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Targeting Scarce Resources: Congress has Critical Opportunity to Boost the Economy and Reduce the Deficit

Cande Iveson, Federal Policy

Background

Significant changes were made to federal tax policy in 2001 and 2003. Officially named the Economic Growth and Tax Relief Reconciliation Act (2001) and the Jobs and Growth Tax Relief Reconciliation Act (2003), these acts are often referred to as the "Bush tax cuts." Changes included adjustments in tax rates on income, capital gains and dividends, as well as a phase out of the estate tax. Nearly all of these changes will expire at the end of 2010.[i]

At the time, business was booming, the nation had a surplus of funds and we expected the wars in Afghanistan and Iraq would end shortly. Today, we face a drastically different environment.

The economic downturn has stifled income and job opportunity for millions of American citizens. There are signs of recovery, but the economic outlook is fragile; unemployment remains high and wages are stagnant. Many families are still vulnerable.

The federal government is faced with record deficits that are the result of rising costs and falling income. The ongoing costs of war and the short-term funds required to stabilize the economy during the recession have increased expenditures.

Revenues lost due to the economic downturn play a significant role in those deficits, but the Bush tax cuts are also a major contributor. Between 2001 and 2008, they added $1.7 trillion to the deficit. If allowed to continue, they will cost almost $4.4 trillion by 2010. [ii]

Some policy makers are suggesting that all of these tax cuts simply be extended for a year or two. In contrast, President Obama has proposed that the tax cuts targeted at middle- and low-income families be made permanent and that the tax cuts for the high-income taxpayers be allowed to expire on schedule.

Impact on Families & Economic Stability

Middle income families: Small benefits yield significant effect on economy

It is important to consider each provision independently; not all the cuts have the same impact on families or on overall economic stability. Middle-income families saw a modest benefit from the tax cuts. This reduction in tax liability gave a little extra income to families made vulnerable in the economic recession. And, these taxpayers are more likely to spend this income, which helps stabilize market demand and contributes to overall economic recovery.

High income families: Large benefits yield minimal effect on economy

The tax cuts reduced the rate of taxation for the top four income brackets. In addition, rate reductions were made for income derived from capital gains and dividends, taxes largely paid by higher-income families. Thus, high-income taxpayers receive a very large share of the benefit from these cuts.[iii]

Income Class	Average Tax Cut	% increase in after-tax income	% share of tax cut
Middle 20 percent	$647	2.3%	8.9%
Top 1 percent	$34,992	5.3%	24.3%
Over $1 million	$123,592	6.4%	15.3%

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High-income taxpayers have already benefited from a disproportionate share of rising income. From 2001 – 2007, two-thirds of total income gains accrued to the top 1 percent of Americans.[iv] Because these families already have sufficient income for necessities, they spend less on consumption goods, and more on discretionary or luxury items that have limited impact on short-term economic stability.

Some have proposed exempting small-business income from the return to higher rates in the top brackets, fearing that in increase in taxes will stifle job creation in this sector. That proposal would benefit only the wealthiest 3 percent of tax filers with business income.[v] The Congressional Budget Office (CBO) and business trades assert that hiring workers or making new investments will only occur when there is sufficient demand for to justify the increased capacity. Demand is a more important factor in job creation than a modest increase in taxes.[vi]

Impact on National Deficit

Responsible fiscal policy demands a balance between bolstering short-term economic stability and long-term deficit reduction.

Middle-class tax cuts are important for families, but constitute a small share of the federal deficit. Their short-term economic benefit outweighs their long-term deficit impact. Allowing them to expire would threaten the individual families and the overall economic recovery. They should be made permanent.

In contrast, wealthy families, who are continuing to gain income, do not need this assistance from the federal government. And, extending tax cuts for the wealthy would add $680 billion to the federal deficit over ten years, excluding interest costs.[vii] Incurring these costs adds little to the emerging economic recovery. The Congressional Budget Office has said that extending these tax cuts is the least effective way to strengthen the economy during a recession. [viii] They should be allowed to expire.

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[i] Center on Budget and Policy Priorities, "Policy Basics: The 2001 and 2003 Tax Cuts," March, 2009, retrieved from http://www.cbpp.org/cms/index.cfm?fa=view&id=2705, May 1, 2010.
[ii] Ibid.
[iii] Shapiro, I. & Friedman, J., "Tax Returns: A Comprehensive Assessment of the Bush Administration Tax Cuts," Center on Budget and Policy Priorities, 2004, retrieved from http://www.cbpp.org/cms/index.cfm?fa=view&id=1811, May 1, 2010.
[iv] Center on Budget and Policy Priorities, unpublished internal documents.
[v] Ibid.
[vi] Ibid.
[vii] Ibid.
[viii] Ibid.