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FACTS AT A GLANCE November 18, 2010

Expiring Federal Tax Cuts: Costs and Beneficiaries of Extending Cuts Targeted at Highest-Income Taxpayers

In the coming weeks, the U.S. House and Senate may debate whether to extend (or make permanent) all or only some of the Bush-era income tax cuts.[1] The Congressional debate most likely will focus on whether to extend the tax cuts that affect only the wealthiest 2 percent of Americans — those households with adjusted gross income (AGI) above $200,000 for single filers and $250,000 for married couples.[2] (There appears to be general consensus that the tax cuts which also affect households with incomes below these thresholds should be extended or made permanent.)[3]

Expiration of the high-end tax cuts will impact only the top 2 percent of all filers,[4] with the large majority of the benefits going to filers with incomes above $1 million.[5] In addition, even if these high-end tax cuts are allowed to expire, extending the "middle-class" Bush-era tax cut provisions — those cuts targeted toward people in lower-income brackets (AGI below $200,000 (single)/$250,000 (married)) —still will provide the top 2 percent of filers with very large tax cuts.[6] This is because a portion of high-income filers' total income falls within the tax brackets affected by the "middle-class" tax cuts. The "middle-class" tax cuts provide high-income filers with tax reductions five times larger, on average, than the cuts that go to middle-class filers.[7]

It is estimated that extending the tax cuts targeted at America's highest-income taxpayers will add over $1 trillion to both the deficit and debt over the next decade.[8] In the near term, the nation is struggling to generate the demand needed to pull itself out of the worst recession since the Great Depression.[9]

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[1] Should Congress not address this question prior to January 1, 2010, these tax cuts will expire automatically, as part of a "sunset" clause contained in the original legislation.

[2] Center on Budget and Policy Priorities, July 26, 2010: http://www.cbpp.org/files/7-26-10tax.pdf

[3] For a list of the specific changes included in the analysis of "high-income" tax cuts that we present in this paper, please see the Department of the Treasury, "Green Book," February 2010 (see pg 152, "Upper-income tax provisions"): http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf

The Treasury's analysis does not include estimates of the revenue losses that would result from the Obama Administration's proposal to cap the tax rate on dividends at 20 percent for high-income people (rather than allowing those rates to return to their pre-2001 level of 39.6 percent), and the estimated cost of extending the 33 percent tax bracket is too low for technical reasons related to the Administration's proposal to extend the 28 percent tax bracket below the $200 K/$250 K income thresholds. The Center on Budget and Policy Priorities estimates that these proposals would increase revenue losses by an additional $144 billion and $15 billion, respectively, relative to the figures presented by Treasury, over the 10-year period in question. Borrowing costs associated with all of the revenue losses will further increase the deficit/debt over the 10-year period. The Treasury's analysis does not include any of the interest payment costs associated with the projected revenue losses. The items NOT included in the Treasury's "Green Book" estimates have been added back in to produce the figures *MassBudget* presents in this factsheet.

[4] Center on Budget and Policy Priorities, July 26, 2010: http://www.cbpp.org/files/7-26-10tax.pdf

[5] Citizens for Tax Justice, September 21, 2010: http://ctj.org/ctjreports/2010/09/most_house_democrats_supporting_tax_cuts_for_the_rich_have_lower_than_average_percentage_of_high-inc.php

[6] Center on Budget and Policy Priorities, August 13, 2010: http://www.cbpp.org/cms/index.cfm?fa=view&id=3263

[7] Ibid

If the Obama proposal capping tax rates on dividend income at 20 percent for high-income people is accepted (rather than allowing rates to return to pre-2001 levels of 39.6 percent, as they would if the Bush era tax cuts were permitted to expire), high-income households would see much larger benefits than those described here (see CBPP report, pg 2).

[8] Center on Budget and Policy Priorities, July 26, 2010 (see pg 4, footnote 9): http://www.cbpp.org/files/7-26-10tax.pdf

The $1 trillion includes direct revenue losses of some $840 billion over the 10-year period and another $180 billion in increased interest payments on the national debt that these revenue losses would engender.

[9] Center on Budget and Policy Priorities, "*Legacy of the Great Recession,*" updated October 8, 2010: http://www.cbpp.org/cms/index.cfm?fa=view&id=3252

The Congressional Budget Office (CBO) has determined that extending all of the Bush-era tax cuts would be the least cost-effective means of stimulating the economy among the 11 options it analyzed.[10] The CBO report specifically identifies the very large percentage of total benefits going to high-income households as the principal reason that the Bush-era tax cuts are not effective stimulus, noting that high-income households are the least likely to spend any tax cuts they may receive, thus generating only limited additional demand.[11]

THE BUSH-ERA TAX CUTS DELIVER LARGEST BENEFITS TO HIGHEST-INCOME FILERS

The Bush-era tax cuts (enacted in 2001 and 2003) reduced tax rates for all income levels, but provided especially large benefits to the highest-income filers. Extending the tax changes affecting only those filers with incomes above $200,000 (single)/$250,000 (married) would deliver about $40 billion in tax breaks in 2011 to households with the highest 2 percent of incomes,[12] and about $840 billion to these households over the coming decade.[13] Roughly 80 percent of these benefits would accrue to households with incomes of $1 million or higher.[14]

It is not just the high-end tax cuts, however, that primarily benefit wealthy households. Even the "middle-class" tax cuts — those rate reductions aimed at households with more modest incomes — deliver far higher dollar benefits to high-income households than to middle-income households. On average, households with incomes between $50,000 and $75,000 receive an annual reduction in their income taxes of about $1,100 from these "middle-class" tax cuts (see the Citizen's for Tax Justice "Tax Calculator" for an estimate of how much taxpayers at different income levels save under each of the plans likely to be considered by Congress: http://www.ctj.org/federalincometaxcalculator.php).[15] By contrast, households with incomes above $200,000 receive annual average reductions of $6,300 as a result of these rate reductions (see Figure 1).[16] (There appears to be general consensus in Washington at this time to extend or make permanent these "middle-class" tax cuts, thus providing substantial tax reductions to filers at all levels of income).

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[10] Urban-Brookings Institute Tax Policy Center, "*Five Myths about the Bush Tax Cut*," August 1, 2010: http://www.urban.org/publications/1001423.html

[11] Congressional Budget Office, "*Policies for Increasing Economic Growth and Employment*," January 2010 (see pgs 24-25): http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf

[12] Center on Budget and Policy Priorities, July 27, 2010: http://www.offthechartsblog.org/best-of-both-worlds-on-high-income-tax-cuts/

[13] Department of the Treasury, "Green Book," February 2010 (see pg 152, "Upper-income tax provisions"): http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf

The Treasury's analysis does not include estimates of the revenue losses that would result from the Obama Administration's proposal to cap the tax rate on dividends at 20 percent for high-income people (rather than allowing those rates to return to their pre-2001 level of 39.6 percent), and the estimated cost of extending the 33 percent tax bracket is too low for technical reasons related to the Administration's proposal to extend the 28 percent tax bracket below the $200 K/$250 K income thresholds. The Center on Budget and Policy Priorities estimates that these proposals would increase revenue losses by an additional $144 billion and $15 billion, respectively, relative to the figures presented by Treasury, over the 10-year period in question. Borrowing costs associated with all of the revenue losses will further increase the deficit/debt over the 10-year period. The Treasury's analysis does not include any of the interest payment costs associated with the projected revenue losses. The items NOT included in the Treasury's "Green Book" estimates have been added back in to produce the figures MassBudget presents in this factsheet.

[14] Citizens for Tax Justice, September 21, 2010: http://ctj.org/ctjreports/2010/09/most_house_democrats_supporting_tax_cuts_for_the_rich_have_lower_than_average_percentage_of_high-inc.php

[15] Center on Budget and Policy Priorities, August 13, 2010: http://www.cbpp.org/cms/index.cfm?fa=view&id=3263

[16] Ibid. If the Obama proposal capping tax rates on dividend income at 20 percent for high-income people is accepted (rather than allowing rates to return to pre-2001 levels of 39.6 percent, as they would if the Bush-era tax cuts were permitted to expire), high-income households would see much larger benefits than those described here (see August 13, 2010 CBPP report, pg 2).

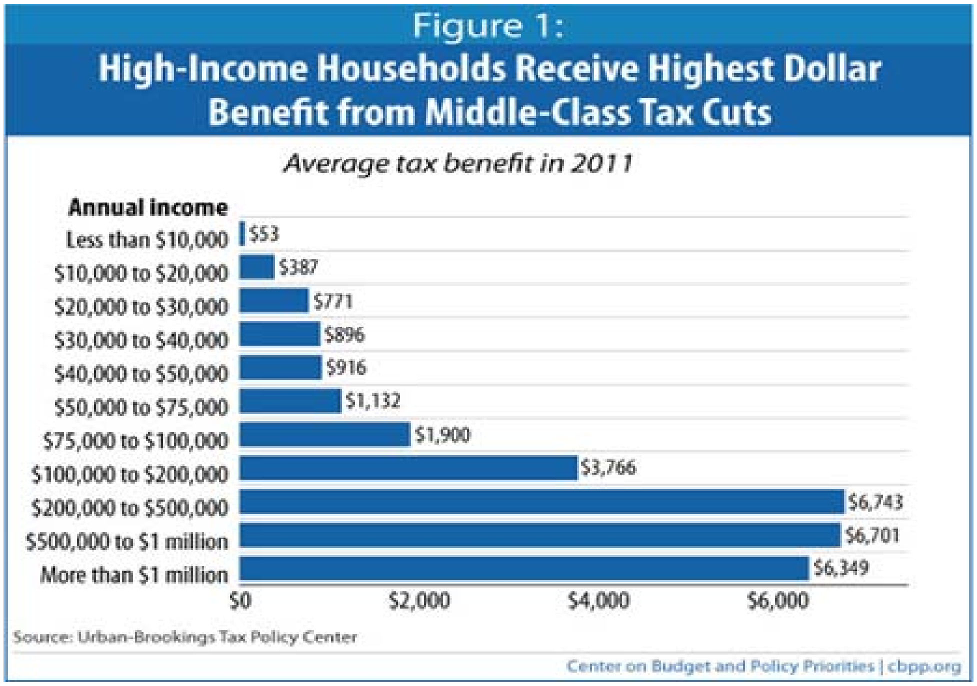

Figure 1:
High-Income Households Receive Highest Dollar Benefit from Middle-Class Tax Cuts

This is because the income tax operates "like a stair case, not an elevator."[17] A married person with a $1 million income (for example) does not go straight to the "top floor," paying the top tax rate on all of that income. Instead, she would pay the lowest tax rate (10 percent, if the "middle-class" tax cuts are extended) on the first portion (or "step") of her income; a rate of 15 percent on the next portion of her income, etc., until she reaches the income level to which the top rate is applied (income above about $380,000).[18] As a result, she is able to derive the full benefit of the rate reductions at every "step" of income. A number of the "middle-class" tax rate reductions, however, apply to levels of income that far exceed what most middle-class families earn (income between about $140,000 and $240,000),[19] and thus most middle-class families derive no benefit from these rate reductions.

TOP-END TAX CUTS BENEFIT VERY FEW SMALL BUSINESSES

A common misconception about the impact of allowing Bush-era rate reductions for the top two income brackets to expire is that this will negatively impact many small businesses. In fact, allowing these tax cuts to expire would affect only the top 3 percent of people with business income of *any kind*, let alone income from what most Americans think of as "small businesses."[20]

Instead, much of this type of business income (S-corporation and partnership income, i.e., income derived through business activity but filed under the personal income tax code) goes to a small number of individuals involved in "concerns like large corporate law practices, accounting firms, and wealthy people who invest in financial and real estate partnerships."[21] Overwhelmingly, it is not the mom-and-pop stores or small family businesses that will be affected by expiration of top-end Bush-era tax cuts.

[17] Ibid
[18] Ibid (see Table 1, pg 4)
[19] Ibid
[20] Center on Budget and Policy Priorities, August 3, 2010: http://www.cbpp.org/cms/index.cfm?fa=view&id=3251
[21] Ibid

TOP-END TAX CUTS WILL SIGNIFICANTLY INCREASE THE NATIONAL DEFICIT AND DEBT

Extending the Bush-era tax cuts for the highest-income filers is projected to increase both the national deficit and the national debt by $1 trillion over the next 10 years.[22] The national deficit is the amount by which spending exceeds revenues in a single year. The high-end cuts will reduce annual revenues by about $40 billion (in 2011), but the annual revenue loss will grow with time, eventually reducing revenues by about $120 billion in 2020.[23] The cumulative total cost of these annual revenue shortfalls is projected to be some $840 billion added to the deficit over the coming decade if the high-end Bush-era tax cuts are extended.[24]

This, however, is not the total impact of the tax cuts on deficits and the national debt. At present, no corresponding spending cuts have been identified to offset the $840 billion in projected revenue shortfalls. As such, the revenue shortfalls will require additional borrowing to fill the resulting budget gap in each of these years. This borrowing, in turn, will increase the national debt and thus will increase the annual cost of servicing this debt – in other words, annual interest payments on the national debt will rise. These increases in annual interest payments will add further to annual deficits. Together, these higher annual interest payments will add another $180 billion to the projected 10-year deficit cost total, bringing the combined total of annual increases in the deficit to $1 trillion over the period from 2011-2020 ($840 billion in lost revenue + $180 billion in interest payments = $1,020 billion).[25]

As noted, annual revenue shortfalls and higher interest payments both will require additional borrowing, thereby increasing the national debt by an equivalent amount. As a result, over the 10-year period from 2011 to 2020, extending the top-end tax cuts will add $1 trillion to the national debt.[26]

TOP-END TAX CUTS PROVIDE LITTLE STIMULUS TO STRUGGLING ECONOMY

While budget deficits and the national debt are very real concerns, in the near-term, the more pressing concern is the state of the national economy. The US currently is experiencing the effects of the worst economic downturn since the Great Depression (see Figure 2).[27]

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[22] Center on Budget and Policy Priorities, July 26, 2010: http://www.cbpp.org/files/7-26-10tax.pdf

[23] Department of the Treasury, "Green Book," February 2010 (see pg 152, "Upper-income tax provisions"): http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf

The Treasury's analysis does not include estimates of the revenue losses that would result from the Obama Administration's proposal to cap the tax rate on dividends at 20 percent for high income people (rather than allowing those rates to return to their pre-2001 level of 39.6 percent), and the estimated cost of extending the 33 percent tax bracket is too low for technical reasons related to the Administration's proposal to extend the 28 percent tax bracket below the $200 K/$250 K income thresholds. The Center on Budget and Policy Priorities estimates that these proposals would increase revenue losses by an additional $144 billion and $15 billion, respectively, relative to the figures presented by Treasury, over the 10-year period in question. Borrowing costs associated with all of the revenue losses will further increase the deficit/debt over the 10-year period. The Treasury's analysis does not include any of the interest payment costs associated with the projected revenue losses. The items NOT included in the Treasury's "Green Book" estimates have been added back in to produce the figures *MassBudget* presents in this factsheet.

Estimates of added interest cost are provided by the Center on Budget and Policy Priorities, July 26, 2010 (see pg 4, footnote 9): http://www.cbpp.org/files/7-26-10tax.pdf

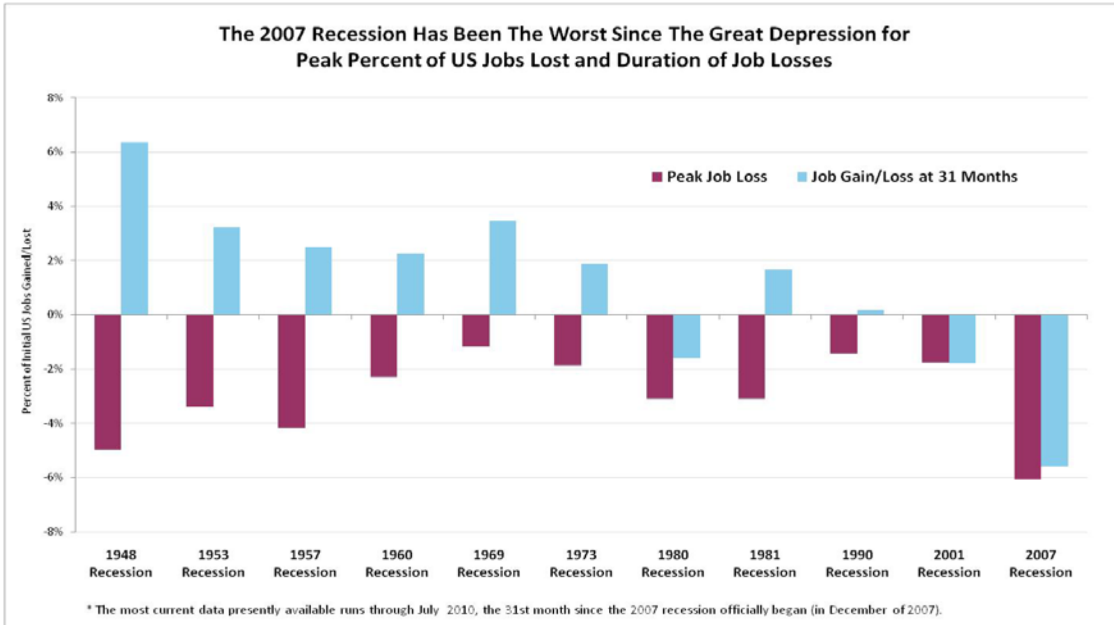
[24] Ibid

[25] Ibid. This estimate is for the cost of extending ALL of the Bush-era high-income tax cuts. The Obama Administration has proposed eliminating MOST (but not all) of these high-income tax cuts. Compared to extending all of the high-income tax cuts, the Obama proposal would reduce the $1 trillion 10-year deficit/debt numbers by some $845 billion (approximately $695 billion in additional revenue collections and $150 billion in resulting reduced interest payments). Relative to allowing ALL of the high-end tax cuts to expire, however, the Obama proposal would increase deficits/debt over the 10-year period by some $160billion-180 billion.

[26] Ibid

[27] Center on Budget and Policy Priorities, "*Chart Book: The Legacy of The Great Recession,*" August 27, 2010 (see Part III): http://www.cbpp.org/cms/index.cfm?fa=view&id=3252

Figure 2



Reviving the economy and putting people back to work as soon as possible will place the US in a better position to address our deficits and debt in the years ahead. To speed that recovery, however, leading economists agree that what is needed is stimulus from the federal government.[28]

Federal stimulus can take either of two forms, tax cuts or spending increases. The Congressional Budget Office (CBO) analyzed the stimulative effects of 11 different options, including extending all of the Bush-era tax cuts. The CBO analysis concluded that, among the options considered, extending these cuts would be the least cost-effective way of stimulating the national economy, because such a large share of the benefit goes to high-income households.[29] High-income households are likely to save much or most of any tax cuts they receive, creating limited additional demand and thus failing to stimulate the economy.[30] In other words, this type of stimulus —but particularly the tax cuts for high-income households — would provide the least "bang for the buck," far less than increasing aid to the unemployed, reducing payroll taxes, or providing continued state fiscal assistance, according to the CBO.[31]

(Note: This fact sheet updates an October 28, 2010 release, providing corrections of the 10-year deficit and debt cost estimates presented in the original release.)

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[28] MassBudget, "*The Economic Theory of How Stimulus Works*," June 9, 2010: http://massbudget.org/doc/729
[29] Urban-Brookings Institute Tax Policy Center, "*Five Myths about the Bush Tax Cut*," August 1, 2010: http://www.urban.org/publications/1001423.html
[30] Center on Budget and Policy Priorities, July 26, 2010: http://www.cbpp.org/cms/index.cfm?fa=view&id=3241
[31] Congressional Budget Office, "*Policies for Increasing Economic Growth and Employment*," January 2010 (see Table 1, pg 18): http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf