

Statement of

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The Future of Individual Tax Rates:
Effects on Economic Growth and Distribution

July 14, 2010

Chairman Baucus, Ranking Member Grassley, and Members of the Committee: Thank you for inviting me to appear today to discuss our individual income tax system.

As this committee knows well, our nation faces difficult economic and fiscal challenges. In the aftermath of the worst financial crisis since the 1930s, almost 15 million workers are unemployed, about one-tenth of our work force. Almost 7 million of those workers have been unemployed for six months or longer. And millions more lack jobs but don't count in the statistics because they're too discouraged to look for work. Moderate economic growth is expected to lower those figures only gradually over the next few years.

At the same time, budget deficits have rocketed to 60-year highs because of the financial crisis, the weak economy, and subsequent policy responses. As a result, the federal debt has grown from about 40 percent of gross domestic product (GDP) at the end of 2008 to about 60 percent of GDP today, the highest since just after World War II.

Deficits should narrow in coming years as the economy recovers and as policy responses to the recession wind down. Our long-term fiscal outlook remains daunting, however, because of a fundamental imbalance between spending and revenues. Because of an aging population and rising health care costs, spending is expected to grow significantly faster than revenues over the next 25 years, pushing our nation deeper into debt.

Today's discussion of the 2001 and 2003 tax cuts, which are scheduled to expire at the end of the year, thus comes at a challenging time when policymakers confront both near-term economic weakness and long-term fiscal imbalances. Against that backdrop, my testimony makes six points:

¹ My testimony draws heavily on the work of numerous Tax Policy Center colleagues. However, the views expressed are my own and should not be attributed to the Tax Policy Center, the Urban Institute, its board, or its funders.

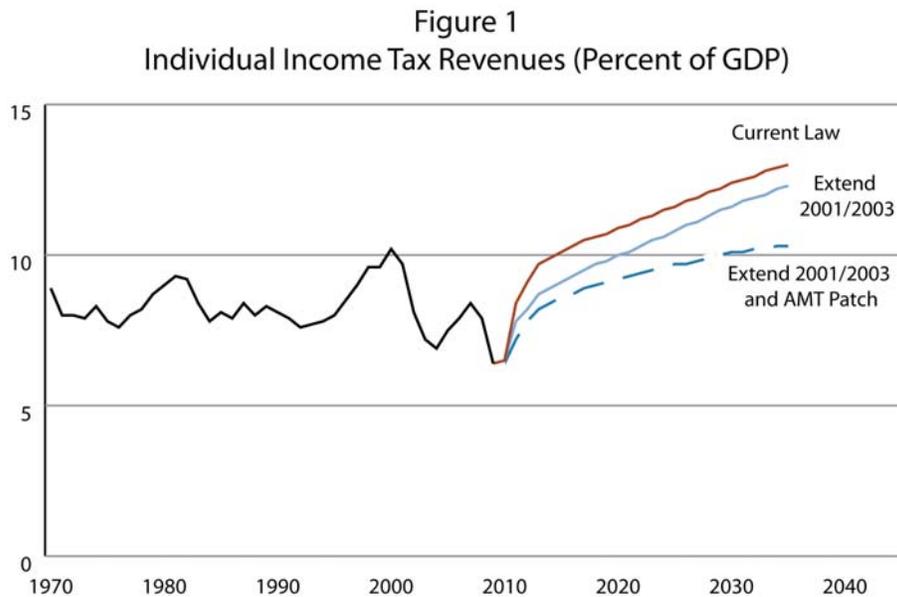
1. **Tax revenues are remarkably low today, relative to the size of the economy, but are scheduled to increase sharply in coming years.** Under current law, revenues from the individual income tax will increase above record levels, relative to the economy, by 2020 and keep rising thereafter. That increase reflects a variety of factors, including the scheduled expiration of the 2001 and 2003 tax cuts, the expansion of the alternative minimum tax (AMT), real bracket creep, demographic changes, the recent health care legislation, and the expected economic rebound.
2. **Full extension of the 2001 and 2003 tax cuts and indexation of the AMT would slow the growth of federal revenues substantially relative to the current law baseline.** Individual income taxes would rise to a projected 9.2 percent of GDP in 2020, rather than 10.9 percent under current law. Over the 10-year budget window, that reduction would correspond to about \$2.9 trillion in forgone revenue.
3. **Full extension of the tax cuts and the AMT patch would provide larger tax reductions to higher-income taxpayers.** Almost all taxpayers in the top half of the income distribution would receive a tax cut, compared with only a quarter of taxpayers in the bottom quintile. Taxpayers in the top quintile would see their effective tax rate decline by 3.1 percentage points on average; the average cut for the middle quintile would be 1.9 percentage points, and that for the bottom quintile would be 0.6 percentage points.
4. **The “middle-income” tax cuts (rate reductions in the bottom four brackets, marriage penalty relief, and expanded credits) provide significant tax reductions not only to middle-income taxpayers, but also to most higher-income taxpayers.** The “upper-income” tax cuts (rate reductions in the top two brackets and elimination of the phaseouts of personal exemptions and itemized deductions), in contrast, primarily benefit taxpayers in the top 1 percent of the income distribution.
5. **The potential economic impact of extending some or all of the tax cuts involves four related issues: stimulus, long-term growth, economic efficiency, and fiscal impacts.** Analysts disagree on the degree to which extending the tax cuts would provide stimulus, promote long-term growth, and improve efficiency. Most analysts believe, however, that the economic benefits of extending some or all of the tax cuts will be maximized if we offset the forgone revenue by reducing unproductive spending or raising offsetting revenues in a more efficient manner.
6. **Regardless of what happens to the expiring tax cuts, policymakers should look for opportunities to pursue fundamental tax reforms that could simultaneously improve economic performance and, if necessary, raise more revenue.** For any future level of government spending, income tax rates could be lower if policymakers take steps to broaden the tax base (by limiting special credits, deductions, and other tax expenditures), introduce a new broad-based consumption tax (e.g., a value-added tax), or rely more on environmental taxes (e.g., a carbon tax).

The Revenue Outlook

It is well known that federal spending is projected to increase rapidly in coming years due to an aging population and rising health care costs. The Congressional Budget Office (CBO) projects, for example, that under current law spending would be 23.5 percent of GDP in 2020 and 27.6 percent of GDP in 2035.² Federal spending averaged only 20.7 percent of GDP during the four decades from 1970 to 2009.

Less well known is that federal revenues are also projected to increase rapidly. CBO estimates, for example, that revenues will rise to 20.7 percent of GDP in 2020 and 23.3 percent in 2035 if current law remains in place. To put those figures in context, note that federal revenues have averaged about 18.1 percent of GDP over the past 40 years. Because of the recession and stimulus measures, tax revenues today are remarkably low—14.9 percent of GDP in 2010. Indeed, they are the lowest they've been since 1950. But that would quickly reverse under existing law. By 2020, revenues would near their all-time record (20.9 percent of GDP in 1944) and by 2035, revenues would be more than 25 percent higher than historical levels.

Much of that increase would come from individual income taxes. CBO projects that under current law they will increase from 6.5 percent of GDP in 2010 to 10.9 percent in 2020 and 13.0 percent in 2035 (figure 1). That growth would take individual income taxes from their lowest level in 60 years, relative to the economy, to well above the record high of 10.2 percent in 2000.



Source: Congressional Budget Office

² All figures in this section come from Congressional Budget Office, "[The Long-Term Budget Outlook](#)," July 2010.

Revenues from individual income taxes would increase for six reasons. First, the economy will likely recover, lifting revenues from currently depressed levels. Second, both the 2001 and 2003 tax cuts³ and the tax cuts enacted in the 2009 stimulus are scheduled to expire. Third, the alternative minimum tax, which is not indexed for inflation, will boost taxes for millions more taxpayers. Fourth, retiring baby boomers will make more taxable withdrawals from tax-deferred retirement accounts. Fifth, in a phenomenon known as real bracket creep, growing real (inflation-adjusted) incomes will push taxpayers into higher tax brackets and will reduce their eligibility for various credits, exemptions, and deductions. Finally, the excise tax on “Cadillac” health plans enacted in the recent health legislation and scheduled to take effect in 2018 will increase the portion of employee compensation that is taken in the form of taxable wages and salaries.

Revenues would rise more gradually if Congress permanently extends some or all of the 2001 and 2003 tax cuts and the AMT patch. But individual income tax revenues would still increase faster than the economy because of the other factors. If the tax cuts alone were permanently extended, for example, revenues would rise to 10.0 percent of GDP in 2020 and 12.3 percent in 2035. If both the tax cuts and the AMT patch were extended permanently, revenue growth would be slower, with individual revenues rising to 9.2 percent of GDP in 2020 and 10.3 percent in 2035.

CBO’s projections indicate that permanent extension of the 2001 and 2003 individual income tax cuts alone would reduce revenues by about \$1.7 trillion over the 10-year budget window (2011–2020). Permanent extension with an AMT patch would reduce revenues by about \$2.9 trillion.⁴ As these figures demonstrate, there is an important interaction between the tax cuts and the AMT. The revenue cost of extending the tax cuts, by themselves, is moderated by the fact that an increasing number of taxpayers would be pushed onto the AMT. The revenue cost would be much larger if both the tax cuts and the AMT patch were permanently extended.

The Tax Cuts

The 2001 and 2003 tax laws made numerous changes to individual income taxes.⁵ Expiring at the end of the year are those that

³ These two laws were the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

⁴ Throughout this testimony, I use current law as the baseline for measuring policy impacts. I thus treat as a tax cut any policies that extend some or all of the 2001 and 2003 tax provisions. Another approach would be to treat current policy—the tax law that applies in 2010—as the baseline. Under that approach, allowing any of the 2001 and 2003 tax cuts to expire would amount to a tax increase. The figures in this testimony can be recast in those terms with an appropriate sign change. For example, if current policy is the baseline, then allowing all the tax cuts and the AMT patch to expire would amount to a \$2.9 trillion tax increase over the budget window.

⁵ The 2001 law also reduced estate taxes—expanding exemptions and lowering rates—leading to full repeal (as of this writing) in 2010. Those changes are outside the scope of this testimony.

- *Lowered rates on ordinary income.* The 28, 31, 36, and 39.6 percent tax rates were reduced to 25, 28, 33, and 35 percent, respectively. In addition, a new 10 percent tax bracket was carved out of the 15 percent bracket.
- *Reduced the marriage penalty.* The standard deduction and the width of the 15 percent tax bracket for married couples filing jointly were both increased to be twice those for single filers; they had previously been only 1.67 times as large.
- *Reduced tax rates on capital gains and dividends.* The tax rate on long-term capital gains was reduced from 10 to 0 percent for taxpayers in the 15 percent bracket and below and from 20 to 15 percent for filers in higher tax brackets. The tax rate on qualified dividends was lowered from ordinary tax rates to the lower long-term capital gains rates.
- *Increased the child credit.* The credit doubled from \$500 to \$1,000 per child and eligibility for refundable credits expanded.
- *Increased other credits.* The maximum child and dependent care credit increased, and the phaseout range for the earned income tax credit for married couples expanded, boosting the value of the credit for some families.
- *Eliminated the phaseout of personal exemptions and limitation on itemized deductions that occur at high incomes.* Those provisions are known as PEP and Pease (after the congressman who proposed the latter), respectively.
- *Expanded tax incentives for education.*

The 2001 and 2003 laws also temporarily increased the exemption level for the AMT. A series of subsequent laws increased the exemption level through the end of 2009.

The Distributional Effects of Extending the Individual Income Tax Cuts

Individual income taxes are the single largest source of federal revenues. Other important sources include payroll taxes, corporate income taxes, and estate taxes. Under current law, the revenues from these federal taxes would average 23.5 percent of taxpayers' cash income in 2012 (table 1). If the individual income tax cuts that originated in 2001 and 2003 were extended, along with the AMT patch, federal taxes would average 20.9 percent of cash income in 2012. Extending the individual income tax cuts would thus reduce the average tax rate by 2.6 percentage points or about 11 percent.⁶

If all the 2001 and 2003 individual income tax cuts and the AMT patch were extended, nearly three-quarters of taxpayers would receive a tax cut compared with current law, but that likelihood varies with income. Only a quarter of taxpayers in the bottom quintile

⁶ As noted earlier, this analysis ignores any extension or reform of the estate tax. For purposes of calculating the figures in table 1, we have assumed that the estate tax remains at its 2009 level.

would receive a tax cut, while 99 percent of taxpayers in the top two quintiles would.⁷ A key reason for this disparity is that many low-income taxpayers already have little or no income tax liability.⁸ Some low-income taxpayers with no tax liability would nevertheless benefit from extending the increases in the refundable child credit and earned income credit that began with the 2001 law.

Table 1
Extension of the 2001 and 2003 Individual Tax Cuts and AMT Patch
Distribution of Federal Tax Change by Cash Income Percentile, 2012¹

| Cash Income Percentile ^{2,3} | Average Effective Tax Rates ⁴ | | | Percent of Tax Units with Tax Cut ⁵ | Average Federal Tax Change (\$) | Percent Change in After-Tax Income ⁶ | Change in Share of Total Federal Taxes (% points) |
|---------------------------------------|--|-------------------|-------------------|--|---------------------------------|---|---|
| | Current Law | Tax Cuts Extended | Change (% points) | | | | |
| Lowest Quintile | 5.2 | 4.6 | -0.6 | 24.7 | -66 | 0.6 | 0.0 |
| Second Quintile | 12.2 | 10.2 | -2.0 | 78.3 | -572 | 2.3 | -0.3 |
| Middle Quintile | 18.2 | 16.3 | -1.9 | 93.2 | -963 | 2.3 | 0.1 |
| Fourth Quintile | 21.6 | 19.3 | -2.3 | 98.6 | -2,077 | 3.0 | 0.1 |
| Top Quintile | 28.3 | 25.2 | -3.1 | 99.4 | -8,672 | 4.3 | 0.1 |
| All | 23.5 | 20.9 | -2.6 | 73.8 | -1,975 | 3.4 | 0.0 |
| Addendum | | | | | | | |
| 80-90 | 24.8 | 21.9 | -2.9 | 99.4 | -3,944 | 3.8 | -0.1 |
| 90-95 | 25.9 | 23.2 | -2.7 | 99.3 | -5,283 | 3.6 | 0.1 |
| 95-99 | 27.7 | 25.2 | -2.6 | 99.3 | -8,897 | 3.6 | 0.3 |
| Top 1 Percent | 32.7 | 28.8 | -3.9 | 99.3 | -70,700 | 5.8 | -0.2 |
| Top 0.1 Percent | 35.6 | 31.2 | -4.4 | 99.3 | -370,486 | 6.9 | -0.2 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extension of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2009 dollars): 20% \$19,356, 40% \$37,493, 60% \$65,656, 80% \$111,659, 90% \$161,739, 95% \$226,402, 99% \$599,181, 99.9% \$2,727,123.

(4) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

(5) Includes both filing and non-filing units but excludes those that are dependents of other tax units.

(6) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

The reductions in average tax rates show a similar pattern. The average tax rate would fall by 0.6 percentage points for taxpayers in the bottom quintile, but by 3.1 percentage points in the top quintile. That difference is primarily driven by the fact that so few taxpayers in the bottom quintile would receive a tax cut. Among those who would receive a tax cut, the differential still exists, but is smaller: an average tax cut of 2.3 percentage points for taxpayers in the bottom quintile who receive a tax cut versus 3.1 percentage points in the top. The size of the tax cut also varies significantly within the top quintile.

⁷ The appendix provides similar information by cash income level rather than income quintiles.

⁸ Roberton Williams, “[Why Nearly Half of Americans Pay No Federal Income Tax](#),” *Tax Notes*, June 7, 2010. The share that pays no income tax will decline as the economy recovers and the temporary stimulus tax cuts, especially the Making Work Pay Credit, expire.

The average tax rate in the 80th to 95th income percentiles would fall by 2.8 percentage points, while the average tax rate in the top 1 percent would fall by 3.9 percentage points.

In dollar terms, the largest tax reductions would go to taxpayers with the highest incomes and the highest tax burdens. Bottom-quintile taxpayers would receive an average cut of about \$70 (a 0.6 percent increase in after-tax income), middle-quintile taxpayers about \$970 (a 2.3 percent increase), and top-quintile taxpayers about \$8,700 (a 4.3 percent increase). But, because current law tax rates increase with income, the tax cut as a share of taxes paid would be largest in the second quintile of the income distribution. As a result, those in the second quintile of taxpayers would pay a slightly smaller share of income taxes than they pay under current law, while the top three quintiles would pay a slightly larger share of federal taxes.

Table 2
Change in Average Effective Tax Rates from Specific Provisions
Distribution of Federal Tax Change by Cash Income Percentile, 2012^{1,2}

| Cash Income Percentile ^{3,4} | Average Effective Tax Rate under Current | Change from Provision (% points) | | | | | | | | Average Effective Tax Rate if All Cuts Extended |
|---------------------------------------|--|----------------------------------|----------------------|-------------------------|-------------------|--------------------------|------------------------------|----------------------|--------------------|---|
| | | AMT Patch | Lower Marginal Rates | Marriage Penalty Relief | Credits Expansion | Lower Rates on Dividends | Lower Rates on Capital Gains | PEP and Pease Repeal | Top Marginal Rates | |
| Lowest Quintile | 5.2 | 0.0 | -0.3 | 0.0 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 4.6 |
| Second Quintile | 12.2 | 0.0 | -0.9 | -0.2 | -0.9 | 0.0 | 0.0 | 0.0 | 0.0 | 10.2 |
| Middle Quintile | 18.2 | -0.1 | -1.0 | -0.2 | -0.5 | 0.0 | -0.1 | 0.0 | 0.0 | 16.3 |
| Fourth Quintile | 21.6 | -0.5 | -1.1 | -0.3 | -0.3 | 0.0 | -0.1 | 0.0 | 0.0 | 19.3 |
| Top Quintile | 28.3 | -0.4 | -0.9 | -0.3 | -0.1 | -0.2 | -0.5 | -0.3 | -0.5 | 25.2 |
| All | 23.5 | -0.3 | -0.9 | -0.3 | -0.2 | -0.1 | -0.3 | -0.2 | -0.3 | 20.9 |
| Addendum | | | | | | | | | | |
| 80-90 | 24.8 | -0.5 | -1.3 | -0.7 | -0.2 | 0.0 | -0.2 | 0.0 | 0.0 | 21.9 |
| 90-95 | 25.9 | -0.5 | -1.4 | -0.5 | 0.0 | -0.1 | -0.2 | 0.0 | 0.0 | 23.2 |
| 95-99 | 27.7 | -0.6 | -1.0 | -0.2 | 0.0 | -0.2 | -0.4 | -0.3 | -0.1 | 25.2 |
| Top 1 Percent | 32.7 | 0.0 | -0.2 | 0.0 | 0.0 | -0.6 | -0.9 | -0.7 | -1.4 | 28.8 |
| Top 0.1 Percent | 35.6 | 0.0 | -0.1 | 0.0 | 0.0 | -0.8 | -1.3 | -0.6 | -1.7 | 31.2 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extension of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.

(2) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of

(3) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(4) The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2009 dollars): 20% \$19,356, 40% \$37,493, 60% \$65,656, 80% \$111,659, 90% \$161,739, 95% \$226,402, 99% \$399,181, 99.9% \$2,727,123.

Table 2 shows how the various provisions in the tax laws combine to reduce average effective tax rates. In interpreting these figures, keep in mind that the provisions interact with one another; as a result, the order in which the provisions are analyzed matters. In this case, the analysis proceeds from left to right. Starting with current law, the table first considers an AMT patch,⁹ followed by the changes that benefit lower- and middle-income taxpayers as well as high-income ones (the 10 percent bracket and the 25 and 28 percent rates, marriage penalty relief, expansion of the child credit and credits for child

⁹ The most recent patch applied to 2009. The analysis assumes that Congress extends that patch with the exemption amount, rate bracket threshold, and exemption phaseout all indexed to inflation.

and dependent care and for education), and the changes that primarily benefit high-income taxpayers (lower rates on qualified dividends and long-term capital gains, eliminating PEP and Pease, and extending the top marginal rates of 33 and 35 percent).

As one example of the potential interactions, the AMT patch would appear to have a larger effect if it came at the end of the stacking order rather than at the beginning, as in table 2. If the AMT patch came at the end, the reductions in the regular income tax would push more people onto the AMT. The effect of patching the AMT would then be larger, and the effect of the other tax cuts would be correspondingly smaller.

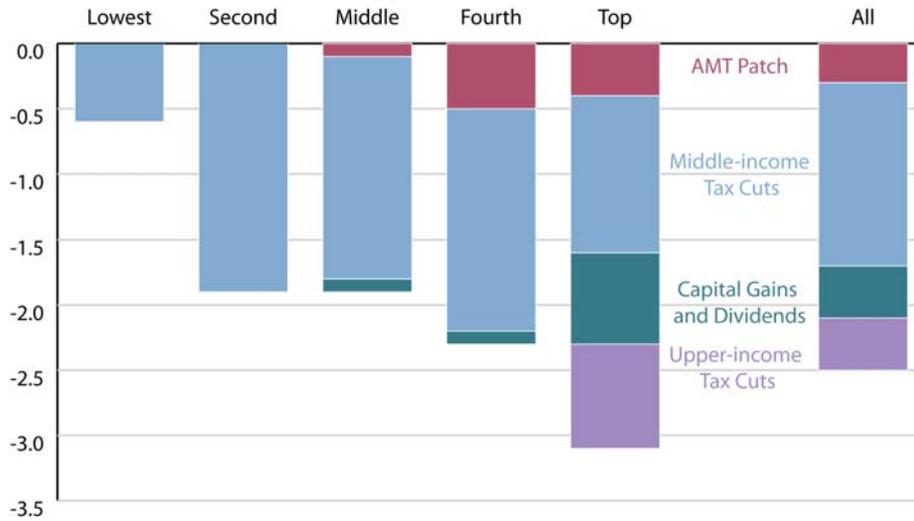
The provision-by-provision changes cumulate to the total changes shown in table 1. For example, the 2.0 percentage point reduction in the average tax rate for the second quintile is explained by the reduction of tax rates in the lower brackets (0.9 percentage point), marriage penalty relief (0.2 percentage points), and the expansion of credits (0.9 percentage points).

As the table demonstrates, several provisions often considered middle-income tax relief also provide benefits to taxpayers high in the income distribution. The rate reductions in the lower brackets, for example, reduce average tax rates by about a percentage point for taxpayers not only in the middle three quintiles of the income distribution, but in the top quintile. Marriage penalty relief similarly provides a sizable tax reduction in the top quintile.

In contrast, the impacts of the provisions that are considered high-income tax relief are concentrated at high incomes. Eliminating PEP and Pease, for example, benefits taxpayers in the top 5 percent of the income distribution, while extending the two top marginal rate reductions primarily benefits the top 1 percent.

To illustrate these differences, figures 2 and 3 condense the tax cuts into four groups: the AMT patch, the “middle-income” tax cuts (the lower brackets, marriage penalty relief, and expanded credits), the dividend and capital gains rate reductions, and the “upper-income” tax cuts (the two highest brackets and the elimination of PEP and Pease). Figure 2 shows the results by quintile, and figure 3 shows greater detail within the top quintile.

Figure 2
 Change in Average Tax Rates from Extending Tax Cuts
 (Percentage Points)
 by income quintile



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

Figure 3
 Change in Average Tax Rates from Extending Tax Cuts
 (Percentage Points)
 by percentiles within top quintile



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

As these figures illustrate, the “middle-income” tax cuts (in blue) account for most of the tax reductions for taxpayers up to the 95th percentile of income and about half of the reductions in the 95th to 99th percentiles. The “upper-income” tax cuts (purple) and the rate reductions for capital gains and dividends (green) account for nearly all of the tax reductions for the top 1 percent of taxpayers.

Economic Growth

In considering the potential economic impacts of the tax cuts, policymakers should consider four related issues: whether extending them would provide helpful stimulus at a time of economic weakness; whether they would encourage long-run economic growth; whether they would reduce inefficiencies created by the tax system; and whether and how the resulting revenue reductions would be paid for.

Stimulus. The U.S. economy clearly remains fragile. Although the overall economy has been growing for a year, the unemployment rate remains near 10 percent, and when one factors in the number of workers who are discouraged or cannot find full-time work, the underemployment rate is about 16 percent. History suggests that it takes a long time for economies to heal after financial crises,¹⁰ and the recent crisis was particularly severe. As a result, most forecasters expect that it will take at least several years for the unemployment rate to decline to levels consistent with full employment.

Given that outlook, it is reasonable to ask whether extending the tax cuts would provide near-term stimulus for the economy or, equivalently, would prevent any “anti-stimulus” that would occur from their expiration. The short answer to that question is clearly yes: extending the tax cuts would provide some demand-side stimulus to the economy.

But that conclusion comes with several caveats. First, the amount of stimulus varies across the different tax provisions. All else equal, the cuts that go to middle- and low-income taxpayers are likely to provide more demand-side stimulus in the near term, because they are less likely to be saved.

Second, only some of the stimulus would show up in 2011, when it is presumably most beneficial. The remainder would show up in the first few months of 2012, when families file their tax returns and most receive tax refunds. When CBO examined this issue earlier in the year, it concluded that extending the tax cuts would provide some stimulus in 2011, but significantly less, on a bang-per-buck basis, than other options, such as extended unemployment benefits.¹¹

Third, the amount of stimulus would be greater if the tax cuts were extended on a permanent basis, rather than just for a year or two. Families would spend more of their

¹⁰ See, for example, Carmen M. Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009).

¹¹ Congressional Budget Office, “[Policies for Increasing Economic Growth and Employment in 2010 and 2011](#),” January 2010.

reduction if they believed it to be permanent. Moreover, permanent reductions in the tax rates on dividends and capital gains could lift the value of stocks and other assets, providing a wealth boost to consumer spending. Both of those effects would increase the demand-side stimulus from an extension. In addition, the potential supply-side responses would be enhanced if the tax cuts were perceived to be permanent. That additional stimulus would, of course, require a much larger reduction in future revenues (relative to the rising path implied by current law) than would a temporary reduction.

Long-term growth. Over the long run, the key economic issue is whether extending the tax cuts would encourage work, saving, and investment and thereby boost economic growth. Such supply-side effects would primarily result from reductions in marginal tax rates on wages, salaries, investment income, and business income.

Analysts disagree on the extent to which extending the tax cuts would have such beneficial effects on growth. On one hand, extending the tax cuts would indeed reduce marginal tax rates; those reductions would encourage work and investment.¹² On the other hand, many of the provisions do not reduce marginal tax rates (e.g., the increase in the child tax credit). All else equal, extending those provisions would tend to weaken supply-side incentives. The potential economic gains from extending the tax cuts would also be offset, at least in part, by the resulting increase in deficits and debt. Over time, deficits crowd out private-sector investment and thus reduce the productive capacity of the economy. For tax cuts to boost long-run growth, their positive supply-side effects would have to be large enough to overcome the drag from crowding out.

Efficiency. A related issue is whether the tax cuts would improve economic efficiency. Our current tax system creates many undesirable distortions in economic activity. The deduction for mortgage interest, for example, encourages homeowners to take on larger mortgages. The exclusion for employer-provided health insurance encourages excessively broad insurance plans. The taxes on dividends and capital gains encourage businesses to finance themselves with debt rather than equity and to avoid corporate form, and the favorable treatment of capital gains relative to dividends encourages them to hoard cash rather than distribute it to shareholders. Higher marginal tax rates amplify all of these distortions.

Fiscal impacts. Finally, there is the issue of whether and how any extension would be paid for. Given the revenue increases that will occur under existing law even if the tax cuts are extended (as noted in figure 1), some analysts argue that the tax cuts should be extended without offsets. Given the current imbalance in our budget, that is effectively arguing that unspecified future spending reductions or revenue increases would have to bridge the gap or that the United States should run up its debt even more quickly. But that latter course would eventually undermine private investment and weaken economic growth. For that reason, most analysts believe that the potential long-run economic

¹² For one recent analysis, see Congressional Budget Office, “[An Analysis of the President’s Budgetary Proposals for Fiscal Year 2011](#),” March 2010.

benefits of a permanent extension would be maximized if policymakers offset the resulting deficit increases by spending reductions or less-distortionary tax increases.

Some analysts have also argued that a temporary one- or two-year extension, without any offsets, would be appropriate to provide stimulus to our weak economy. Given extremely low borrowing rates (the 10-year Treasury rate is currently about 3 percent), the costs of financing the resulting increase in debt would likely not be a major immediate problem, but the additional borrowing would, of course, add to the debt burden in coming years.

However, another strategy for near-term stimulus would be to pair a temporary extension of most or all of the tax cuts with offsetting spending reductions or revenue increases several years in the future. Most analysts believe that this approach would provide the greatest economic benefit, since it would combine short-term economic stimulus with a commitment to greater fiscal responsibility in the future.

The Need for Fundamental Tax Reform

As a closing note, I should emphasize that our current tax system is already highly inefficient and will not scale well if there are higher revenue demands in the future. Regardless of any near-term decisions they make about extending the tax cuts, policymakers should also begin to consider more fundamental reforms.

In principle, there are substantial opportunities to reduce the economic burdens created by our tax system while raising the same or more revenue. One option would be to limit the numerous special credits, exclusions, and deductions that narrow our income tax base. Reducing such tax expenditures would allow for the economic benefits of lower rates and reduced distortions from the tax system. A second option would be to introduce a new, broad-based tax on consumption, such as a value-added tax, rather than to increase more-distortionary income taxes. Finally, the nation could raise additional revenue by taxing behaviors we want to discourage—such as carbon emissions—rather than behaviors that we would prefer to encourage—such as working, saving, and investing.¹³

¹³ For a longer discussion of the role of revenue options in addressing our fiscal challenges, see Donald B. Marron, "[America in the Red](#)," *National Affairs*, March 2010.

Appendix: Distributional Analysis by Cash Income Level

Table 3
Extension of the 2001 and 2003 Individual Tax Cuts and AMT Patch
Distribution of Federal Tax Change by Cash Income Levels, 2012¹

| Cash Income Level (thousands of 2009 dollars) ² | Average Effective Tax Rates ³ | | | Percent of Tax Units with Tax Cut ⁴ | Average Federal Tax Change (\$) | Percent Change in After-Tax Income ⁵ | Change in Share of Total Federal Taxes (% points) |
|--|--|----------------------|----------------------|---|---------------------------------------|--|---|
| | Current Law | Tax Cuts Extended | Change (% points) | | | | |
| Less than 10 | 5.4 | 5.3 | -0.1 | 1.0 | -4 | 0.1 | 0.0 |
| 10-20 | 5.3 | 4.5 | -0.8 | 41.9 | -119 | 0.8 | 0.0 |
| 20-30 | 10.7 | 8.7 | -2.0 | 74.7 | -504 | 2.2 | -0.2 |
| 30-40 | 14.8 | 12.8 | -2.0 | 86.9 | -734 | 2.4 | -0.1 |
| 40-50 | 17.3 | 15.5 | -1.8 | 91.4 | -845 | 2.2 | 0.0 |
| 50-75 | 19.5 | 17.6 | -1.9 | 96.5 | -1,202 | 2.3 | 0.2 |
| 75-100 | 21.6 | 19.3 | -2.3 | 98.8 | -2,074 | 2.9 | 0.1 |
| 100-200 | 24.7 | 21.9 | -2.8 | 99.3 | -3,951 | 3.7 | -0.1 |
| 200-500 | 27.4 | 24.8 | -2.6 | 99.4 | -7,826 | 3.6 | 0.3 |
| 500-1,000 | 28.6 | 25.8 | -2.8 | 98.7 | -19,652 | 3.9 | 0.1 |
| More than 1,000 | 33.8 | 29.7 | -4.2 | 99.5 | -129,318 | 6.3 | -0.3 |
| All | 23.5 | 20.9 | -2.6 | 73.8 | -1,975 | 3.4 | 0.0 |

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extension of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

(4) Includes both filing and non-filing units but excludes those that are dependents of other tax units.

(5) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Table 4
Change in Average Effective Tax Rates from Specific Provisions
Distribution of Federal Tax Change by Cash Income Levels, 2012^{1,2}

| Cash Income Level (thousands of 2009 dollars) ³ | Average Effective Tax Rate under Current | Change from Provision (% points) | | | | | | | | Average Effective Tax Rate if All Cuts Extended |
|--|--|----------------------------------|----------------------------|-------------------------------|----------------------|--------------------------------|---------------------------------------|----------------------------|--------------------------|---|
| | | AMT Patch | Lower Marginal Rates | Marriage Penalty Relief | Credits Expansion | Lower Rates on Dividends | Lower Rates on Capital Gains | PEP and Pease Repeal | Top Marginal Rates | |
| Less than 10 | 5.4 | 0.0 | 0.0 | 0.0 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 5.3 |
| 10-20 | 5.3 | 0.0 | -0.4 | -0.1 | -0.3 | 0.0 | 0.0 | 0.0 | 0.0 | 4.5 |
| 20-30 | 10.7 | 0.0 | -0.8 | -0.2 | -0.9 | 0.0 | 0.0 | 0.0 | 0.0 | 8.7 |
| 30-40 | 14.8 | 0.0 | -1.0 | -0.2 | -0.8 | 0.0 | -0.1 | 0.0 | 0.0 | 12.8 |
| 40-50 | 17.3 | -0.1 | -1.0 | -0.2 | -0.5 | 0.0 | -0.1 | 0.0 | 0.0 | 15.5 |
| 50-75 | 19.5 | -0.2 | -1.1 | -0.1 | -0.4 | 0.0 | -0.1 | 0.0 | 0.0 | 17.6 |
| 75-100 | 21.6 | -0.5 | -1.1 | -0.3 | -0.3 | 0.0 | -0.1 | 0.0 | 0.0 | 19.3 |
| 100-200 | 24.7 | -0.5 | -1.3 | -0.6 | -0.2 | 0.0 | -0.2 | 0.0 | 0.0 | 21.9 |
| 200-500 | 27.4 | -0.6 | -1.1 | -0.2 | 0.0 | -0.1 | -0.3 | -0.2 | 0.0 | 24.8 |
| 500-1,000 | 28.6 | -0.1 | -0.5 | -0.1 | 0.0 | -0.3 | -0.5 | -0.6 | -0.7 | 25.8 |
| More than 1,000 | 33.8 | 0.0 | -0.1 | 0.0 | 0.0 | -0.6 | -1.1 | -0.7 | -1.6 | 29.7 |
| All | 23.5 | -0.3 | -0.9 | -0.3 | -0.2 | -0.1 | -0.3 | -0.2 | -0.3 | 20.9 |

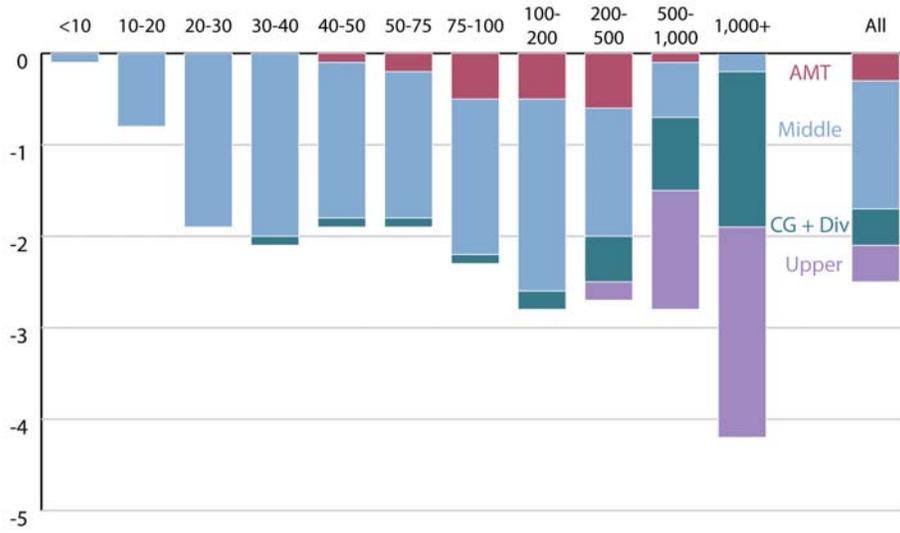
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extension of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.

(2) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

(3) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

Figure 4
 Change in Average Tax Rates from Extending Tax Cuts
 (Percentage Points)
 by cash income levels (\$thousands)



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).