CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1080 center@cbpp.org www.cbpp.org

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WILL EXTENDING THE "MIDDLE-CLASS" TAX CUTS BENEFIT THE MIDDLE CLASS?

The full report can be viewed at http://www.cbpp.org/9-21-04tax.htm

A new Center report, *Many Middle-Class Families Likely to Wind Up as Net Losers from the "Middle-Class" Tax-Cut Legislation,* examines the probable effects of the "middle-class" tax-cut legislation Congress approved on September 23.

The legislation extends a series of tax cuts that were scheduled to expire on December 31.* It also extends relief from the Alternative Minimum Tax for one year. According to Congress's Joint Committee on Taxation, the legislation — which contains no offsets so will be financed entirely by higher deficits — will cost $146 billion over the next ten years. (When the added interest costs on the national debt are taken into account, the legislation will raise deficits by $211 billion over that period.)

Over the next several years, most middle-class families will pay lower taxes if the tax cuts are extended than if they were allowed to expire. Yet over the longer term, most middle-class families could end up *worse* off, for the following reasons:

- **Many middle-class families will receive only modest gains from the extension.** As is shown in the table at right, which contains new data from the Urban Institute-Brookings Institution Tax Policy Center, the legislation's biggest gains will go to high-income households.

Average Benefit in 2005 from "Middle-Class" Tax-Cut Extension Package	
Households in the middle 20 percent of the income spectrum	$162
Households in the top 20 percent of the income spectrum	$1,317
Households with incomes between $200,000 and $500,000	$2,390
Source: Tax Policy Center	

  In 2005, more than two-thirds (70 percent) of the legislation's benefits will go to the top fifth of households, while only 9 percent of the benefits will go to the middle fifth of households, a peculiar outcome for a "middle-class" tax-cut bill.

- **Ultimately, the extension will have to be paid for.** Sooner or later the federal government will have to cover the cost of extending the middle-class tax cuts. Financial markets will not indefinitely tolerate the large, persistent deficits that are currently projected. As Federal Reserve Board Chairman Alan Greenspan recently warned, "If you're going to lower taxes, you shouldn't be borrowing essentially the tax cut. And that

* In 2003, Congress enacted legislation accelerating implementation of most of the pieces of the 2001 tax package, including the measures sometimes referred to as the "middle-class" tax cuts: the expansion of the 10-percent tax bracket, the increase in the child tax credit to $1,000 per child, and two tax cuts for married filers. The accelerations of the middle-class tax cuts were scheduled to expire on December 31 but will be extended under the new legislation.

over the long run is not a stable fiscal situation." Simply stated, funds that are borrowed must eventually be paid back.

- **For many in the middle class, the offsets would likely outweigh the tax cuts.** The tax increases and/or program cuts that will eventually become necessary to pay for the middle-class tax cuts are likely to offset part or all of the gains that many families receive from the tax cuts. And since many middle-class families are securing only modest gains from the tax cuts, there is a substantial possibility that they ultimately will lose more from the measures ultimately adopted to pay for the tax cuts than they gain from the tax cuts themselves.

  To get a sense of whether middle-class families would likely wind up net winners or net losers once the tax cuts are paid for, the Tax Policy Center examined two hypothetical scenarios. In the first scenario, every household would pay the same dollar amount to finance the tax cuts. (Something like this scenario could occur if the tax cuts were financed largely or entirely through program cuts.) In the second scenario, all households would pay the same percentage of income to finance the tax cuts. (This could occur if the tax cuts were financed by a combination of program cuts and progressive tax increases.)

  Under both scenarios, middle-class households would experience a net loss in income once the tax cuts were paid for, according to the Tax Policy Center data.

Corporate Tax-Reform Savings Could Have Been Used to Finance Tax Cuts

Congress could have ensured that middle-class households would benefit from the middle-class tax package over time, as well as immediately, by incorporating into that package various revenue-raising measures that the Senate or House has approved this year as part of corporate tax bills. These measures, which consist in large part of steps to crack down on abusive corporate tax shelters, could have been used to finance the extension of the tax cuts. Tax Policy Center data indicate that under such an approach, most middle-class households would gain more from the tax cuts than they would lose from the revenue-raising measures.

That, however, is not what Congress did. Instead, Congress pushed through the middle-class tax package without paying for it, and now seems determined to use the corporate tax-reform savings largely to finance an array of *new* tax breaks for corporations and other special interests. This approach will force Congress at some future time to adopt other financing measures for the middle-class package, which are likely to more than cancel out the tax-cut benefits for many middle- and lower-income families.

Using the revenue from the corporate tax reforms to finance narrow corporate tax breaks also is unsound from an economic standpoint. The corporate tax preferences that would be created would narrow the tax base and make the "playing field" less level for business investments, causing some investments that are more profitable than others on a *before*-tax basis to be less profitable on an *after*-tax basis. When that occurs, investment decisions are distorted, and the economy does not perform as well as it should.