend and expand the research and development tax credit, which expired at the end of 2005. Similarly, both would extend the expansion of small business expensing (which allows small businesses to deduct up to $100,000 of investment costs from current income). Both bills would extend that provision, which is slated to expire in 2007, for two years.

- Both bills also would extend the Saver's Credit, a provision intended to encourage moderate-incomes taxpayers to save for their retirement. This credit expires in 2006. The Senate bill extends it for three years, while the House measure would extend it for two years. Both measures also would extend the above-the-line deduction for higher education expenses, which expires this year. The House bill extends this provision for one year, while the Senate measure would extend it through 2009.

- In addition, both bills would extend for one year the deduction for state and local sales taxes, the deduction for teachers' classroom expenses, and the work opportunity and welfare-to-work tax credits. All of these provisions expired at the end of 2005.

- The Senate measure includes a number of provisions related to charitable giving. The charitable package calls for the establishment of a new deduction for charitable contributions for taxpayers who do not itemize their deductions, and would allow tax-free distributions from IRAs for charitable donations. It also would expand the deduction for donations of food inventories. The charitable package costs $532 million over five years (although most of the tax-cut provisions in this package would be in effect only for two years, so the package would cost more if its provisions were subsequently extended, as would likely be the case).

The Congressional Research Service analyzed the 2003 dividend tax cut under a variety of assumptions and concluded that, in the long-run, "the dividend relief proposal would *harm long-run growth as long as it is based on deficit finance*" (emphasis added).[5] Similarly, Brookings Institution economists William Gale and Peter Orszag concluded that even if the more optimistic assumptions about the positive effects of the dividend and capital gains tax cuts on the economy were to prove accurate, as long as these tax cuts continued to add to the deficit, "the net effects would be roughly a zero effect on long-term growth."[6]

Finally, supporters of these tax cuts argue that failure to extend them today, three years before they are scheduled to expire, could undermine investor confidence. This claim lacks credibility. At the heart of this argument is the belief that investors will be reassured by more certainty in the tax code. That may be true, but it is unclear how a two-year extension of these tax cuts would offer much reassurance. And investor concerns about the uncertainty in the tax code extend far beyond

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[5] Jane Gravelle, "Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market," Congressional Research Service, March 28, 2003.

[6] William Gale and Peter Orszag, "An Economic Assessment of Tax Policy in the Bush Administration, 2000-2004," Boston College Law Review, Vol. 45, No. 4, 2004.

these two provisions, given that all of the other tax cuts enacted in 2001 and 2003 are slated to expire by 2010 and that the nation faces mounting deficits in the years after that.

To give investors confidence that the tax environment is stable would entail more than deciding whether various tax cuts are made permanent. To extend permanently the tax cuts that the House and Senate bills would extend for temporary periods would cost about *eight times* as much over the next ten years as the temporary extensions that these bills contain and would add hundreds of billions more to deficits (unless the tax cuts were offset by deep spending cuts). Moreover, extending *all* of the 2001 and 2003 tax cuts without offsetting their costs would increase deficits by substantially more.

Simply making all of the tax cuts permanent represents a course that many investors are likely to view as unsustainable over the long run, given the pressures that the retirement of the baby-boom generation will place on the budget. In the end, investors may feel a significantly greater degree of confidence if they believe Congress is beginning to get serious about tackling the deficit, rather than simply continuing on its current course of increasing deficits by enacting another round of deficit-financed tax cuts every year.