Center on Budget and Policy Priorities

# POLICY POINTS

May 12, 2006

## NEW TAX-CUT LEGISLATION MEANS WINDFALL BENEFITS FOR THE FEW, LARGER DEFICITS FOR THE NATION

The tax-cut reconciliation agreement approved this week by Congress will provide windfall benefits to those at the top of the income scale but little for most other Americans.

Although the agreement's supporters claim that the 2003 cuts in capital gains and dividend taxes helped spark strong economic growth, the data show that this economic recovery has been weaker than the typical post-World War II recovery. (Only the growth in corporate profits has been especially strong.) At the end of 2005, the total number of jobs was more than 4 million below the level the President's Council of Economic Advisors (CEA) had predicted in early 2003 would be reached without the President's proposed tax cut, and more than 6 million below what CEA forecast with the proposed tax cut.

Moreover, the nation as a whole will pay for the new tax agreement through larger deficits and a greater squeeze on government programs, as explained briefly below.

**Digging the deficit hole deeper, in part by using one tax cut to "pay for" another.**

- The legislation's official price tag — $70 billion over the first five years and zero cost after that point — is seriously misleading, in two ways. First, the legislation uses several budget gimmicks to create the appearance that it does not increase long-term deficits. The most egregious of these is a new tax cut (the effective elimination of income limits on Roth IRAs, described below) that raises revenue initially but loses much larger amounts of revenue in years after those covered by the bill's official cost estimate, according to analyses by the Joint Tax Committee, the Congressional Research Service, and the Urban Institute-Brookings Institution Tax Policy Center. Other gimmicks include a series of timing shifts and early sunsets designed to reduce the bill's official cost.

- Second, House-Senate conferees stayed within the $70 billion limit set for the tax bill over the first five years only by agreeing that a second tax-cut bill will follow in coming weeks. That bill will reportedly include more than a dozen tax cuts that were in both the House- and Senate-passed reconciliation bills but were dropped from the final agreement to make room for a two-year extension of the capital gains and dividend tax cuts. Extending the dropped tax cuts — which have already expired or will expire at the end of 2006 (unlike the capital gains and dividend tax cuts, which do not expire until the end of 2008) — would cost about $20 billion for one year.

**$20 for the middle class, $43,000 for millionaires.**

- Middle-income households would receive an average tax cut of just $20 from the reconciliation tax bill, according to Tax Policy Center estimates. In contrast, households with incomes over $1 million would receive an average tax cut of $43,000, and the top 0.1 percent of households — a group whose incomes exceed $1.6 million — would receive an average tax cut of $84,000.

- The benefits are skewed this way largely because of the capital gains and dividend tax cuts. Nearly half (45 percent) of the benefits of these tax cuts will go to households with incomes over $1 million.

**A new tax shelter for high-income households.**

- A little-understood feature of the Roth IRA provision in the tax bill is that it not only would eliminate the income limit on converting a traditional IRA to a Roth IRA starting in 2010, but also would effectively eliminate the income limit on contributing to a Roth IRA. (The latter limit is $160,000 for married couples filing jointly or $110,000 for singles and heads of household.)

- This means that starting in 2010, a married couple could deposit $10,000 in a non-deductible IRA, roll over these funds into its Roth IRA the very next day, and pay no tax on the amount converted (since the conversion would be from a non-deductible IRA that contained contributions made with after-tax dollars). The couple could repeat this process every year, thereby building a large Roth IRA that is permanently sheltered from taxation.

- The Tax Policy Center, while concurring with the Joint Tax Committee's estimate that the Roth IRA provision will raise about $6.4 billion through 2015, projects that the provision will lose $100 billion through 2049. (This $100 billion equals between $14 billion and $15 billion in "net present value," or the amount that, if set aside today and allowed to collect interest until 2049, would offset the cost of this tax cut.)

**Cutting government services to help pay for high-income tax cuts.**

- This reconciliation tax bill is the second of two reconciliation bills authorized under last year's budget resolution. The first bill, enacted in February, cut entitlement programs by $39 billion over five years, including Medicaid, child support enforcement, and other programs that assist low-income families, elderly people, and people with disabilities.

- The cuts in that bill will affect millions of Americans. For example, the Congressional Budget Office estimates that 13 million Medicaid beneficiaries will ultimately be subject to higher co-payments, and many of them will be forced to cut back on the amount of health care they receive. CBO estimates that 80 percent of the Medicaid savings obtained through raising co-payments will come from people using less health care, rather than paying higher co-payments.

- Also as a result of the bill, roughly 250,000 child care slots for low-income working families will be lost, and nearly $8 billion in child support that otherwise would have been collected will go uncollected because of cuts in child support enforcement funding.

- At the time, congressional leaders promoted the budget-cut reconciliation bill as a deficit-reduction measure. But enactment of the new reconciliation tax-cut bill means these program cuts will be used not to reduce the deficit, but simply to offset about half of the cost of the new tax cuts. And since the tax-cut reconciliation bill costs more than the budget-cut bill will save, the combined effect of the two reconciliation bills will be to increase deficits, while further widening income disparities between the most well-off households and Americans of more modest means.