



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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MANY MIDDLE-CLASS FAMILIES LIKELY TO WIND UP AS NET LOSERS FROM THE “MIDDLE-CLASS” TAX-CUT LEGISLATION

By Robert Greenstein and Isaac Shapiro

Several tax-cut measures often termed “middle-class tax cuts” are scheduled to expire on December 31. On September 23, Congress passed legislation to extend these tax cuts. The legislation did not offset the tax cuts’ costs.

As a result of this action to extend the tax cuts, most middle-class families will have lower tax bills over the next several years than they would have if the tax cuts were allowed to expire. Yet it is far from clear that middle-class families will be better off over the longer term. To the contrary, there is reason to believe that a majority of middle-class families could end up *worse* off, for two related reasons:

- First, although the legislation has been promoted as aimed at the middle class, it provides many middle-class families with only modest gains; the primary beneficiaries are higher-income families. New analysis by the Urban Institute-Brookings Institution Tax Policy Center shows that households in the middle fifth of the income spectrum will receive an average tax cut from the legislation of \$162 in 2005, while households in the top fifth will receive an average tax cut of \$1,317. Those with incomes between \$200,000 and \$500,000 will receive an average of \$2,390.¹
- Second and more importantly, although the bill includes no “offsets” to pay for the cost of its tax cuts, sooner or later the federal government will have to cover these costs, either by raising taxes or by cutting programs. These financing measures ultimately will offset part or all the gains that many families receive from the tax cuts. Since the gains that many middle-class families will secure from these tax-cut provisions are modest, there is a substantial possibility that many, if not most, middle-class households will lose more from the measures that ultimately are adopted to offset the tax cuts’ costs than they will receive in tax-cut benefits.

To date, all of the tax cuts enacted since 2001 have been financed by borrowing, which has contributed to higher deficits. But financial markets will not indefinitely tolerate large, persistent deficits of the type that the nation is projected to face. As Federal Reserve Board Chairman Alan Greenspan recently warned, “If you’re going to lower taxes, you shouldn’t be

¹ The Tax Policy Center analysis reflects the effects of extending the various “middle-class” provisions, relief from the Alternative Minimum Tax, and various corporate tax cuts. These extensions all are included in the legislation.

borrowing essentially the tax cut. And that over the long run is not a stable fiscal situation.”² Simply stated, funds that are borrowed must eventually be paid back.

Whether middle-class households ultimately come out ahead or behind from the legislation will depend on whether they lose more from the measures that eventually are adopted to pay for the tax cuts than they gain from the tax cuts themselves. The precise results will depend on the specific measures adopted. According to Tax Policy Center data, however, most households that do not have high incomes are likely to be net losers under most approaches to financing the tax cuts, particularly approaches that rely heavily on program cuts rather than progressive tax increases. Since more of the tax-cut gains from the legislation will go to high-income than to middle-class households, only under an approach that targets the top fifth of households for a large share of the financing burden will middle-income households not end up worse off.

Congress Could Have Ensured that the Middle Class Would Come Out Ahead

An approach was available under which middle-class households would have been certain to benefit from the tax-cut package over time, as well as immediately. The alternative was to incorporate into the legislation various revenue-raising measures that the Senate or House has approved this year as part of corporate tax bills. These measures consist in large part of steps to crack down on abusive corporate tax shelters. The revenues from such measures could have been used to finance the extension of the middle-class tax cuts.

Tax Policy Center data indicate that if the costs of the tax package were offset through corporate tax-reform savings, most middle-class households would gain more from the tax cuts than they would lose from the revenue-raising measures.

This, however, is not what Congress did. Instead, Congress leaders made a decision to use the corporate tax-reform savings largely to finance an array of *new* tax breaks for corporations and other special interests, and to push through the middle-class tax package without paying for it. This approach will force Congress at some future time to adopt other financing measures for the middle-class package, which (as noted above) 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.

The remainder of this analysis examines these issues in more detail.

² Chairman Alan Greenspan in “U.S. Representative Jim Nussle (R-IA) Holds Hearing on the Budget and the Economy,” FDCH Political Transcripts, September 8, 2004.

To Whom Will the “Middle-Class” Tax Cuts Go?

In 2003, Congress enacted legislation accelerating implementation of most of the elements of the 2001 tax cut. Several of these tax-cut accelerations — those related to 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 — are scheduled to expire on December 31, 2004. The middle-class tax package that the House and Senate approved on September 23 extends these expiring provisions. The tax package also extends relief from the Alternative Minimum Tax for one year, a measure sometimes described as necessary to ensure that middle-class taxpayers are not snared by the AMT. Furthermore, in a last-minute addition, the package includes \$13 billion in corporate tax-cut extensions.

Altogether, the package results in revenue losses of \$146 billion over ten years, according to the Joint Committee on Taxation. And when the costs of the increased interest payments on the national debt that the legislation will engender are taken into account, the overall effect of the bill is to increase the deficit by \$211 billion over ten years.

Although the broad middle class will benefit from these provisions, it is not well understood that higher-income households will gain more. For example, 72 percent of the benefits from the “marriage penalty” provisions of the package will go to the top 20 percent of households.³ Some 96 percent of the benefits from extending AMT relief will go to the top 20 percent of households.

Data from the Urban Institute-Brookings Institution Tax Policy Center indicate that under the legislation that Congress adopted:

- Households in the top 20 percent of the income spectrum will receive 70 percent of the tax-cut benefits in 2005. The top 10 percent of households will receive 47 percent of the tax-cut benefits.
- In contrast, households in the middle 20 percent of the income spectrum will receive 9 percent of the tax-cut benefits, a peculiar outcome for a “middle-class” tax-cut bill.
- In dollar terms, the top fifth of households will receive an average tax cut of \$1,317 in 2005 from the legislation, while the average tax cut for the middle fifth of households will be \$162.
- The largest tax cuts in dollar terms go to households with incomes between \$200,000 and \$500,000; they will receive an average tax cut of \$2,390 in 2005. This is due, in part, to the provision to extend relief from the Alternative Minimum Tax, which is of greatest value to households in this income range.

³ Leonard E. Burman, “An Analysis of the 2004 House Tax Cuts,” The Urban Institute and the Tax Policy Center, June 2004. This is the case because the larger of the two marriage penalty relief provisions in the legislation benefits only households that are in the higher tax brackets.

Middle-Class Households Likely to Lose if the Tax Cuts Are Not Financed Now

Supporters of this legislation praise it as making everyone — and especially middle-class families — better off.⁴ Unfortunately, there is no “free lunch.” Financing the tax cuts through bigger deficits postpones — but does not eliminate — the need to pay for the m. The situation is analogous to that of a consumer who charges a major purchase to a credit card: the charge postpones but does not eliminate the need for the ultimate payment. (For a fuller discussion of why these and other tax cuts, as well as spending increases, eventually have to be offset, see an earlier joint Center on Budget and Policy Priorities/Tax Policy Center study, “The Ultimate Burden of the Tax Cuts,” June 2004.⁵)

It cannot be known at this time just how the middle-class tax legislation ultimately will be financed in future years. To get a sense of the potential effects of such financing measures, we examined two hypothetical scenarios, using data from the Tax Policy Center.⁶

In the first scenario, every household would pay the same dollar amount — \$374, as it turns out — to finance the tax cuts for 2005 contained in the legislation. Something close to 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 reductions. This could occur if the tax cuts were financed by a combination of program cuts and progressive tax increases.

Tax Policy Center data show that if each household paid the same dollar amount to pay for the cost of the tax cuts in 2005, the middle fifth of households would experience an average

Average Change in Incomes Under the Middle-Class Tax Package Cuts with Cost of Financing Included, Two Hypothetical Scenarios (assuming the tax cuts in 2005 are offset by financing)

Income Class	Average net effect, financing with equal dollar burden per household	Average net effect, financing with payments proportional to income
Bottom 20 percent	-\$372	-\$45
Middle 20 percent	-\$212	-\$51
Top 20 percent	+\$943	+\$202

Source: Urban-Brookings Tax Policy Center, September 28, 2004 tabulation.

⁴ It may be noted that tens of millions of households would receive no tax cut. Those left out tend to be poor, single individuals, and families with children that have earnings of less than about \$10,750.

⁵ William G. Gale, Peter R. Orszag, and Isaac Shapiro, “The Ultimate Burden of the Tax Cuts: Once They are Paid For, Low- and Middle-Income Households Likely to be Net Losers, On Average,” Urban-Brookings Tax Policy Center and Center on Budget and Policy Priorities, June 2, 2004.

⁶ The scenarios reflect the impact the financing mechanisms would have if they were in place in 2005.

net *loss* of \$212 per household, while the top 20 percent of households would experience an average net *gain* of \$943.

If each household paid the same percentage of income to pay for the tax cuts, middle-income and low-income households still would be net losers and those at the top net winners, although by smaller amounts. Under this scenario, the middle fifth of households would lose an average of \$51, while those in the top fifth would gain an average of \$202.

Middle-Class Households Would Be Winners if Corporate Tax-Reform Savings Were Used to Pay for the Bill

Both the House and Senate have passed corporate tax bills this year, which will go to a conference committee at some point. Both of those bills would eliminate an export subsidy that the World Trade Organization has ruled illegal, raising about \$50 billion over the next 10 years. Both bills also include other revenue-raising measures, many of which would close abusive corporate tax shelters. Primarily by cracking down on these tax shelters, the Senate bill raises an additional \$122 billion over the next ten years. The House bill raises an additional \$59 billion.

Tax Policy Center data show that if the tax-cut extensions Congress just passed were financed by measures to increase the amount of revenue raised through the corporate income tax, such as by closing corporate loopholes, middle-class households would end up net winners:

- Households in the middle fifth of the income spectrum would gain an average of \$69. The middle 60 percent of households, as a group, also would end up ahead.
- The top fifth of households would lose an average of \$172, but those losses would be more than outweighed by the much larger gains — averaging thousands of dollars a year — that these households are receiving from other tax cuts enacted since the start of 2001.

Unfortunately, the Senate and House corporate tax bills instead use the corporate tax-reform savings to pay for a grab bag of new tax breaks for corporations and other special interests. Many of these tax breaks are notable more for the votes they seek to secure for the legislation than for their likely positive effects on the economy or tax policy. Moreover, these new tax breaks would further complicate an already cumbersome tax code.

The House corporate tax bill contains provisions ranging from tax subsidies for corporations that lease out aircraft or import ceiling fans to tax breaks that benefit businesses with certain types of overseas income. The Senate measure includes large parts of the energy bill that the Senate blocked earlier this year, which was widely criticized for its special-interest tax breaks.⁷

⁷ For further discussion of the array of subsidies included in the corporate tax bills, see Jill Barshay, “Corporate Tax Bills Stuffed, Scorned -- and Supported,” *CQ Weekly*, June 26, 2004, pp. 1540-1543 and Jeffrey H. Birnbaum and Jonathan Weisman, “GE Lobbyists Mold Tax Bill: Firm Saw Subsidy Repeal as Chance to Pay Less,” *The Washington Post*, July 13, 2004, p. A1.

It does not represent sound policy to use the revenues secured by closing corporate loopholes to fund new special-interest corporate tax breaks, especially since corporate tax revenues already are at historically low levels as a share of the economy. Corporate tax revenues will equal only 1.6 percent of the Gross Domestic Product in 2004, according to new projections issued by the Congressional Budget Office on September 7; that is lower than the average level in every decade from the 1940s to the present. Moreover, CBO projects that corporate tax receipts will remain low in coming years in historical terms and will equal only about 1.5 percent of GDP in 2014.⁸

It would have been much better policy — for middle-class families and for the nation as a whole — if Congress had paid for the middle-class tax-cut package with revenues from curbing abusive tax shelters.⁹

⁸ See Joel Friedman, “The Decline of Corporate Income Tax Revenues,” Center on Budget and Policy Priorities, October 24, 2003.

⁹ If the corporate tax-reform savings proved sufficient to pay in full for the middle -class tax extensions, the difference could have been made up by scaling back by a small percentage the tax cuts adopted in 2001 and 2003 for households with the highest incomes. The Tax Policy Center reports that households with incomes exceeding \$1 million are receiving an average tax cut this year of \$123,600.

Appendix Table 1
Middle Class Extension Package¹
Distribution of Federal Tax Benefits by Cash Income Percentiles
With and Without Financing, 2005

Income Class ²	Average Tax Cut, Assuming no Financing	Average Net Change in Income		
		Financing with equal dollar burden per household	Financing with payments proportional to income	Financing through corporate tax increases and reforms
Lowest Quintile	\$ 2	\$ -372	\$ -45	\$ -18
Second Quintile	55	-318	-65	1
Middle Quintile	162	-212	-51	69
Fourth Quintile	331	-43	-43	132
Top Quintile	1,317	943	202	-172
All	374	0	0	0

Source: Urban Institute-Brooking Institution Tax Policy Center

(1) Proposal includes extending the three middle class provisions, relief from the Alternative Minimum Tax, and various corporate tax cuts.

(2) Includes both filing and non-filing tax units. Tax units that are dependents of other taxpayers are excluded from the analysis.

Appendix Table 2
Middle Class Extension Package¹
Distribution of Federal Tax Benefits by Cash Income Class
With and Without Financing, 2005

Income Class (thousands of 2003 dollars) ²	Percent of Total Tax Unit	Average Tax Cut, Assuming no Financing	Average Net Change in Income		
			Financing with equal dollar burden per household	Financing with payments proportional to income	Financing through corporate tax increases and reforms
Less than 10	14.0%	\$ 2	\$ -372	\$ -35	\$ -14
10-20	18.1	23	-351	-73	-18
20-30	14.1	112	-262	-48	39
30-40	10.8	167	-207	-56	74
40-50	7.9	242	-132	-46	99
50-75	13.8	353	-21	-43	139
75-100	8.1	763	389	208	442
100-200	9.7	1,342	968	485	730
200-500	2.5	2,390	2,014	537	-74
500-1,000	0.4	1,401	1,028	-2,929	-7,043
More than 1,000	0.2	5,654	5,280	-12,716	-55,502
All	100.0	374	0	0	0

Source: Urban Institute-Brooking Institution Tax Policy Center

(1) Proposal includes extending the three middle class provisions, relief from the Alternative Minimum Tax, and various corporate tax cuts.

(2) Includes both filing and non-filing tax units. Tax units that are dependents of other taxpayers are excluded from the analysis.