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DESPITE SOME IMPROVEMENTS OVER OTHER BILLS, SENATE FINANCE COMMITTEE TAX-CUT MEASURE REMAINS DEEPLY FLAWED

By Joel Friedman and Robert Greenstein

When the Congressional budget resolution limited the cost of the Senate reconciliation tax-cut measure to $350 billion through 2013, that created the expectation that the Senate measure would avoid some of the excesses of the more costly tax-cut packages proposed by the Administration and adopted by the House Ways and Means Committee. Although the measure reported by the Senate Finance Committee yesterday is more moderate in many ways than the Administration and Ways and Means proposals, it nonetheless fails to provide effective medicine for the economy's ills. The Senate Finance measure offers relatively little in the way of stimulus to boost the economy in the short term while it is weak, especially in relation to the measure's cost. Of its $350 billion cost through 2013, only 12 percent of the cost occurs in 2003 and only two-fifths occurs through 2004, the years when the economy is most in need of stimulus.

The Senate Finance Committee bill makes improvements relative to the House Ways and Means Committee measure, but also contains many of the flaws that plague the Ways and Means proposal — although not to the same degree. For instance, the benefits of the Finance Committee bill are tilted toward the top of the income spectrum. An analysis by the Urban Institute-Brookings Institution Tax Policy Center shows that people with incomes above $1 million would receive an average tax cut of $64,400 in 2003 from the Finance measure, while those in the middle of the income spectrum would receive an average tax cut of $233. (Under the Ways and Means bill, the "millionaire" groups would receive an average tax cut of $93,500 in 2003, while the middle of the income spectrum would receive an average tax reduction of $217.) The Finance measure also relies on several gimmicks to mask its true costs, although none are as egregious as the gimmicks employed by the Ways and Means Committee. Finally, like the Ways and Means bill, the Senate Finance package excludes several provisions that would provide more effective stimulus.

Among the concerns regarding the Senate Finance Committee bill are the following:

- The Senate Finance bill fails either to extend or to strengthen the Temporary Emergency Unemployment Compensation (TEUC) program that expires on May 31, 2003. Analyses by Economy.com and various economists have found that extending TEUC would be one of the most effective forms of economic stimulus under consideration. Moreover, such as provision would ensure that those hardest hit by the slowdown will receive vital assistance, and thus should rightly be the first item in any package designed to address a weak economy.

- The package's effectiveness as economic stimulus is also weakened because one of its largest tax cuts — accelerating the upper-bracket rate reductions that are scheduled to go into effect in 2006 — would benefit primarily those at the top of the income spectrum. Tax Policy Center data show that more than half of this tax cut would flow to the top one percent of tax filers, and those with incomes over $1 million would receive an average tax cut of approximately $60,000 in 2003 just from the rate acceleration. This upper-income group is far more likely to save (rather than spend) these additional funds than people with lower incomes. Only if funds are spent will they provide the immediate stimulus that would boost the economy.

- In addition, the Senate Finance bill fails to accelerate a measure enacted in 2001 that would reduce marriage penalties and provide tax benefits to lower-income married working families with children, even though this provision would provide more effective stimulus. The 2001 tax cut contained three provisions offering marriage penalty relief — one targeted at middle-income families, one benefiting only higher-income filers, and one focused on lower- and moderate-income families. The Committee bill accelerates the middle- and upper-income marriage penalty relief provisions, both of which are expensive, while providing no acceleration of the lower-cost relief for married families at lower-income levels.

- The Senate Finance bill relies on gimmicks to obscure its true costs. Many of the tax increases that are included as offsets are unlikely to materialize, facing stiff opposition from business groups. Senate Republican leaders have already begun to spread the word that a number of the offsets in the Senate bill expected to be dropped in conference, when the House and Senate meet to resolve the differences between their measures. Further, a number of the offsets in the Senate Finance bill will have already been used to offset the cost of legislation that has passed the Senate this year. Although the Senate Finance measure eschews the more flagrant phony sunsets included in the House Ways and Means bill, it nonetheless includes two artificial sunsets — both the dividend tax cut and the increase in the small business write off for investments would expire artificially in 2012. Partly as a consequence, the bill as a whole actually *raises revenue* in 2013. Of course, the bill's framers intend for no such thing to occur in 2013 and for these provisions to be extended beyond 2012.

- The measure's limited dividend exemption clearly represents a "foot in the door" strategy. None of the strong supporters of tax relief for dividends will be content with the bill's exemption level ($500 plus 10 percent of dividends above this amount, rising to 20 percent in 2008). If the Finance Committee provision were enacted, the Administration and its allies almost certainly would soon argue that 10 percent and 20 percent exemptions are too small to have the desired effects and that the exemption limits must be raised.

The measure adopted by the Senate Finance Committee includes a number of positive changes relative to the House Ways and Means Committee package. For instance, the Finance

Committee measure includes $20 billion in fiscal relief for the states over two years, although the measure's dividend proposal negates some of this assistance because it would cause states to lose between $8 billion and $11 billion of revenue over the next ten years. The Finance bill also would accelerate the "refundable" provision of the child tax credit (pursuant to an amendment that was adopted during Committee consideration of the bill). Both the state relief and the refundable part of the child tax credit represent excellent economic stimulus. Yet in total, they account for less than 7 percent of the bill's $350 billion cost through 2013.

Further, although the Committee adopted the child tax credit amendment, it rejected amendments to include an extension of the federal unemployment benefits beyond May 31 and to accelerate EITC marriage penalty relief, both of which would have improved the measure's ability to boost the economy in the short run.

Finally, the package's multi-year tax cuts not only are poorly designed for stimulus, but they add to the deficit in years after the economy is anticipated to have recovered. The impact on the long-term deficit is even greater when the gimmicks in the bill are stripped away. It would raise the deficit now and in the future, at a time when, even before considering any new tax cuts, federal revenues as a share of the economy are on course to hit their lowest level since either 1965 or 1959.[1] Thus, the Senate Finance measure does not represent the type of sustainable fiscal policy needed to address the future budget challenges the nation faces, such as the cost of meeting new security needs and the retirement of the baby boom generation. While the Senate Finance Committee measure reflects some improvements relative to the House Ways and Means package, it still falls well short of what the economy needs in the either the short or long term.

Senate Finance Bill Would Be Ineffective Stimulus

The Senate Finance Committee measure is not likely to do a great deal to boost the economy in the immediate future. Although the measure includes a modest $20 billion of assistance to the states to address their dire fiscal situation, most of the other provisions in the bill would be inefficient at boosting the economy immediately. A recent study by the economic-analysis firm Economy.com examines the "bang for the buck" of various proposals under consideration to stimulate the economy, estimating how much a dollar of revenue loss will generate in terms of increased economic growth.[2] Based on that analysis, it appears that nearly two-thirds of the cost of the package's tax cuts and spending increases would be devoted to provisions that yield less than one dollar of added demand for each dollar of revenue loss (see box on page 4).

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[1] Isaac Shapiro, "Federal Revenues Appear To Be Drying Up More Than Expected," Center on Budget and Policy Priorities, May 5, 2003.

[2] The Economy.com analysis estimates the one year change in real gross domestic product (GDP) relative to each dollar of federal government revenue loss or spending increase. The only proposals in the Senate Finance measure that yield more than a dollar of stimulus for each dollar of revenue loss or spending increase are the acceleration of the widening of the 10 percent bracket, state fiscal relief, and the acceleration of the increase in the child tax credit. See "The Need for Federal Government Aid to State Government," Economy.com, February 2003.

Ineffective Stimulus Provisions Make Up Nearly Two-Thirds of Senate Finance Package

	Demand generated per dollar of cost (Economy.com)	Share of tax cuts and spending in Finance Committee package*
High "Bang for the Buck"		
Extend UI benefits	$1.73	0%
Widening of 10% bracket	$1.34	10%
State fiscal relief	$1.24	5%
Child tax credit	$1.04	21%
Total		36%
Lower "Bang for the Buck"		
Marriage penalty relief	$0.74	12%
AMT adjustments	$0.67	11%
Accelerate 2006 rate cuts	$0.59	17%
Small business expensing	$0.24	5%
Dividend tax reduction	$0.09	19%
Total		64%

* These percentages leave out a number of small provisions that were not evaluated by Economy.com. These small provisions make up only about 1 percent of the tax cuts and spending increases in the package.

In addition, the Senate Finance bill leaves out the proposal that the Economy.com study concluded offers the highest "bang for the buck" — extension of the Temporary Emergency Unemployment Compensation (TEUC) program that expires on May 31, 2003. (An amendment offered by Senator Jeff Bingaman to extend and strengthen TEUC was rejected in the Finance Committee by a vote of 11 to 10.) According to Economy.com, for every $1 in unemployment insurance benefits provided by extending TEUC, an estimated $1.73 in demand will be generated in the year ahead. Failure to include this provision not only weakens the effectiveness of the bill as economic stimulus, but also fails to assist the approximately 2.1 million workers who are expected to exhaust their benefits in the six-month period after May 31. (A total of 3.9 million unemployed workers could be aided if the TEUC program were extended and strengthened, as proposed by legislation introduced in both the House and Senate; see box on page 5.)

Distribution of Benefits

The effectiveness of the Senate Finance measure as economic stimulus is weakened because the benefits of the tax cuts in the package tend to flow to people with higher incomes. This group is more likely to save, rather than spend, additional funds than people with lower incomes, whose budgets are more constrained. Yet only if funds are spent that will they provide the economy with a boost in the short run. Further, tax cuts for upper-income households benefit those who have the most ability to weather the current economic slowdown without additional assistance.

According to estimates by the Urban Institute-Brookings Institution Tax Policy Center, one-quarter of the benefits of the Senate Finance package would flow to the top one percent of

The Need to Extend and Strengthen
The Temporary Emergency Unemployment Compensation Program

A number of key indicators of the labor market are worse now than when the federal Temporary Emergency Unemployment Compensation program (TEUC) — which provides additional weeks of unemployment insurance benefits to individuals who exhaust their regular unemployment benefits — was first enacted in March 2002 and then extended in January 2003.

- The unemployment rate is 6.0 percent. This compares to a rate of 5.7 percent both when the TEUC program was enacted (in March 2002) and when the program was extended (January 2003).

- The Labor Department reported that new applications for unemployment insurance have now remained above 400,000, a level associated with a stagnant job market, for 12 consecutive weeks. Similarly, the more stable four-week "moving average" of new applications for UI rose in the week ending April 26 to its *highest level in more than a year*
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- More than half a million jobs have been lost since January, with the overall number of jobs dipping to a *41-month low*. There are now fewer jobs in the labor market than at any other point in the current slowdown.

- Some 365,000 workers exhausted their regular unemployment benefits in March (the latest month for which data are available). The number of "exhaustees" increased for 24 straight months, from March 2001 through February 2003, when compared to the number of exhaustees in the same month of the previous year.

- Adding to this concern, the percentage of workers beginning to receive regular unemployment benefits who subsequently exhaust those benefits without finding work was at the *highest level ever recorded* in February and at the second highest level ever recorded in March. (These data go back to 1973.)

The TEUC program is set to begin to phase down sharply on May 31. If it is not extended, workers exhausting their regular UI benefits after May 31 will receive no further assistance in most states. (Workers already receiving TEUC benefits will be able to receive their remaining weeks of benefits.) If the economy continues on its current course, approximately 2.1 million workers are expected to exhaust their regular unemployment benefits in the six-month period after May 31. Failure to extend the program would cause the vast majority of workers who exhaust their regular benefits after the end of May to "fall off a cliff," as they would cease receiving unemployment insurance benefits and have no paycheck either.

Legislation has been introduced in the House and Senate to extend the TEUC program for six months and to strengthen it by providing some additional weeks of benefits for workers whose TEUC benefits run out before they can find employment. We estimate that 3.9 million of the long-term unemployed would be assisted by this legislation, including (1) the estimated 2.1 million workers who will exhaust their regular unemployment benefits from June through November; (2) an estimated 1.1 million workers whose TEUC benefits will have run out and who will still be unemployed at the end of May; and (3) another 680,000 workers whose TEUC benefits will run out after the end of May and who would benefit from extra weeks of benefits.

the income spectrum in 2003, and 59 percent would go to the top 10 percent. The 0.1 percent of households with incomes over $1 million would receive an average tax cut of $64,400 — or 14 percent of all benefits — in 2003; in contrast, those with incomes in the middle of the income spectrum (i.e., the middle fifth of households) would receive an average tax cut of only $233.

The benefits of the Senate Finance measure favor higher income households largely because the measure includes the provision that would accelerate implementation of the upper-bracket rate reductions enacted in 2001. Over half of the benefits of this costly provision flow to the top one percent of households. Not only are the benefits of this provision skewed, weakening their effectiveness as economic stimulus, but locking in these rate cuts will make it more difficult to address future budget problems. Once these rate cuts are in place, any calls to roll them back will be labeled a tax increase, rather than viewed as simply postponing or canceling tax cuts not yet in effect. Locking in these lower rates now may essentially remove them from future debates on how to address deficits that threaten to mount to unmanageable levels as a result of a combination of tax cuts, the impending retirement of the baby boom generation, pressure for a prescription drug benefit for seniors, and increased security needs. Accelerating the rate cuts so they take effect in 2003 could exempt the rate cuts currently scheduled to take effect in 2006 from scrutiny during the 2004 election cycle, where one would otherwise expect an active debate on the affordability of these rate cuts in a budget environment that has deteriorated sharply. It also would make it much more difficult to reconsider the 2006 rates cuts in 2005 if the fiscal picture deteriorates further over the next two years.

Marriage Penalty Relief for Low-Income Families

Although the Senate Finance package accelerates implementation of a number of provisions that were enacted in 2001 but phase in throughout the decade, the Committee rejected an amendment to accelerate a tax-relief provision that would benefit married couples with children who have low- or moderate-incomes. This provision would be more effective stimulus because it targets those with lower incomes.

The 2001 tax law contained three "marriage penalty" relief provisions: one primarily for moderate- and middle-income families — a provision increasing the standard deduction for married filers; one for upper-middle and upper-income families — a provision increasing the income level at which the 15 percent bracket ends and the next-higher tax bracket begins; and one for lower-income families — a provision reducing the marriage penalty that the Earned Income Tax Credit can cause by increasing the EITC for certain low-income married filers. All three of these provisions are phased in over a number of years. The Senate Finance bill accelerates implementation of the first two of these provisions, as proposed by the President, but fails to accelerate the provisions related to the EITC. Accelerating that provision would benefit working families with incomes between about $15,000 and $37,000. Most families in this income range would see their earned income tax credits rise by about $300 or $400 if the provision were accelerated. (An amendment to accelerate the low- and moderate-income marriage penalty relief provision was offered yesterday by Senator Jim Jeffords, but was defeated on a 11 to 10 party-line vote.)

It is not sound on either equity or economic grounds to accelerate the other "marriage penalty" provisions contained in the 2001 act but *not* to accelerate the low-income component, especially since the low-income working families who benefit from this provision are the very families most likely to spend the accelerated tax benefits they would receive and thereby to plow these funds right back into the economy. Moreover, the marriage penalties that the EITC can cause can be quite large, and penalties of this magnitude may have a greater effect on cash-strapped households than on those who are more affluent.[3]

Senate Finance Measure Relies on Gimmicks To Hide Costs

According to the Joint Committee on Taxation, the Senate Finance measure will cost $350 billion through 2013. This total reflects tax cuts and spending increases of approximately $442 billion and offsetting tax increases and spending reductions totaling $92 billion.[4] Yet the official figures are distorted by the inclusion of several budget gimmicks. As a result, these estimates understate what would likely be the true cost of the measure.

One sign of the impact of the gimmicks is that the official cost estimates show that the measure as a whole will begin to *raise revenue* in 2013. That is, this bill actually increases taxes by $5.5 billion in 2013. This results, in part, because two provisions that the Administration proposed to be permanent — the dividend exemption and the increase in the small business write-off for certain investments — expire artificially at the end of 2012, or nine months before the end of fiscal 2013, the period covered by the cost estimate. Only by having these provisions expire before the end of the ten-year budget period could the bill as a whole stay within the $350 billion limit.[5]

The increase in the Alternative Minimum Tax relief also expires artificially in 2005, thereby allowing the number of tax filers subject to this alternative tax rise from about 2 million today to 30 million in 2010, according to Joint Tax Committee estimates. Making this relief permanent would cost at least several hundred billion dollars.

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[3] The Earned Income Tax Credit provides an income supplement for low- and moderate-income workers. For married families with two or more children, the credit is gradually phased out between earnings of about $15,000 and $35,000. Due to the structure of the phaseout, families that receive the EITC can face large marriage penalties. For example, two individuals, each with $10,000 and one child, each would receive $2,547 in federal income tax benefits in 2003 due to the Earned Income Tax Credit — for a combined income tax benefit of $5,093. If the two individuals were married, however, their income tax benefits would be reduced to $4,044 (from the EITC and the refundable child tax credit) due to the phaseout of EITC benefits. Thus, they face a marriage penalty of $1,049, or 5.2 percent of their combined income**.**

[4] These totals reflect the adoption of amendments during Senate Finance Committee consideration of the measure introduced by Chairman Charles Grassley. Note that the package includes $422 billion in tax cuts and $72 billion in tax increases. The measure also includes $20 billion of spending increases, plus an offsetting $20 billion of user fees and spending cuts, which are reflected in the totals mentioned above in the analysis.

[5] Under Senate rules, the measure would have to sunset any deficit-increasing provisions in 2013 to avoid a 60-vote point of order. The 2012 sunsets, however, are gimmicks intended to reduce costs artificially, allowing more tax cuts to be squeeze within the $350 billion total.

Many Offsets Are Gimmicks

Republican leaders have already begun to make it clear that they will reconsider many of the tax increases that are used as offsets in the Senate Finance measure. *Tax Notes* reported that House Majority Tom DeLay has vowed to strike any provision raising revenues when the measure goes to the House-Senate conference.[6] Similarly, Senator Rick Santorum is quoted as saying many of the offsets would have to be reconsidered "given the level of opposition." In all probability, many if not most of the offsets will never be enacted, but rather will be jettisoned — with the support of Senate leaders — as soon as the bill reaches conference.

Further, a number of the offsets in the Senate Finance package that may survive conference have already passed the Senate as part of the CARE bill (the name for the faith-based legislation that has passed both the House and the Senate in different forms). These provisions, which total $16.6 billion — representing nearly one-fifth of the total offsets in the Finance package — were used to offset the cost of the tax cuts in the CARE bill. If they are now used to pack more tax cuts into the reconciliation bill, the tax-cut provisions in the CARE bill would no longer have offsets and enactment of the CARE bill — which the Administration also is pushing for — would increase the deficit. This is simply another way to get around the limits imposed on reconciliation.

It also should be noted that in compiling offsets that total $92 billion, the Senate Finance Committee has used a number of fairly non-controversial offsets (such as the Customs user fees) to pay for more tax cuts primarily for upper-income households. As a result, these offsets will not be available to pay for other pressing priorities — such as increasing child care funding as part of the welfare legislation that would require placement of more public assistance recipients in work programs[7] — that are expected to be addressed in Finance Committee legislation later this session. It is particularly ironic, for example, that the package includes $655 million of savings in the State Children's Health Insurance Program to pay for tax cuts, when the Administration's own estimates have shown a large funding shortfall in the SCHIP program and that hundreds of thousands of moderate-income children will lose health coverage and become uninsured in the years ahead unless funding for the SCHIP program is increased.

Dividend Proposal

The Senate Finance bill includes a proposal to exempt a portion of dividend income from taxation. It would allow individuals to exclude from their income the first $500 of dividends received from corporations plus an additional 10 percent of the dividends above $500 through 2007. This additional percentage rises to 20 percent in 2008 and the years thereafter. As noted above, the provision would expire artificially at the end of 2012. According to Joint Tax Committee estimates, the provision would cost $81.1 billion through 2013. In addition to these

[6] Patti Mohr and Warren Rojas, *Tax Notes*, May 9, 2003.

[7] When the Senate Finance Committee considered the welfare reform reauthorization last year, it used a portion of the Customs user fees to offset the cost of child care expansion. When the Committee considers the measure again this year, it may also be in need of offsets to provide child care increases.

federal revenue losses, states stand to lose between $8 billion and $11 billion through 2013 as a result of this provision, because of the linkages between the federal and state income tax codes.[8]

The Senate Finance dividend proposal is less costly than either the Administration's full exemption or the related House Ways and Means Committee proposal. The $81.1 billion cost of the Finance provision was no doubt constrained by the amount of offsets that the Committee could devise and the Senate's $350 billion limit. But even a scaled-down proposal in the Senate bill ensures that some type of dividend tax cut will be part of the final package, and the Administration and its allies are expected to seek to enlarge the dividend tax cut in conference.

Moreover, even if the Senate Finance provision were the version somehow enacted this year, that would start a process that likely would lead ultimately to revenue losses far greater than $81.1 billion. Once the provision was enacted, the Administration would surely press for expanding the size of the exemption, arguing that a 10 percent or 20 percent exclusion was too small to have the economic benefits the Administration claims a larger exclusion would have. (At the very least, the Administration would likely call for the acceleration of the 20 percent exclusion, just as it has called for the immediate implementation of tax-cut provisions enacted in 2001 that phase in over time.) The Senate dividend provision thus would open the door to periodic, if not annual, efforts to raise the dividend exclusion to larger and larger levels. The final result could well be a dividend tax reduction that resulted in substantial long-term revenue losses during the period when the budget must confront the high costs associated with the retirement of the baby boom generation. (If the process led to a gradual increase in the dividend exclusion that reached 100 percent by 2013, for example, the cost would exceed $750 billion in the subsequent ten years, 2014 through 2023.[9])

Conclusion

The Senate Finance Committee tax-cut package offers little of what the economy needs to overcome its current sluggishness. Although the Senate Finance package represents improvement over the House Ways and Means Committee measure and the Administration's proposal in that it includes state fiscal relief, avoids the temptation to sunset most of its provisions at the end of 2005, and limits its "official" cost to $350 billion, the Finance package nonetheless offers only limited economic stimulus in relation to its cost. Nearly 60 percent of the measure's cost occurs after 2004, years in which the economy is expected to have recovered. Further, the measure fails to include provisions, such as the extension of the Temporary Emergency Unemployment Compensation (TEUC) program that expires on May 31, 2003, and marriage penalty relief for low-income families, that would be more effective stimulus — and that, in the case of the unemployment insurance, would be most targeted to the victims of the economic slump.

[8] Iris J. Lav and Nicholas Johnson, "States Could Lose $8 Billion To $11 Billion Over Ten Years As A Result Of Senate Finance Committee Proposal," Center on Budget and Policy Priorities, May 9, 2003.

[9] The revenue losses for 2014 through 2023 assumes that the tax loss estimated by the Joint Tax Committee in 2013 for the Administration's proposal continues to grow at the same pace as the economy over the following decade (a standard estimating assumption that the Congressional Budget Office and forecasters use when making long-term projections).

Finally, although the official cost estimate of the measure would seem to imply it has little or no long-term costs, this is misleading. The measure relies on artificial sunsets, with some provisions expiring before the end of ten-year budget period covered by the cost estimate. Further, many of the tax increases used as offsets are highly unlikely ever to be enacted, and a number of other offsets are being used here for a second time this year. Finally, inclusion of the dividend proposal in the package virtually ensures that some dividend tax cut will be part of the final package, which may result in intense pressure to increase the dividend exclusion in subsequent years.