Testimony Before

U.S. Senate

Committee on Finance

March 26, 2009

Hearing on

"The Middle Income Tax Relief Question: Extend, Modify, or Expire?"

Alan D. Viard

American Enterprise Institute

Chairman Baucus, Ranking Member Grassley, Members of the Committee: It is an honor to testify at this hearing on middle-class tax relief. The views expressed in this testimony are my own and do not necessarily reflect the views of any other person or any organization.

Congress faces critical decisions about middle-class tax relief in the next two years. Most provisions of the Bush tax cuts are scheduled to expire at the end of 2010, as are the income tax cuts provided in the recent stimulus package. President Obama has proposed permanent extension of the Bush tax cuts, except for households with the highest incomes, as well as permanent extension of the stimulus tax cuts.

The concept of middle-class tax relief enjoys strong political support. Notably, the concept was endorsed by both President Obama and his Republican opponent during the 2008 presidential campaign. Nevertheless, I recommend that Congress not adopt a significant package of permanent middle-class tax relief at this time. Middle-class tax cuts provide limited incentives for the work and saving that drive economic growth while imposing substantial revenue costs. Adoption of a large package of permanent middle-class tax relief would add to the long-run fiscal imbalance and impede capital formation, increasing the fiscal burdens on future middle-class taxpayers and reducing wages for middle-class workers.

It should be noted that other provisions of the Bush tax cuts provide much stronger improvements to economic incentives, such as the marginal rate reductions in the top two brackets, the repeal of the phase-outs of personal exemptions and itemized deductions, and the dividend and capital gains rate reductions. Yet, President Obama largely supports the scheduled expiration of these provisions (although he would maintain most of the dividend tax cut). From the standpoint of economic growth, the proposed combination – the expiration of these growth-oriented provisions and the extension of middle-class tax relief – would offer the worst of both worlds. Revenue would be reduced without a commensurate improvement in incentives.

Significant permanent middle-class tax relief should be considered only as part of a bipartisan compromise that addresses the long-term fiscal imbalance. The appointment of a bipartisan commission may help produce such a compromise.

In the remainder of my testimony, I discuss the decline in middle-class tax burdens over the last few decades, the limited extent to which middle-class tax relief promotes economic incentives, and the fiscal costs of middle-class tax relief.

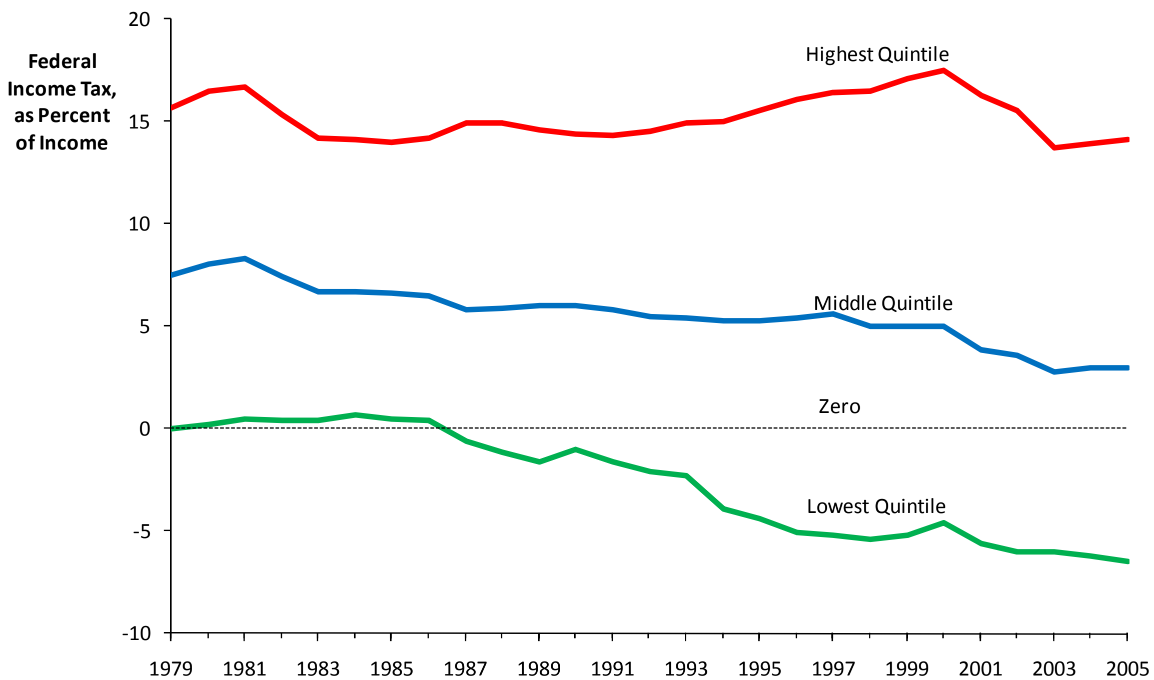
MIDDLE-CLASS TAX BURDENS HAVE FALLEN OVER TIME

Due to a series of laws that dramatically lowered income taxes for low-income and middle-income households, many such households now have zero or negative income tax liabilities. Even when payroll taxes are included, taxes have fallen significantly for these income groups. The federal tax system is highly progressive, with a small fraction of wealthy households bearing a large share of the tax burden.

A number of tax laws adopted during the last quarter-century have reduced income taxes for middle-income and low-income households, particularly those with children. These laws increased the personal exemption and the standard deduction, dramatically expanded the earned income tax credit, and introduced the child tax credit. Even some laws that increased the overall tax burden, such as the Omnibus Budget Reconciliation Act of 1990 and the Omnibus Budget Reconciliation Act of 1993, cut taxes for low income Americans by expanding the earned income tax credit.

These laws have significantly altered the distribution of the individual income tax burden. **Figure 1** presents Congressional Budget Office (CBO) data on federal individual income tax liabilities, as a percentage of income, for households in different parts of the income distribution from 1979 to 2005. The bottom line shows the income tax liability of households in the lowest quintile of the income distribution, the 20 percent of households with the lowest incomes (adjusted for household size). The middle line shows the income tax burden on households in the middle quintile and the top line shows the income tax burden on households in the top quintile.[1]

Figure 1: Income taxes have fallen for low-income and middle-income households



Source: Data appendix, Congressional Budget Office. *Historical Effective Federal Tax Rate 1979 to 2005*. December 2007. <http://www.cbo.gov/ftpdocs/88xx/doc8885/Appendix_tables_toc.xls>.

---

[1] In 2005, a four-person household was in the bottom quintile if it had income below $35,800, was in the middle quintile if it had income between $61,000 and $90,400, and was in the top quintile if it had income above $134,800. The corresponding income ranges for one-person households were half of those values.

Figure 1 reveals that the following changes occurred from 1979 to 2005:

- The income tax liability of the bottom quintile fell from roughly zero to *negative* 6.5 percent of income.
- The income tax liability of the middle quintile fell from 7.5 percent of income to 3.0 percent of income.
- The income tax liability of the top quintile fell from 15.7 of income to 14.1 percent of income.

Although income taxes fell for all three groups over this time period, low-income and middle-income groups enjoyed the largest reductions, both as a share of income and as a share of initial income tax liability.

During this period, negative income tax liabilities became more common due to the expansion of refundable income tax credits. In August 2008, the Urban-Brookings Tax Policy Center estimated that 37.8 percent of tax units would have zero or negative income tax liabilities in 2009 under the laws then in place.[2]

The above data do not reflect the additional middle-class tax relief provided by the stimulus package enacted on February 17, 2009, the American Recovery and Reinvestment Act (ARRA). Effective for 2009 and 2010, ARRA created the refundable Making Work Pay credit, expanded the refundable earned income tax credit, and increased the refundability of the child tax credit. As a result, a married couple with two children owes zero income tax in 2009 on an income of $50,233.[3]

So far, I have discussed only the individual income tax. To be sure, even workers with negative income tax liabilities are subject to the payroll taxes that finance Social Security and Medicare Part A. For example, the couple discussed above pays $7,686 of employee and employer payroll taxes on its $50,233 of earnings. It is arguably misleading, however, to include these taxes without including the associated Social Security and Medicare benefits that they finance. In any case, including payroll taxes, along with corporate income taxes and excise taxes, does not change the basic outcome. As shown by the CBO data charted in **Figure 2**, low-income and middle-income households received significant reductions in their total federal taxes between 1979 and 2005. In these data, employee and employer payroll ("social insurance") taxes are assumed to be borne by the worker.

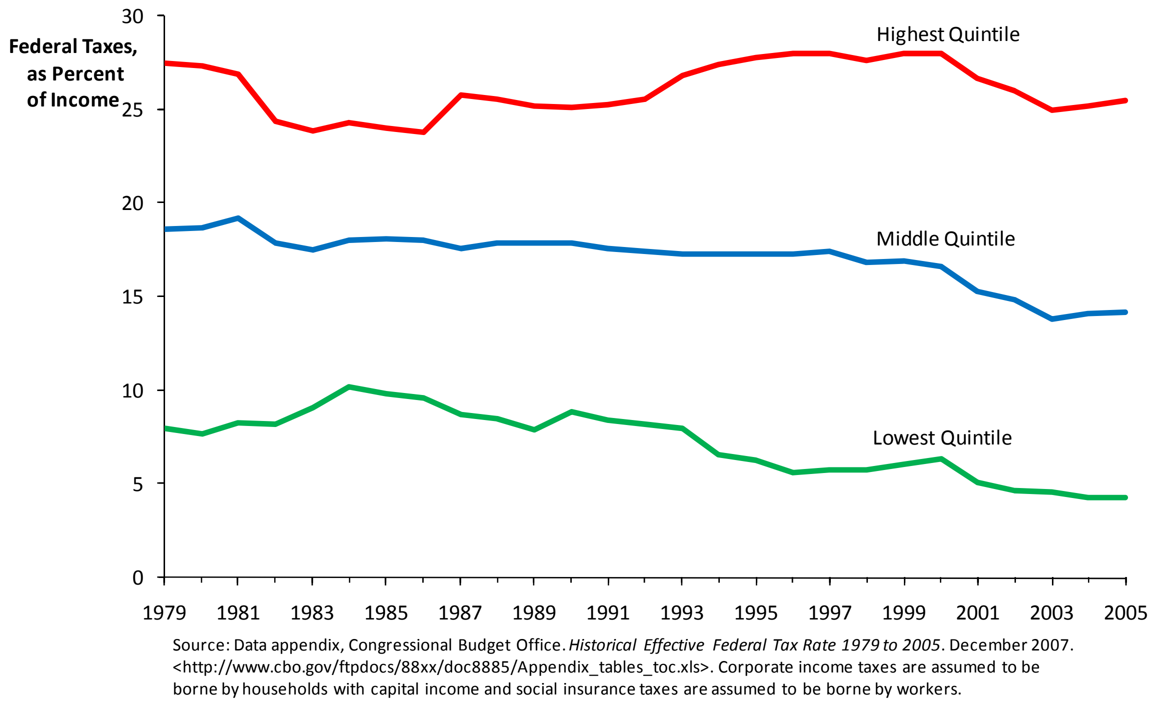
---

[2] Urban-Brookings Tax Policy Center, Table T08-0208, "Distribution of Tax Units with Zero or Negative Individual Income Tax Liability by Cash Income Level, 2009," August 15, 2008, <http://www.taxpolicycenter.org/numbers/Content/PDF/T08-0208.pdf>.

[3] After claiming an $11,400 standard deduction and four personal exemptions totaling $14,600, the couple has taxable income of $24,233. Of this taxable income, the first $16,700 is taxed at 10 percent and the remaining $7,533 is taxed at 15 percent, yielding $2,800 tax before credits. This tax liability is offset by $2,000 of child tax credits and an $800 Making Work Pay credit. The computation assumes that the couple does not incur child care costs; with such costs, the tax-free threshold would be even higher.

Figure 2: Federal taxes have fallen for low-income and middle income households

(Individual and corporate income taxes, social insurance taxes and excise taxes)



Source: Data appendix, Congressional Budget Office. *Historical Effective Federal Tax Rate 1979 to 2005*. December 2007. <http://www.cbo.gov/ftpdocs/88xx/doc8885/Appendix_tables_toc.xls>. Corporate income taxes are assumed to be borne by households with capital income and social insurance taxes are assumed to be borne by workers.

Figure 2 reveals that the following changes occurred from 1979 to 2005:

- The federal tax burden on the bottom quintile fell from 8.0 percent of income to 4.3 percent of income.
- The federal tax burden on the middle quintile fell from 18.6 percent of income to 14.2 percent of income.
- The federal tax burden on the top quintile fell from 27.5 of income to 25.5 percent of income.

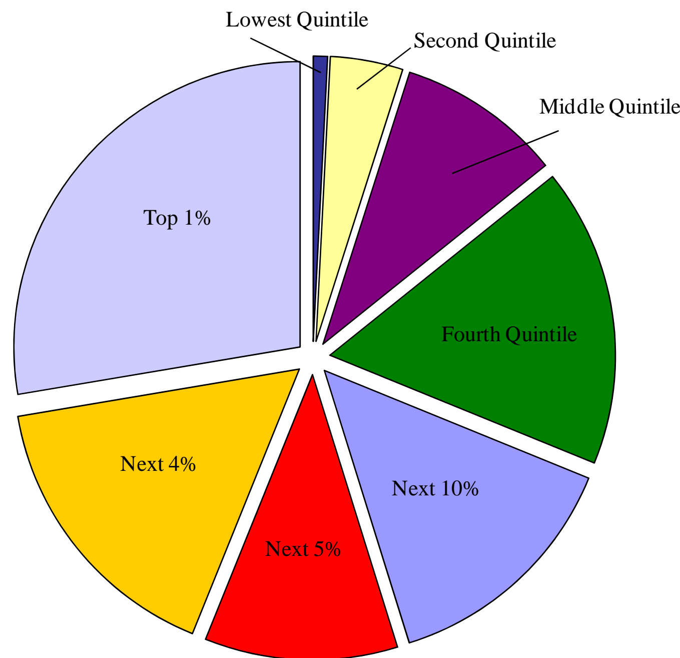
As before, low and middle income groups received the largest reductions, both as a share of income and as a share of initial tax liability.

Once again, the above computations do not include the additional tax relief provided by ARRA. A married couple with two children has a combined income and payroll tax liability of zero in 2009 with an income of $31,370.[4]

[4] After claiming a standard deduction of $11,400 and personal exemptions of $14,600, the couple has taxable income of $5,370. This income is taxed at 10 percent, yielding $537 tax before credits. Against this tax, the couple claims $2,000 of child tax credits, an $800 Making Work Pay credit, and a $2,537 earned income tax credit, yielding an individual income tax liability of negative $4,800, which offsets the $4,800 of employee and employer payroll taxes that they pay.

As a result of the various tax laws adopted over the years, the United States has a highly progressive federal tax structure. The CBO data charted in **Figure 3** reveal that high-income households bore most of the federal tax burden in 2005. Note that these data include payroll taxes and all of the other taxes included in Figure 2.

Figure 3: High-Income Groups Bear Most of Federal Tax Burden
(Shares of Federal Tax Liabilities, 2005)



Source: Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2005*, December 2007. Data include federal individual and corporate income taxes, social insurance taxes, and excise taxes. Corporate income taxes are assumed to be borne by households with capital income and social insurance taxes are assumed to be borne by workers.

Although high-income households earn a significant share of national income (and that share has risen over time), their share of the federal tax burden exceeds their share of national income. Notably, the top one percent of households paid 27.6 percent of all federal taxes in 2005 while earning 18.1 percent of total national income. The next four percent of all households paid 16.2 percent of federal taxes while earning 13.0 percent of national income.

In contrast, the bottom quintile paid a mere 0.8 percent of federal taxes while earning 4.0 percent of total national income. The bottom two quintiles combined – comprising 40 percent of the population – paid only 4.9 percent of federal taxes while earning 12.5 percent of national income.

Before further middle-class tax cuts are provided, or existing cuts are made permanent, it is necessary to consider the benefits and cost of middle-class tax relief, a topic to which I now turn.

MIDDLE-CLASS TAX RELIEF PROVIDES LIMITED BOOST TO INCENTIVES

Economists have long recognized that tax cuts can spur economic growth by reducing disincentives. Unfortunately, middle-class tax relief has less powerful incentive effects than tax relief at the top because they are less likely to affect marginal tax rates. When a household considers whether to earn an additional dollar of income, the relevant question is how that additional dollar will change its tax liability. The key variable is therefore the household's marginal tax rate, the rate that applies to the last dollar of income.

For example, consider a married couple in 2009 with a taxable income of $75,000. The couple's income tax before credits is $11,125. That reflects a 10 percent tax on the first $16,700 of income plus a 15 percent tax on the next $51,200 plus a 25 percent tax on the final $7,100. Because the couple pays 14.8 percent of their income in tax, their *average* tax rate is 14.8 percent. That number is irrelevant, however, to their decision of whether to earn an additional dollar of income.

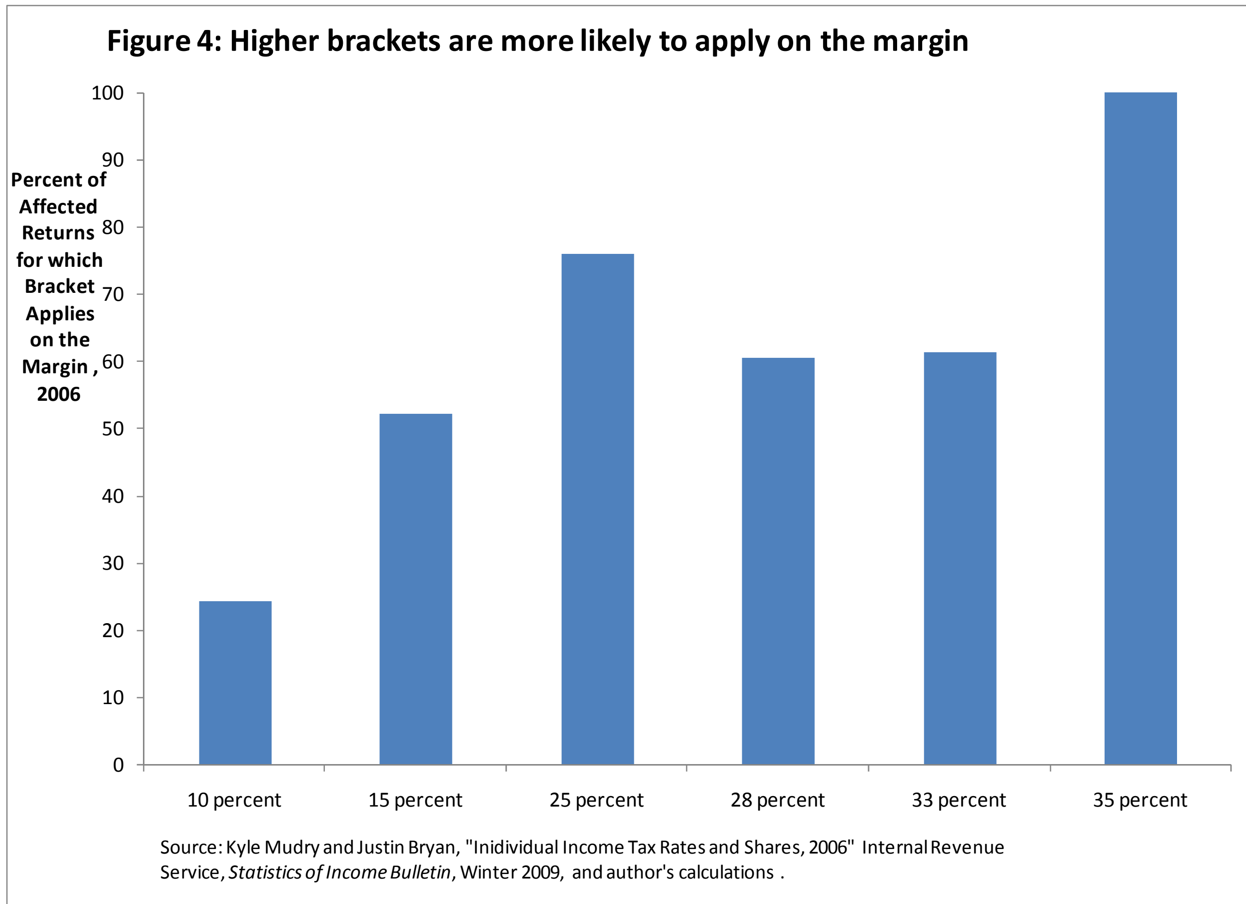
Instead, the relevant consideration is how earning an additional dollar will change the couple's tax. If the couple's income rises from $75,000 to $75,001, their tax liability will rise by 25 cents, from $11,125.00 to $11,125.25, because the additional dollar is taxed in the 25 percent bracket. (Similarly, if the couple lowers their income by one dollar, their tax liability falls by 25 cents.) The couple's *marginal*, or last-dollar, tax rate is 25 percent. The average tax rate is lower than the marginal tax rate, because part of the couple's income is taxed in the 10 and 15 percent brackets.

For this couple, reductions in the 10 and 15 percent brackets would have no beneficial incentive effects, because the couple's marginal tax rate would be unchanged at 25 percent. Such reductions would increase their disposable income and reduce government revenue, but would not give them an incentive to earn additional income. In contrast, a reduction in the 25 percent bracket would have a beneficial incentive effect for this couple.

In general, reductions in a tax bracket have larger incentive effects if there are more households for whom that bracket applies on the margin. **Figure 4** graphs the extent to which different tax brackets affected taxpayers on the margin in 2006. For each of the six regular brackets, it plots the tax returns that faced that bracket on the margin (on their last dollar of income), as a fraction of the tax returns that had some income taxed in that bracket.

For example, 105 million tax returns (all tax returns with positive ordinary taxable income) had part of their income taxed in the 10 percent bracket in 2006. If the 10 percent bracket had been reduced, all of those tax returns would have received a tax cut, with a corresponding revenue loss to the government. But, only 26 million, or 25 percent, of those tax returns faced a 10 percent rate on the *last* dollar of income; in other words, only 25 percent of those returns faced a 10 percent marginal rate. If the 10 percent bracket had been reduced, only those returns would have received a boost to incentives.

In contrast, each and every tax return that had part of its income taxed in the top 35 percent bracket necessarily faced that rate on the last dollar of income. A reduction in that bracket would have boosted incentives for every household that received a tax cut.



The above comparison understates the extent to which the different brackets matter for incentives. Although reducing the 10 percent bracket would improve incentives for one quarter of the households that would receive a tax cut, those households earn far less than one quarter of the aggregate income earned by the households receiving a tax cut. Furthermore, the top brackets, along with the special tax rates for qualified dividends and long-term capital gains, have the largest impact on saving incentives.

The above discussion pertains only to changes in income tax brackets. Some of the Bush tax cuts and many of the ARRA tax cuts take the form of tax credits. Depending on how they are designed, tax credits can raise marginal tax rates, lower them, or leave them unaffected:

- If the credit is phased in as earnings or other income rises, the credit lowers marginal tax rates throughout the phase-in range. (Also, a nonrefundable credit lowers marginal tax rates for those taxpayers whose tax liability is zeroed out by the credit).

- If the credit is refundable and its value is unrelated to income, it has no impact on marginal tax rates, because it simply reduces tax liability by a fixed amount.
- If the credit is phased out as income rises, it raises marginal tax rates, because earning additional income triggers a reduction in the credit.

The refundable Making Work Pay credit, which is phased in at low levels of earnings and is phased out at high income levels, exhibits each of these properties at different income levels. Consider its impact on the marginal tax rates of a married couple that obtains all of its income from labor earnings:

- As earnings rise from zero to $12,903, the credit *lowers* marginal tax rates by 6.2 percentage points, because each additional dollar of earnings increases the credit by 6.2 cents. In this range, the credit rises from zero to $800.
- As earnings rise from $12,903 to $150,000, the credit has no impact on marginal tax rates. In this range, the credit remains fixed at $800.
- As earnings rise from $150,000 to $190,000, the credit *raises* marginal tax rates by 2.0 percentage points, because each dollar of earnings reduces the credit by 2.0 cents due to the income phase-out. In this range, the credit falls from $800 to zero.

The credit lowers tax payments in all three of these income ranges, with a corresponding revenue loss to the government. But, it lowers the marginal tax rate and improves economic incentives only in the first range. In the other ranges, it either fails to improve incentives or actually creates disincentives. Attempting to target tax credits to the middle class can dampen, or even reverse, any beneficial incentive effects that would otherwise occur.

The limited boost to economic incentives from middle-class tax relief becomes more troubling when one considers the budgetary costs of such relief.

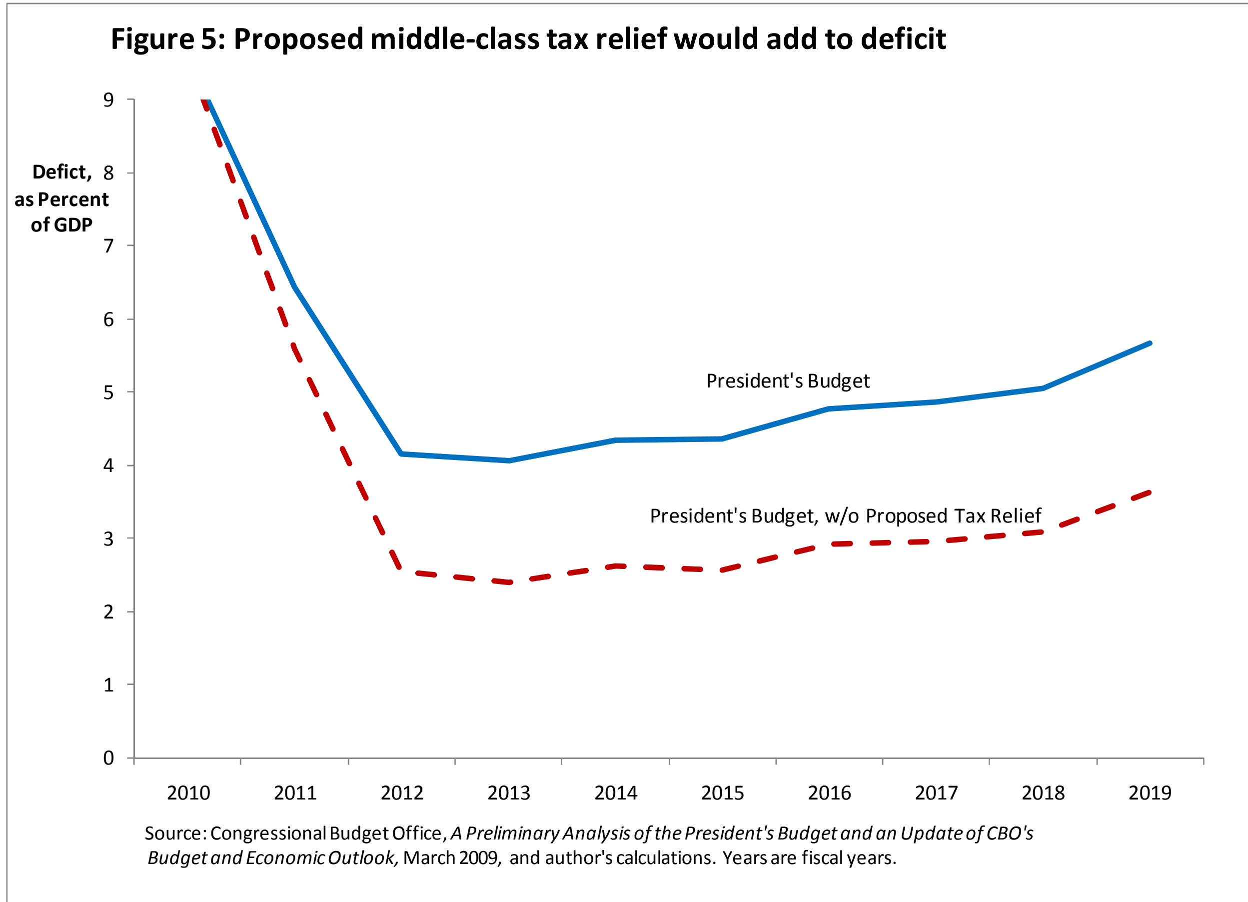
MIDDLE-CLASS TAX RELIEF WIDENS THE FISCAL IMBALANCE

Permanent middle-class tax relief will impose substantial revenue costs, further widening the existing fiscal imbalance.

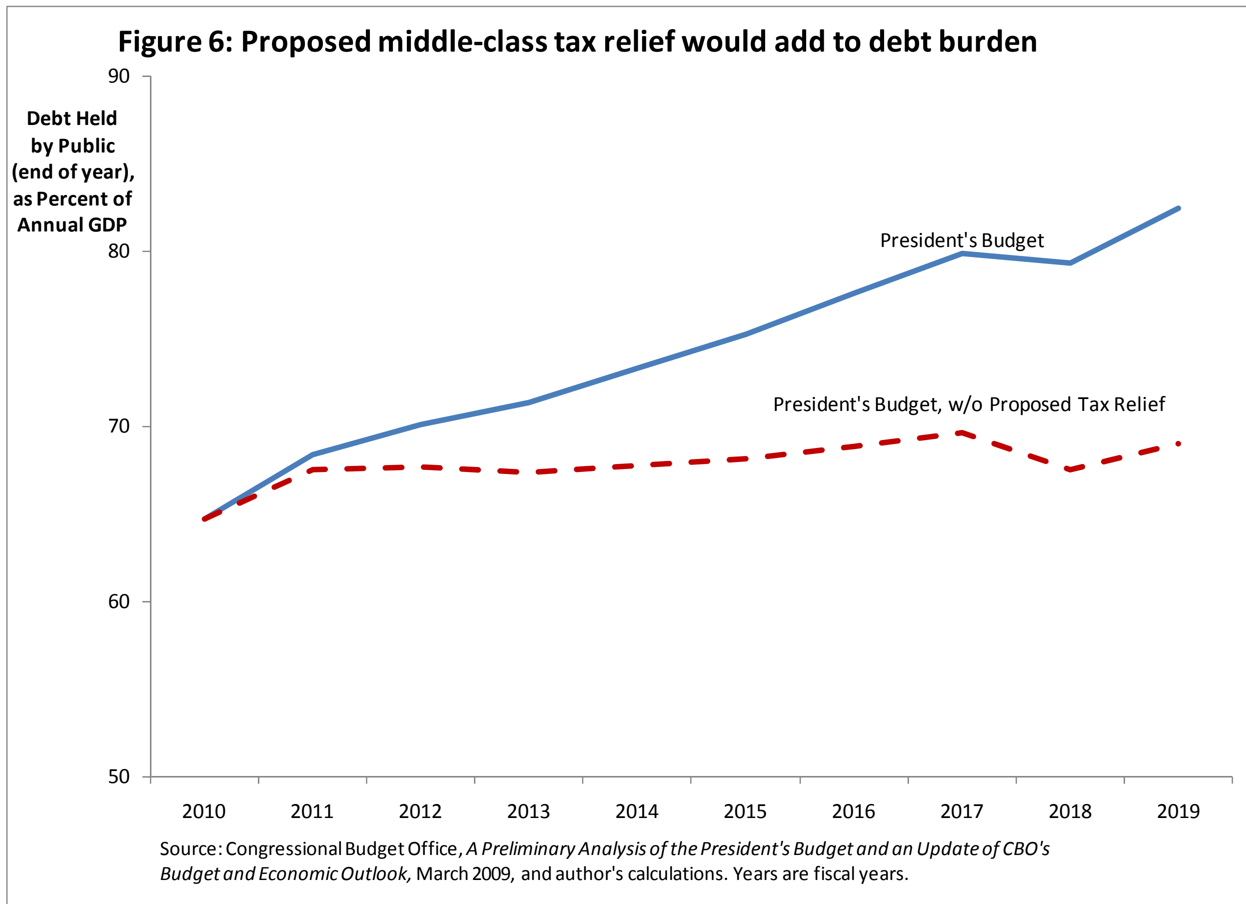
On March 20, CBO released an updated economic forecast and a preliminary analysis of President Obama's budget. CBO estimates that adoption of the budget would result in a federal deficit equal to 5.7 percent of GDP in fiscal 2019. President Obama's proposals for middle-class tax relief would account for a significant part of the deficit.

CBO estimates that, in fiscal 2019, President Obama's proposed partial extension of the individual income tax rate provisions of the Bush tax cuts would reduce revenue by $134 billion, his proposed partial extension of other provisions of the Bush tax cuts (excluding his proposed partial extension of provisions relating to the estate and gift tax and capital gains and dividends) would reduce revenue by $54 billion, and his proposed extension of the Making Work Pay credit

and other tax credit provisions would reduce revenue by $45 billion and increase outlays by $61 billion. The combined direct budgetary impact in 2019 would be $294 billion, about 1.4 percent of GDP. Simple calculations indicate that these tax relief proposals would also increase 2019 interest costs by $132 billion, more than 0.6 percent of GDP. Without these proposals, the fiscal 2019 deficit would be 3.6 percent, rather than 5.7 percent, of GDP. The deficit impact of the specified tax relief proposals is shown in **Figure 5**.



The cumulative deficit increase would add to the federal debt throughout the 10-year budget window, as shown in **Figure 6**. Without the specified tax relief proposals, the debt at the end of fiscal 2019 would be 69 percent, rather than 82 percent, of annual GDP.



This addition to the debt would aggravate the long-run fiscal imbalance caused by the projected doubling of Social Security, Medicare, and Medicaid spending as a share of GDP in upcoming decades. An increase in the debt burden would be particularly harmful to the middle class. The resulting drag on capital accumulation would reduce labor productivity and thereby reduce wages for middle-class workers. Also, the need to service the debt would add to the fiscal burdens on future middle-class taxpayers. Providing tax relief without a strategy for addressing the long-run fiscal imbalance is not a sound way to help the middle class.

POLICY IMPLICATIONS AND CONCLUSION

A broad package of middle-class tax relief should not be adopted at this time. Such tax relief would trigger substantial revenue losses while doing little to improve economic incentives. The resulting increase in the fiscal imbalance would reduce the wages of middle-class workers and impose fiscal burdens on future middle-class taxpayers.

It should be noted that the ARRA tax relief was adopted as a response to the ongoing severe recession. The tax relief, like the accompanying temporary expansion of unemployment benefits and other transfer payments, was intended to provide a Keynesian stimulus to aggregate demand

and also to aid low-income and middle-income Americans suffering from the weak economy. Those justifications do not warrant the adoption of permanent middle-income tax relief.

In particular, permanently increasing aggregate demand in a futile effort to permanently increase output would be a misapplication of Keynesian macroeconomics. The appropriate (and maximum feasible) role of Keynesian demand management is to *stabilize* the economy by increasing aggregate demand when the economy is weak and reducing aggregate demand when the economy is strong. The long-run level of output depends on the economy's productive resources, not on aggregate demand. Long-run growth is therefore best promoted by fiscally responsible policies that maintain economic incentives. Broad permanent middle-class tax relief would threaten, rather than advance, those objectives.

The tax relief provided by the Bush tax cuts and by ARRA is locked securely into place for the next 21 months. If the recession lasts longer than expected, Congress should, and undoubtedly will, temporarily extend the tax relief and the accompanying government benefits.

Permanent middle-class tax relief should be considered only as part of a bipartisan compromise that comprehensively addresses the long-run fiscal imbalance. Such a compromise might also include a move away from income taxation and toward consumption taxation; under consumption taxation, it is possible to achieve a similar degree of progressivity with a smaller amount of economic distortion.

A good way to spur such a bipartisan compromise would be to appoint a commission that includes Senate and House members from both parties. The commission would be tasked with developing a legislative plan to narrow the long-term fiscal imbalance that would then be voted upon by both chambers of Congress. Senators Kent Conrad (D-North Dakota) and Judd Gregg (R-New Hampshire) introduced S. 2063, which would have provided for the establishment of such a commission, in the 110th Congress. Although that bill was not enacted, the 111th Congress has ample time to act on similar legislation.

The best way to help the middle class, and all Americans, is to move toward a fiscal framework that ensures long-run growth while meeting short-term needs.