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   http://www.cbpp.org

Revised January 24, 2002

CRITICISMS OF KENNEDY TAX PROPOSAL IGNORE ITS SUBSTANCE AND DISTORT ITS IMPACT

by Joel Friedman, Robert Greenstein, and Andrew Lee

On January 16, Senator Edward Kennedy proposed postponing implementation of selected future tax reductions that were part of the tax-cut package enacted last year. The Administration has been swift to condemn the Kennedy proposal. Much of the substance of the Administration's criticisms, however, have little to do with the changes Senator Kennedy endorsed.

- The Kennedy proposal has been attacked for raising taxes on large numbers of individuals and small businesses. Yet under his proposal, no tax rates would be raised above their current level. Rather, he called for rolling back future tax cuts that impact only the highest-income taxpayers — affecting only the top 5 percent of income tax filers and the largest 1 percent of estates. All of the broader-based tax cuts in last year's legislation — such as the expansion of the child tax credit, marriage penalty relief, and the pension and education provisions — would continue to take effect as scheduled; many of these provisions also benefit high-income taxpayers, in some cases disproportionately. As a result, 95 percent of tax filers would be unaffected by his proposal, and even those with the highest incomes would continue to see their taxes reduced over the decade.

- The Kennedy proposal has been criticized for raising taxes during a recession. Yet none of his proposals would take effect until 2004 or later — years when the economy is expected already to have recovered from the current slowdown — and he declared his support for the same immediate tax cuts for individuals and businesses that Senate Majority Leader Tom Daschle recently proposed to stimulate the economy in the short-term. Deferring tax reductions not scheduled to take place for two to four years would take no money out of the hands of consumers and businesses during the current downturn.

  Moreover, if a portion of the savings were used for debt reduction, it could improve the long-term budget outlook. That, in turn, could have the positive effect of putting downward pressure on long-term interest rates now — a point emphasized by former Treasury Secretary Robert Rubin and other experts. Such a reduction in long-term interest rates would help to stimulate the economy today by lowering the cost of financing business investments and consumer purchases. (The Kennedy proposal would rechannel the savings for significant domestic needs, such as providing a Medicare prescription drug benefit and reducing the ranks of the uninsured. An alternative formulation could divide the savings between such needs and debt reduction.)

Senator Kennedy and the Administration Talk Past Each Other

What Senator Kennedy said:

"We can and should postpone a portion of the future tax cuts that overwhelmingly benefit the wealthiest taxpayers. Those tax cuts are not scheduled to be made until 2004 and later....Families earning less than 130,000 dollars a year and filing joint returns would not be affected. No taxpayers would pay a higher tax rate than they pay now. In fact, income tax rates for everyone will still be lower in 2002 and in succeeding years than they were in 2001. The child tax credit would be increased as planned, and marriage penalty relief would be provided as scheduled."

"These future tax cuts for those at the top are not part of the fight against the recession. They are not scheduled to occur until long after the economy emerges from the downturn. In fact, taking fiscally responsible action now will actually help the economy — by leading to reductions in long-term interest rates that have remained stubbornly high because of the fear that unaffordable tax cuts will lead to growing federal deficits throughout the decade. Reducing that threat will reduce the cost of long-term borrowing for businesses, and provide stimulus for new job creation now."

Senator Edward Kennedy, speech at the National Press Club, January 16, 2002

How the Administration responded:

"I think raising taxes in the midst of a recession is wrong economic policy. It'd be a huge mistake. It's bad for American workers. It would hurt when it comes to creating jobs so I strongly disagree with those who want to raise taxes here in Washington, D.C."

President Bush, January 16, 2002

"Raising taxes on job creators is always a bad idea, and it's an especially bad idea during an economic slowdown. We should be nourishing our nascent recovery, not smothering it with new taxes on job creators."

Treasury Secretary Paul O'Neill, January 16, 2002

Senator Kennedy stated that his speech was focused on "the longer-run challenges before us," and warned that "[i]t makes no sense for anyone in Congress or the Administration to try to blur the very obvious difference between the short run and the long run." That, however, is precisely what the Administration seems to have done.

To keep the Kennedy proposal in perspective, it is instructive to compare it to the tax increases that followed the enactment in 1981 of the tax cuts championed by President Reagan. About one third of the 1981 tax cuts were offset the following year — by rolling back enacted tax cuts that had already gone into effect, cancelling some that had not yet taken effect, and increasing existing taxes. By comparison, Senator Kennedy's proposal would cancel only about one-fifth of the tax cut enacted last year and would do so without increasing any taxes above their current levels.

Finally, to build its case that the Kennedy proposal is bad for the economy, the Administration contends the Kennedy proposal would have a disproportionate impact on small businesses. The Administration has asserted that, if the scheduled upper-bracket rate reductions are cancelled, 80 percent of the added taxes would be paid by business owners who file individual returns and has implied that these are primarily "small business owners." These claims are deceptive. The Administration is counting as "small business owners" high-income individuals who have *some* business income, even in those cases when the "business" is a passive investment vehicle, a law firm, or a medical practice. Most of these individuals are not proprietors of small business concerns. In fact, analysis by Citizens for Tax Justice shows that only eight percent of the small businesses in the nation would be affected by the proposal to freeze the three top tax rates at their current levels. More than 90 percent of small businesses would remain untouched.

Treasury Department Press Release Gives Wrong Impression

The Treasury Department's Office of Public Affairs released information to coincide with the Kennedy speech, giving the impression that it was intended to respond to his proposal; however, much of the information in the press release had nothing to do with the Kennedy proposals. For instance, the first three points in the press release assert that two-thirds of families with children would be hurt by reinstating the marriage penalty, reducing the child credit, and repealing the scheduled rate reduction to 25 percent. Senator Kennedy proposed none of these changes.

The Treasury materials discussed the impact of rolling back most of the major tax reduction enacted last year, while the Kennedy proposals are far more targeted. Kennedy has called for postponing future rate reductions in the top three income tax brackets — those brackets in which the 39.6 percent, 36 percent, and 31 percent rates applied prior to the enactment of the tax bill. (In 2002, all of these rates are one percentage point lower.) Further rate reductions are scheduled to occur in 2004 and 2006. According to Congressional Budget Office estimates, only 4.4 percent of tax filers are in these top three brackets and thus would be affected by Senator Kennedy's proposal to

Distribution of Tax Filers By Marginal Income Tax Rate, 2000

Highest marginal rate faced by tax filer	Tax units (thousands)	Percent
owe no income tax	46,900	31.5
15 percent	67,500	45.3
28 percent	28,100	18.9
31 percent	3,900	2.6
36 percent	1,300	0.9
39.6 percent	1,300	0.9
Total	149,000	100.0
Addendum:		
top bracket	1,300	0.9
top two brackets	2,600	1.8
top three brackets	6,500	4.4

Source: Congressional Budget Office

cancel future tax reductions in these brackets; the other 95 percent of tax filers would be unaffected by this proposal.[1]

Kennedy calls for no changes in the vast majority of the enacted tax provisions — such as those increasing the child tax credit, providing marriage penalty relief, or expanding pension and education tax breaks. Many of these provisions also benefit upper-income taxpayers. (In some cases, as with many of the pension provisions, they benefit high-income taxpayers disproportionately.) As a result, all taxpayers — including those with the highest incomes — would continue to see their taxes reduced over the decade as these provisions continue to phase in (see table on following page).

Misleading Claims About Effects on Small Business Owners

Secretary O'Neill, drawing on other information in the Treasury release, also attacked the Kennedy proposal on the grounds that "80 percent of the higher income taxes that he proposed would be paid by business owners who file individual returns." Larry Lindsey repeated this assertion in an op-ed piece in the January 18, 2002, *Washington Post*, and stated further that "[m]illions of small businesses would see their taxes increased under the Kennedy plan. More than 7 million returns are likely to be affected."

Both O'Neill and Lindsey chose their words carefully, to create the impression that vast numbers of small businesses would be affected by the Kennedy proposal. In fact, what their statements really signify is simply that a high percentage of the 5 percent of tax filers who would be affected by the Kennedy proposal show *some* business income on their income tax returns. This should not be surprising; many wealthy investors who do not own or operate small businesses have some business income.

To gain some perspective on this issue, one should ask what proportion of small businesses would actually be affected by the Kennedy proposal. Contrary to the impression that O'Neill and Lindsey have sought to foster, most small businesses and their owners would be entirely unaffected by the Kennedy plan. An analysis by the Citizens for Tax Justice finds that only 8.3 percent of sole proprietorships with positive income in 2001 — or about 1.1 million small businesses — paid taxes in the top three brackets, and thus would be affected by the proposal to postpone the scheduled reductions in these brackets. According to CTJ, this business income is actually one of the smallest components of income for those paying taxes in the top

[1] In addition to postponing future reductions in the top three income tax rates, the Kennedy proposal would also undo provisions of the tax bill under which two provisions of current tax law that affect only upper-income taxpayers would be phased out, starting in 2006. Specifically, he would cancel the scheduled repeal of the provision of current-law under which the personal exemption is phased out for high-income taxpayers as well as the current- law provision that places a limitation on the itemized deductions that a high-income taxpayer can claim. Nearly all of the taxpayers affected by these changes are in the top three brackets.

Impact of Kennedy Proposal on a Married Couple with Two Children
(all amounts given in 2002 dollars)

	2002		2004		2006	
Income (AGI)	Enacted tax cut	Kennedy proposal	Enacted tax cut	Kennedy proposal	Enacted tax cut	Kennedy proposal
$50,000	$800	$800	$760	$760	$1,017	$1,017
100,000	963	963	1,086	1,086	1,949	1,949
120,000	1,113	1,113	1,386	1,386	2,253	2,253
250,000	1,931	1,931	3,232	2,563	5,941	3,752
500,000	3,633	3,633	6,636	4,265	13,557	5,454
1,000,000	7,133	7,133	13,636	7,765	31,406	8,954

Notes:
1. Estimates assume taxpayers are not affected by the Alternative Minimum Tax. For taxpayers subject to the AMT, the tax cuts would be smaller under both the enacted law and the Kennedy proposal.
2. Families with income over $50,000 are assumed to itemize deductions and to receive a portion of their income in long-term capital gains. The table reflects estimates of itemized deductions and capital gains income that are typical of families at these income levels, based on IRS Statistics of Income data for tax year 1998.
3. Estimates of the enacted tax bill reflect the impact of the marginal rate cuts, the child tax credit expansion, marriage penalty relief, and the phaseout of the "Pease" limitation on itemized deductions and "PEP" (personal exemption phaseout). They do not include other income tax changes involving pensions and education, many of which would also benefit higher-income families.
4. Estimates of the Kennedy proposal to modify the enacted tax cut reflect the impact of cancelling reductions in the top three marginal rates scheduled for 2004 and 2006 and cancelling the phaseouts of "Pease" and "PEP," which start in 2006.

three brackets — representing only about four percent of the total income of taxpayers in these brackets.[2]

Moreover, O'Neill and Lindsey are using an expansive definition of "small business" that includes, for instance, partnerships and S corporations. These types of businesses are often passive investment vehicles. Those who include this income on their tax forms are generally not the proprietors of struggling mom-and-pop businesses. Overall, the Administration has simply

[2] According to CTJ, 48 percent of the income for those in the top three brackets comes from wages and salaries, while 23 percent comes from capital gains and 12 percent from partnerships. Also see Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," National Bureau of Economic Research, Working Paper 8467, September 2001. Using IRS Statistics of Income data, the authors estimate that "entrepreneurial income" accounted for a small share of the overall income relative to wages and salaries of those in the top five percent of the income spectrum.

revived the exaggerated claims related to small businesses that it used to promote its favored top-bracket reductions last year.[3]

Cancellation of Estate Tax Repeal

Finally, the Kennedy proposal would cancel the repeal of the estate tax scheduled for 2010. In lieu of repeal, Kennedy would raise the estate-tax exemption from the current $1 million level to $4 million per estate. In 1999, the last year for which IRS data are available, the exemption was $675,000; even at that lower level, only 2 percent of estates were large enough to be subject to estate tax. Raising the exemption to $4 million would exempt all but the very largest estates — less than 0.5 percent of estates — from the estate tax. Stated another way, the proposal would retain the estate tax on the estates of fewer than one of every 200 people who die.

Kennedy Proposal is Modest Compared With Rollback of Reagan Tax Cuts

Critics of Senator Kennedy's proposal have attempted to portray it as a major tax increase that would vitiate much of what the enacted tax cut would accomplish. In fact, the Kennedy proposal is relatively modest. It would reduce the cost of the tax cut over the next ten years by about 20 percent, leaving 80 percent of it in place.

This is smaller than the proportion of the 1981 tax cut that President Reagan, a Republican Senate behind then-Senate Finance Committee Chairman Bob Dole and a Democratic House undid in the years after 1981 as the nation's fiscal condition worsened. For example, the Congressional Budget Office reported that the revenue-raising provisions of the Tax Equity and Fiscal Responsibility Act of 1982 — which scaled back tax cuts already in effect, cancelled tax cuts not yet in effect, and also raised existing taxes — "partly offset the revenue effects of ERTA [the 1981 act] by offsetting almost two-thirds of the ERTA corporate income tax reductions and about 10 percent of the ERTA individual income tax reductions."[4] In total, the 1982 legislation offset about one-third of ERTA.[5]

Moreover, this excludes the additional revenue-raising measures that were enacted in subsequent years to counter the large deficits that ensued after approval of the Reagan tax cuts. With fiscal conditions remaining troublesome, President Reagan, the Republican Senate, and the Democratic House followed up on the 1982 tax measure by adopting a series of further revenue-raising bills in the years after that. Many of these measures raised existing taxes. In addition, one such measure — the Deficit Reduction Act of 1984 — included a provision cancelling an additional tax cut enacted in 1981 that had not yet taken effect.

---

[3] Isaac Shapiro and Robert Greenstein, "Reducing the Top Tax Rates: How Much Benefit to Small Business? Many More Small Businesses Owners Would Fail to Benefit from Bush Tax Plan than Would Benefit from Cut in Top Tax Rates," Center on Budget and Policy Priorities, May 3, 2001.

[4] Congressional Budget Office, "Baseline Budget Projections for Fiscal Years 1984-1998," February 1983, page 27.

[5] Peter Orszag, "How the Bush Tax Cut Compares in Size to the Reagan Tax Cuts," Center on Budget and Policy Priorities, revised February 20, 2001.