

**THE MIDDLE-INCOME TAX RELIEF QUESTION:  
EXTEND, MODIFY, OR EXPIRE?**

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**HEARING**

BEFORE THE

**COMMITTEE ON FINANCE  
UNITED STATES SENATE**

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

—————  
THURSDAY, MARCH 26, 2009  
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# CONTENTS

## OPENING STATEMENTS

	Page
Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance .....	1
Grassley, Hon. Chuck, a U.S. Senator from Iowa .....	2

## WITNESSES

Taylor, Paul, executive vice president, Pew Research Center, Washington, DC .....	5
Yin, George, Edwin S. Cohen distinguished professor of law and taxation, University of Virginia, School of Law, Charlottesville, VA .....	6
Greenstein, Robert, executive director, Center on Budget and Policy Priorities, Washington, DC .....	8
Viard, Alan, resident scholar, American Enterprise Institute, Washington, DC .....	10

## ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:	
Opening statement .....	1
Prepared statement .....	29
Grassley, Hon. Chuck:	
Opening statement .....	2
Prepared statement .....	31
Greenstein, Robert:	
Testimony .....	8
Prepared statement .....	33
Responses to questions from committee members .....	42
Nelson, Hon. Bill:	
“No Pity for Rich Tax Cheats,” <i>Wall Street Journal</i> article by Martin Vaughan, February 11, 2009 .....	47
Taylor, Paul:	
Testimony .....	5
Prepared statement .....	50
Responses to questions from committee members .....	63
Viard, Alan:	
Testimony .....	10
Prepared statement .....	67
Responses to questions from committee members .....	79
Yin, George:	
Testimony .....	6
Prepared statement .....	83
Responses to questions from committee members .....	92



## **THE MIDDLE-INCOME TAX RELIEF QUESTION: EXTEND, MODIFY, OR EXPIRE?**

**THURSDAY, MARCH 26, 2009**

U.S. SENATE,  
COMMITTEE ON FINANCE,  
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:03 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Nelson, Menendez, Carper, Grassley, and Snowe.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Cathy Koch, Senior Advisor, Tax and Economics; Tiffany Smith, Tax Counsel; and Kelcy Poulson, Tax Research Assistant. Republican Staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Nick Wyatt, Tax Staff Assistant; Jim Lyons, Tax Counsel; and Grant Menke, Staff Assistant.

### **OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE**

The CHAIRMAN. The committee will come to order.

In his work entitled, "Politics," Aristotle wrote: "The best political community is formed by citizens of the middle class." What was true in Aristotle's analysis has proven all the more true in America. America's great strength lies in the broad American middle class.

In 2001, this committee led the way to easing the tax burdens of the American middle class. Now, there have been different views about the 2001 tax cuts, but, whatever differences there have been, there is pretty wide agreement that working families have welcomed the relief. Tax cuts like the Child Tax Credit, the lower middle-income tax rates, and marriage penalty relief have helped working moms and dads to pay the bills and raise their families.

For example, in 2001 we increased the Child Tax Credit from \$500 to \$1,000 per child. Then we also made the credit partially refundable so that working families can get some money back. In 2001, we provided marriage penalty relief. That way a married couple does not get penalized with higher taxes when they take their wedding vows.

But on the horizon, we have a challenge. Those tax cuts, and a lot of other ones, expire at the end of 2010. Allowing these tax cuts to expire would mean a drastic tax increase for tens of millions of American families. Pretty soon we need to decide which of these tax cuts to make permanent.

On top of that, we have the ever looming Alternative Minimum Tax. The AMT creeps forward every year, snaring more and more taxpayers in its grasp. The AMT was meant to make sure that 155 wealthy taxpayers paid their fair share, but now it ensnares millions of middle-income families. Frankly, the AMT fills many taxpayers with dread. People have to calculate their taxes under the regular tax system, and then they have to do it again under this alternative system. They have to worry about whether this will be the year that they fall prey to AMT.

Over and over again, Congress has passed a 1-year fix. The fix, also known as the AMT patch, is holding the number of taxpayers subject to the tax at just over 4 million; without the fix, more than 26 million taxpayers will be paying higher taxes.

Another question is: who are these middle-income taxpayers? People throw the term “middle class” around a lot, but different people have different ideas about who is included. Judith Martin, who has long written the “Miss Manners” column, once said, “There are three social classes in America: upper middle class, middle class, and lower middle class.”

Today we will hear some thoughts about just who is in the middle class. We will hear about how the middle class has fared over the last few decades. In particular, we will hear how they have fared over the last couple of years, and we will hear about how our tax laws affect the middle class. We will discuss the temporary nature of several other tax provisions and will consider whether some of these provisions should be made permanent.

Today I am introducing a bill to make the middle-income 2001 tax cuts permanent. My bill would make permanent the middle-income tax rates—the Child Tax Credit, marriage penalty relief in the 2001 tax law, for example—and I am very hopeful that we can move legislation along these lines this year.

And so let us examine ways to help the great strength of America, let us look for ways to continue tax relief for the broad American middle class, and let us see how we can extend these welcome tax cuts for America’s working families.\*

Senator Grassley?

**OPENING STATEMENT OF HON. CHUCK GRASSLEY,  
A U.S. SENATOR FROM IOWA**

Senator GRASSLEY. Thank you, Mr. Chairman.

I want to say, first of all, to the chairman as well as to our distinguished panel, this is the only day of the year that the Budget Committee puts out a document. There are a lot of amendments. I am a member of that committee, so I probably will not be around here a long time to listen to everything. I hope you will appreciate that fact.

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\*For more information, *see also*, “Present Law Related to the Individual Income and Social Insurance Taxes as in Effect for 2009 and Background Data Related to the Distribution of Federal Taxes,” Joint Committee on Taxation staff report, March 24, 2009 (JCX-21-09), <http://www.jct.gov/publications.html?func=startdown&id=1687>.

The answers that we eventually come to in responding to questions that we are asking in this hearing will, in part, determine whether the United States is able to continue to rely on the spirit and ingenuity of a dynamic middle class, or if the middle class is to be shredded by the tax code and parceled out to fund corporate welfare and welfare benefits for people who do not pay income taxes.

Under current law, Americans will be subject to the largest tax increase in history in 2011 if Congress does nothing. In other words, without a vote of Congress, we will have the largest tax increase in the history of the country.

I have a chart I would like to show here of the impact that this could have on a family of four with \$50,000 in annual income. They will be subject to a tax increase of \$2,300. The next chart shows the tax increase faced by a single-parent household with two kids and \$30,000 in income, which is \$1,100. So I think it is pretty clear what is at stake here, keeping in mind that these tax increases are only what is now built into current law. They do not include items in the President's budget, like the cap-and-trade tax that would increase energy prices on these very same families as well.

For a long time now I have been urging the Democratic leadership to tear down this wall, and it seems that my message has finally been heard, at least partially. President Obama's budget makes most of the bipartisan tax relief of 2001 and 2003 permanent. We now have agreement on issues like the marriage penalty. Working families will be able to continue to count on lower rates. Low-income seniors who are counting on their capital gains and dividend income can sleep a little easier.

The fourth example I will give, but not the end of all the examples that could be given, is the ravenous monster that the Alternative Minimum Tax is will be held back from the middle class. If Democrats in Congress share President Obama's commitment to tearing down at least part of this wall, then they will find allies on my side of the aisle to do that.

As pleased as I am to find that the new President has come to agree with me on these issues, there is still more that we need to do, especially in these formidable economic times that we are in. President Obama intends to allow parts of the 2001 and 2003 tax relief to expire that, if extended, will continue to provide incentives for the creation of jobs and the resuscitation of the economy: provisions such as the marginal rate reductions in the top two income tax brackets, the repeal of the phase-out of personal exemptions and itemized deductions, and dividends and capital gains reductions for everyone.

These provisions helped grow the economy when they were put into effect. These provisions then, common sense tells me, could be a valuable tool in a recovery, if we do not cast them aside. Many of my colleagues are skeptical of any income source that is not a check from the Federal Government, but the 2001 and 2003 tax relief packages did not benefit the rich, or let us say did not benefit just the rich, as some are leading us to believe. In fact, these packages are part of a broad trend where our tax system has become more progressive—let me emphasize that, more progressive—over

the past several decades. Why can we not get through to some people that the tax code has become more progressive in this process?

Recent tax relief has continued to shift more of the Federal tax burden onto wealthy households, while lowering rates or eliminating Federal income tax liability for many middle-income and lower-income households. One of today's witnesses cites the Congressional Budget Office data in showing that income taxes, as a percentage of income, have fallen more for low-income and middle-income households over the past several decades than they have fallen for wealthy households. This indicates that, as a percentage of Federal income tax revenue, the tax burden on our wealthiest citizens has steadily increased over time, while it has decreased for lower- and middle-income households.

This chart is derived from CBO data, showing how effective Federal tax rates have changed from 1979 through 2005. It shows those changes for two groups. One group is Americans in the top 5 percent in terms of income, and the other is everyone else, the remaining 95 percent. The blue line represents the top 5 percent, the red line represents the remaining 95 percent. The vertical line shows where rates were in 2000.

According to an analysis of CBO data, the effective tax rate for the top 5 percent of earners was around 31 percent in 2000 and the effective rate was around 20 percent for everyone else. In 2005, the effective rate had decreased to around 29 percent for the highest earners and 17 percent for the other 95.

In a period where effective tax rates declined by roughly 2 percent for the top 5 percent of earners, rates decreased by 3 percent for the remaining 95 percent. The tax relief enacted in 2001 and 2003 decreased effective Federal tax rates for the bottom 95 percent more than it did for the top 5 percent. What has been maligned as tax cuts for the rich increased the share of Federal taxes paid by that category.

What we as a committee take from this hearing will be very important. I hope that my colleagues come away with a better understanding of what we need to do to drive our economy out of the hole that we are in and why we should fully extend and make permanent the 2001 and 2003 bipartisan tax relief so that we are able to offer everyone a ladder to productivity and prosperity.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

I would now like to introduce the panel. The first witness is Paul Taylor, executive vice president at the Pew Research Center. Thank you, Mr. Taylor, for joining us today.

Second is George Yin, whom we all know here as former Director of the Joint Committee on Taxation, and now professor at the University of Virginia School of Law. Thank you again, Mr. Yin. Good seeing you again, George.

Then we have Robert Greenstein, executive director of the Center on Budget and Policy Priorities. And Bob, I am very sorry to hear that your wife was in an accident Monday. Apparently her legs are not in very good shape. But thank you for taking the time to be here. I know your thoughts are very much with her, but you are here today to help out, too. So we deeply appreciate that and hope for a speedy recovery for your wife.



Finally, we have Alan Viard, resident scholar at the American Enterprise Institute.

As is our regular practice, and we will follow it, I ask each of you to give about a 5-minute statement. Your statements will automatically be in the record.

Mr. Taylor?

**STATEMENT OF PAUL TAYLOR, EXECUTIVE VICE PRESIDENT,  
PEW RESEARCH CENTER, WASHINGTON, DC**

Mr. TAYLOR. Thank you, Chairman Baucus and Ranking Member Grassley, for the opportunity to testify.

Let me say at the outset that I am neither a tax policy expert nor an economist. I am the lead author of a major report that the Pew Research Center published last year on the middle class. We looked at the subject through two lenses: a nationwide public opinion survey in which we asked people what it means to be middle-class, and an analysis of the major economic and demographic trends that have affected the middle class since 1970. The report was long; it ran nearly 200 pages. This morning, let me just very briefly summarize about a half-dozen key points.

First, when we asked people in our survey to identify what class they are in, 53 percent said they were middle class. But it was very clear from our survey that self-identifying as “middle-class” is as much an expression of a state of mind as it is a statement of income and assets.

For example, younger adults and older adults are both more likely than middle-aged adults to identify as middle-class, even though middle-aged adults have more income. The reason is that middle-aged adults also have more financial burdens. Similarly, blacks, whites, and Hispanics are all equally likely to identify as being middle-class, even though the whites who do so have considerably more income than the blacks and Hispanics who do so.

Overall, our survey shows that how much money people think it takes to be middle-class correlates directly with their own income: the higher the income, the higher the bar people set for living a middle-class lifestyle.

Our second major finding was that the middle class feels stuck in its tracks. We did our survey 13 months ago, in the early days of a recession that had not yet been officially declared, but even then, when we asked people how they were doing in life compared with 5 years before, we got the most downbeat reading on this question in the half-century it has been asked by the Pew Research Center and other polling organizations. Nearly 6 in 10 middle-class respondents said that they either had not moved forward in life in the past 5 years or had actually fallen backwards.

When we examined census data, we could see why people feel this way. Our third key finding was that inflation-adjusted median household income, arguably the best single indicator of the middle-class standard of living, had not yet surpassed the peak it reached in 1999.

We have since updated this analysis with another year of census data, and this still holds true, making the current decade the longest stretch of years in the modern era in which this key indicator has remained at or below its previous peak, first during a shallow

recession at the beginning of this decade, but later during 6 years of economic expansion that ran through the end of 2007. So for the typical American household, the great recession that began 15 months ago was preceded by an equally unusual, if slightly less dramatic, phenomenon: a phantom recovery.

The picture is very different and much more positive when we lengthen our time horizons. Our fourth finding is that, since 1970, median household income has risen by 21 percent in inflation-adjusted dollars. If you correct for the changes over this time period in average household size, the effective increase has been 41 percent.

Moreover, the middle class understands this. Just as they are frustrated by a sense of stagnation in the short term, they also appreciate a rising standard of living over the longer arc of their own lives. In our survey, two-thirds of middle-class respondents say they are doing better in life than their parents did, just 10 percent say they are doing worse.

But there are also some less positive long-term trends that the middle class is keenly aware of. Our analysis of all key data related to middle-class family finances—income, wealth, consumption, expenditures, debt, et cetera—tells one consistent story. Even as the middle-class standard of living has risen since the 1970s in absolute terms, it has fallen behind relative to the folks above them on the socioeconomic ladder.

Thus, the past 4 decades for the middle class have been a period of rising prosperity and rising inequality. By contrast, the economic period before that, from the end of World War II through the early 1970s, had been a time of rising prosperity and declining inequality.

Finally, we examined the changing economic and demographic composition of the middle class since 1970. We found that it has shrunk a bit over time, reflecting a dispersion of slightly greater shares of the population into both the upper- and the lower-income tiers. We found that, demographically, the middle class has changed since 1970 in much the same way that the country as a whole has changed: it is older than it used to be, it is less white than it used to be, it is better educated than it used to be, and it is less likely to be married.

We covered a lot of other ground in our report, and also in my written testimony, but I think I have used up my time for now. I would welcome the opportunity to answer your questions. Thank you.

The CHAIRMAN. Thank you, Mr. Taylor. That was very interesting.

[The prepared statement of Mr. Taylor appears in the appendix.]

The CHAIRMAN. Mr. Yin?

**STATEMENT OF GEORGE YIN, EDWIN S. COHEN DISTINGUISHED PROFESSOR OF LAW AND TAXATION, UNIVERSITY OF VIRGINIA, SCHOOL OF LAW, CHARLOTTESVILLE, VA**

Mr. YIN. Thank you, Mr. Chairman, Senator Grassley, members of the committee. Thank you for inviting me to testify at this hearing today. It is a pleasure to see you both once again.

I will quickly make just four points. First, the committee should allow the expiring income tax cuts to lapse, including those applicable to middle-income taxpayers. The country simply cannot afford them. I have included in my testimony today CBO projections showing the dire and imminent fiscal crisis facing the country, and these projections do not include all of the recent events stemming from the financial crisis that have likely made the outlook significantly worse. The Bush tax cuts may or may not have been wise in the first place, but that debate is now long past. We simply cannot afford them in the future.

Second, other deficit-reducing options, including reforming health care and entitlements and increasing other taxes, are not sufficient to substitute for letting the income tax cuts lapse. The fiscal situation is so bleak that we must make dramatic reductions in spending and find additional revenue sources. In this context, letting the income tax cuts lapse is a comparatively easy option, and the committee should take it.

Third, fairness considerations do not justify extending any of the tax cuts. Although some may believe that the Bush income tax cuts disproportionately benefitted the wealthy, I include in my testimony data from the IRS that does not support that conclusion. That said, just as we are beyond the point of debating whether the Bush tax cuts were wise in the first instance, we are also past the time of worrying about their distributional effect.

Letting all of the income tax cuts expire across the board would return the country approximately to the tax system of the last Democratic administration. That policy decision would, first, address concerns that the tax cuts have disproportionately benefitted the wealthy; second, be fiscally responsible; and third, be consistent with the principle of shared sacrifice during this very challenging time for the country.

Finally, Congress should agree now on a target level of economic growth that would have to occur before any tax cuts would be allowed to expire. The agreement would provide for a continuation of the cuts until the target is achieved, but also expiration of the cuts once the target is met. It may be easier to reach agreement now, committing to this balanced and responsible future action while the committee and the Congress are somewhat blind to the precise timing, than to wait and try to obtain consensus at the future time.

As Mr. Taylor's research indicates and as we all know, my policy prescriptions today are politically unappealing. No one likes taking the steps I have advocated; I certainly do not. But the core numbers indicative of an imminent fiscal crisis do not lie. We are beyond the point of being able to kick this problem down the road a little further.

As our Nation's leaders, you must persuade the American public that, unless steps like the ones I have described are taken very soon, we risk such serious economic disruption in this country as to make recent events look like child's play, and even worse, we risk the possibility of triggering global instability and geopolitical conflict.

With respect, Mr. Chairman and Senator Grassley, I would just like to comment on the point that letting the tax cuts lapse will result in a huge tax increase. In my view, Congress has already

passed that huge tax increase by passing spending programs that are not sufficiently financed. Since there is no free lunch, the effect is to have passed a large tax increase to finance all of that spending. The only question before us is, when will that tax increase occur, and on whom? My point, simply, is that the sooner and the more broad-based the tax increase, the less economic disruption for the country.

I am happy to answer any questions you may have.

The CHAIRMAN. Thank you, Mr. Yin, for your very forthright statement. I really appreciate that very much. Thank you.

[The prepared statement of Mr. Yin appears in the appendix.]

The CHAIRMAN. Mr. Greenstein?

**STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC**

Mr. GREENSTEIN. Thank you, Mr. Chairman. Thank you for your kind words about my wife.

I would like to start, also, with a brief note on the fiscal context. I share Mr. Yin's view about the seriousness of the fiscal situation that the Nation faces, which was reinforced by the Congressional Budget Office report released last week.

Now, it does seem clear to me that those tax cuts enacted in 2001 and 2003, that affect people with incomes up to about \$250,000 a year, are going to be made permanent. That seems to be the position of a majority in both parties up here, and the President.

So I wanted to talk a little bit about the major outstanding issue politically, which is the disposition of the tax cuts for those at the top of the income scale. It does seem to me, given the Nation's fiscal position, that extending those tax cuts, particularly without paying for them, would be unwise from both a budgetary and an economic standpoint.

Research suggests that extending these tax cuts without paying for them would likely reduce long-term growth because of the corrosive effects of the increased debt. That conclusion emerges from the work of CBO, the Joint Tax Committee, and others.

I also wanted to make a few points about the President's proposals under which the income tax cuts at the top would be allowed to expire at the end of next year. Those proposals have been criticized by some as producing a high tax burden and high-tax government and imposing crushing burdens on high-income Americans in general, and small business in particular. So, I wanted to take a brief look at those charges.

Now, regarding the charge that it would lead to high levels of taxation, the CBO report issued last Friday shows that, under the President's proposals, total Federal revenues would average 18.4 percent of GDP over the next 10 years, about the average over the last 30 years. I would note that in 4 of the last 30 years when the budget was balanced, in every one of those, revenues were between 20 and 21 percent of GDP. Nor do I think it is the case that allowing the tax cuts at the top to expire would result in crushing tax burdens on people at the top.

The Urban-Brookings Tax Policy Center data show that average tax burdens, the percentage of income paid in Federal tax, for virtually every income group, including the top 1 percent, would be lower under those proposals than it was in the 1990s, a period when the economy boomed. It is sometimes overlooked that, if one extends the 10-percent bracket, marriage penalty relief, the reduction in the rates in the brackets right below the two top brackets, and the like, that the benefits from that go to everyone, including the people at the top of the income scale.

This is why even high-income people, under the President's proposals under which the tax cuts at the top would be allowed to expire, would pay a smaller percentage of their income in Federal taxes than under the pre-Bush policies.

Nor would the proposals oppress small business. The latest Tax Policy Center data show that only 2.2 percent of people with small business income would be in the top two tax brackets, and hence affected by the proposal to allow the rate reductions in those brackets to expire. A higher figure has been cited recently, as I can explain in Q&A. The higher figure is based on a misapplication or a misunderstanding of a Treasury report from several years ago and is not accurate.

The number of small business owners who would benefit from the middle-class tax cuts that would be extended dwarfs the number who would be affected by allowing the tax cuts at the top to lapse. A little-known fact: the number of small business owners who get the Earned Income Tax Credit is 10 times the number of filers with small business income who are in the top two brackets.

There is also little evidence for the claim that a return to the Clinton-era rates of taxation at the top of the income scale would seriously injure small businesses or damage U.S. job growth. If that were the case, the experience of the last 2 decades would show small business job growth was faster in the years when the Bush tax cuts were in effect than in the Clinton years when the rates were higher, but the opposite is true.

The average rate of small business job growth was twice as high in the Clinton years, 756,000 jobs per year, an average job growth rate of 2.3 percent per year, as it was under President Bush before the current recession set in, when it was 367,000 jobs per year, or 1 percent per year.

There is also the issue of increased inequality and after-tax income. CBO data show that the 2001 and 2003 tax cuts widened the inequality further. Particularly noteworthy is the Tax Policy Center estimate that, in 2010, households with incomes of over \$1 million a year will receive an average tax cut from the 2001 and 2003 tax changes of \$158,000 each, compared to \$810 for households in the middle of the income scale. Given the fiscal situation Mr. Yin described, it is difficult to see how we can afford that.

My final point is, there is strong merit, I believe, in the administration's proposals to extend the expansions in the Child Credit, the Earned Income Tax Credit, and the American Opportunity Credit that you and your colleagues enacted on a temporary basis in the recent economic recovery legislation, and to pay for the cost of those extensions. Those extensions should better reward work

among many low-income parents, increase educational attainment and productivity, and significantly reduce child poverty.

Thank you.

The CHAIRMAN. Thank you, sir. Thank you very much.

[The prepared statement of Mr. Greenstein appears in the appendix.]

The CHAIRMAN. Next, Mr. Viard?

**STATEMENT OF ALAN VIARD, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC**

Mr. VIARD. Thank you, Mr. Chairman, Ranking Member Grassley, members of the committee. It is an honor to testify here today about middle-class tax relief. The views that I express are my own and do not necessarily reflect the views of any other person or any organization.

Congress faces important decisions in the next 2 years about middle-class tax relief, including the decision of whether to extend the middle-income provisions of the Bush tax cuts and whether to extend the stimulus tax relief.

I recognize, as George Yin mentioned, that middle-class tax relief is politically popular. It was embraced during the presidential campaign, both by President Obama and by his Republican opponent.

Nevertheless, Mr. Chairman, I respectfully recommend that Congress not adopt a broad package of permanent middle-class tax relief at this time. Substantial tax reductions have already gone to low-income and middle-income households over the last 3 decades. Middle-class tax relief would add to the fiscal imbalance, as George Yin has discussed, and would do little to improve economic incentives. Capital formation would be impeded, reducing labor productivity. In short, adoption of a large package of middle-class tax relief would increase the fiscal burden on future middle-class taxpayers and reduce the wages of middle-class workers.

From the standpoint of economic growth, it is particularly troubling to extend middle-class tax relief while allowing the expiration of many of the provisions of the Bush tax cuts that provide a stronger boost to economic incentives, such as the reductions in the top brackets.

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 along the line that Senators Conrad and Gregg have proposed would be a good way to help produce such a compromise.

In the remaining time, Mr. Chairman, let me briefly review the points that I made in my written testimony. I provide Congressional Budget Office data, some of the data that Senator Grassley mentioned earlier, that documents the decline in tax burdens for low- and middle-income households since 1979. Federal income taxes have fallen particularly sharply for those groups and, indeed, many lower-income households now have negative income tax liabilities.

Payroll taxes, of course, do hit workers at the bottom harder than do income taxes. Now, I am not sure that the payroll taxes should be included in the analysis without also including the progressive benefits provided by Social Security and Medicare Part A

that are financed by those taxes, but, in any case, including payroll taxes in the analysis does not change the basic picture. Figure 2 in my written testimony shows the decline in total Federal tax burden since 1979 as being greater for the bottom and middle quintiles of the income distribution than for the top, even with payroll taxes fully included, even with employee and employer payroll taxes assumed to fall on workers.

Figure 3, on page 5 of my testimony, shows the distribution of the total Federal tax burden in 2005, again, including employee and employer payroll taxes. It shows a highly progressive tax system with the top 1 percent of the income distribution bearing more than 25 percent of the total Federal tax burden, a higher share than represented by its share of national income.

Now, a major advantage of tax relief is that it can boost incentives to work and save. Unfortunately, middle-class tax relief provides only a limited boost to incentives. The key incentive variable is the marginal tax rate, the rate that applies to the last dollar of a household's income.

The question is not how much in taxes the household is already paying, but how much more it will pay if it earns another dollar of income. A reduction in any given tax bracket boosts incentives only for those households that face that bracket on the last dollar of their income, even though taxes go down and revenues are lost with respect to households that have any part of their income taxed in that bracket.

As I show in Figure 4 of my testimony, there is great variation among the six ordinary tax brackets in that regard. The bottom 10 percent bracket is a marginal bracket only for a quarter of the tax returns that have some income taxed in that bracket. In contrast, each and every household that has any income taxed in the top 35 percent bracket does face that rate on the last dollar of income, as must be true for the top bracket.

The chart that I have in my testimony actually understates the relative importance of the top brackets, because the top brackets are marginal for those households that have the largest amount of income and do the largest amount of saving.

Tax credits, which are a major part of the stimulus tax relief and were also part of the Bush tax cuts, generally do even less to improve economic incentives. If those credits are phased out as income rises, they can actually impair economic incentives in particular income ranges.

Finally, as George Yin mentioned, middle-class tax relief will significantly widen the fiscal imbalance. In Figures 5 and 6, I have taken the CBO's analysis of the President's proposed budget and modified it by removing tax relief that is targeted towards the middle class. I compute that, without that relief, the deficit would be 3.6 percent rather than 5.7 percent of GDP in fiscal 2019, and the debt at the end of that year would be 69 percent rather than 82 percent of annual GDP. Of course, widening the fiscal imbalance impedes capital accumulation, which reduces wages for middle-class workers and imposes fiscal burdens on future middle-class taxpayers.

Let me mention that the stimulus tax relief, in particular, was adopted as a temporary measure to help workers during the reces-

sion and to provide a Keynesian stimulus to aggregate demand. Those considerations do not warrant permanent extension. In particular, Keynesian economics does not call for permanently increasing aggregate demand in a futile attempt to permanently boost output. Instead, it calls for increasing demand when the economy is weak and reducing it when the economy is strong in order to stabilize output.

The middle-class tax relief is locked securely into place for the next 21 months, as President Obama and OMB Director Orszag have mentioned in recent days. If the recession proves to last longer than expected, a temporary extension clearly can, and will, be provided.

In summary, Mr. Chairman, permanent middle-class income tax relief should be considered as part of a bipartisan fiscal compromise that addresses the long-term imbalance. Appointing a bipartisan commission along the lines proposed by Senators Conrad and Gregg would be a desirable way to help bring about that compromise. The best way to help the middle-class, and all Americans, is not to rush into middle-class tax cuts, but rather to adopt a fiscal framework that ensures long-run growth.

Thank you. I am eager to take your questions.

The CHAIRMAN. Thank you. Thank you, Mr. Viard.

[The prepared statement of Mr. Viard appears in the appendix.]

The CHAIRMAN. If I can, I have two questions, basically, for Mr. Greenstein and Mr. Yin, if you could, to try to more sharply determine your disagreement. As I understand it, Mr. Yin, you say, do not extend any of them because of the fiscal problems we are facing. Mr. Greenstein, you say, yes, extend the middle-income rates, I guess, because it is good in the short term.

So is this a short-term/long-term difference of opinion? Either one of you might explain why you think the other one is not accurate, not right.

Mr. GREENSTEIN. I am not sure there really is that strong a disagreement here. Historically, we at the Center on Budget and Policy Priorities, along with groups like the Concord Coalition and Committee for Economic Development, have taken the position that any extension of the tax cuts should be paid for. I would certainly prefer to see any extension of the tax cuts paid for.

I think my testimony is reflecting my assessment of political reality. It seems clear to me that there is pretty strong agreement across both parties and the White House that the middle-income tax cuts should be extended and that offsets will not be required. What my testimony is reflecting is, if that is the case, let us limit it to that and say that anything beyond that either is not extended, or, if it is extended, is fully paid for.

The CHAIRMAN. Well, there is sort of a ghost behind what you are saying, that you think, academically and intellectually, irrespective of politics, if I am understanding you correctly, my sense of what you are thinking is that they, too, should not be extended.

Mr. GREENSTEIN. I have some sympathy for Mr. Viard's recommendation. I think back to Andrews Air Force Base in 1990—

The CHAIRMAN. Yes. I remember that.

Mr. GREENSTEIN [continuing]. Through a major negotiation where everything on Medicare, Social Security, the entire tax code,



individual, and corporate is on the table, and we look at the long-term fiscal problems and deal with it.

The CHAIRMAN. Nobody wants to go through that again, let me tell you.

Mr. GREENSTEIN. Sooner or later, I am afraid it is inevitable, because we are on an unsustainable fiscal course. But my testimony is attempting to reflect where we are now, from both a standpoint of issues like equity and fiscal responsibility, to sort of weigh them and say, all right, if we are extending the middle-income tax cuts as the President has proposed, then it seems to me—for which there is overwhelming support in both parties—let us at least say—

The CHAIRMAN. All right.

Mr. GREENSTEIN. As I said, I strongly favor extending a number of the refundable credit improvements in the Recovery Act.

The CHAIRMAN. Right.

Mr. GREENSTEIN. But I favor paying for them.

The CHAIRMAN. All right. My time is expiring so, if you could be very brief, because I have one more question.

Mr. YIN. Yes. Thank you, Mr. Chairman. Just one quick comment, which is, my recommendation is that I think that this is the fiscally responsible step to take. I do lay out in my testimony a number of other options to address the fiscal crisis.

The CHAIRMAN. All right. Right.

Mr. YIN. In my view, of all of the options, this is in some sense the easiest option to take, based on principles of equity, efficiency, and administrability. I address the issue about equity in my testimony and try to make the point that letting all of the tax cuts lapse is not inequitable.

The CHAIRMAN. Right. All right.

Mr. YIN. From efficiency, Dr. Viard's point is, I think, correct, that to some extent, the middle-income tax increases would be inframarginal and would not have the kind of distortive effect on efficiency that other changes would have.

The CHAIRMAN. I appreciate that very much. I am sorry to have to encourage you to truncate your statement.

The next question is the effect on small business. A lot of people say, if middle-income tax cuts are extended, but the top two tiers, top two rates are not, that that is going to have an adverse effect on small business in America.

Two statistics I have seen—the data from the Tax Policy Center indicates that about 2.2 percent of people with small business income fall in the top two tax brackets. On the other hand, I have heard that some say that small business income from the top two brackets accounts for nearly 70 percent of small business income. It depends on what your ideology is, I guess, or what axe you are trying to grind here. But what is the truth? To what degree will non-extension of the top two brackets have an adverse effect on American small business? This is a very important question.

Mr. GREENSTEIN. Mr. Chairman, we have looked at both sets of data. Maybe I can try to illuminate this. The higher figures come from a Treasury study from 2007, and there is a misunderstanding of what that study did and what it showed, so some statistics that are in some tables in that study have been misunderstood and mis-

applied. There are two problems. It distributed a subgroup of small business owners, people with small business income, and only looked at a fraction of them.

At least, the tables that are being cited, the figures you mentioned, are a subset of small business owners. Second, the big problem with the figures that are being cited is that what that Treasury study did was, it distributed small business owners by the tax bracket they would be in if there were no Alternative Minimum Tax. But there is.

Under the AMT, as you know, a very large share of people between \$250,000 and \$500,000 a year do not pay in the 33- or 35-percent brackets now, they pay at the AMT rate of 28 percent. If you raised the 33-percent rate back to 36 and the 35-percent rate back to 39.6—in other words, if you allow that to occur at the end of 2010—to the degree that people are still under the AMT, they still pay the 28-percent rate. They are not affected then by the increase in the top brackets.

The difference between the 2.2-percent figure and the 7- or 8-percent figure is in large part the difference of whether you act as though the AMT does not exist or you act as though it does exist and the patch is continued. The Tax Policy Center data assume that the AMT continues, that the current patch is continued, and indexed for inflation. The Treasury data take all those people who are not really in the two top brackets because they are under the AMT and it puts them in the two top brackets and it makes it look, therefore, like they would be affected, but they really would not be.

The CHAIRMAN. My time is expiring. I went way over my time, frankly. But I think this is an important issue. With the indulgence of the rest of the members, just very, very briefly, like in 30 seconds, get to your last point.

Mr. GREENSTEIN. Well, the last point is that, if you look at it, it turns out that the subgroup of small business filers who are in the top two brackets under the Treasury study constitutes  $\frac{1}{2}$  of 1 percent of all small business filers. It is smaller than the 2.2-percent figure because they took a subgroup that is more likely to be affected, and then that number is inflated by ignoring the AMT.

The CHAIRMAN. Thank you very much.  
Senator Grassley?

Senator GRASSLEY. Yes. I want to go to something that Mr. Yin and Mr. Viard brought up about PEP and Pease, kind of like a non-transparent tax rate increase. In fact, according to an analysis by my staff, a married couple in 2011, filing jointly in the 36-percent income tax bracket, with two children, could effectively be paying a hidden tax of an additional 5 percent, thus, the effective income tax rate would be 41 percent and not what people are led to believe would be 36 percent. It is kind of a double-whammy, because this exact same couple, only a year before in 2010, would be in the 33-percent bracket and without any PEP and Pease limitations, because PEP and Pease were temporarily phased out, as you know. So they would jump from 33 to 41 percent in just 1 year without any change of income.

So my preference and the best option would be to have PEP and Pease eliminated without any offsetting tax rate increase, and the

worst option would be to have PEP and Pease become full force in 2011.

Given the President's stated praiseworthy commitment to transparent budgeting, I would think the administration would not desire to return to PEP and Pease. So my first question would be to Professor Yin. When, in your testimony, you call for allowing the Bush tax cuts to lapse, it appears that you were mostly just talking about the statutory rate cuts and the increases in the Child Tax Credit. What is your advice on PEP and Pease limitations?

Mr. YIN. Thank you, Senator Grassley. My thoughts on PEP and Pease are quite straightforward. The decision on whether to let PEP and Pease return is strictly an issue of how redistributive you want the tax system to be. That is obviously an issue that you all are going to have to resolve.

If you were to decide that you in fact want to have a tax system that is redistributive to the extent of bringing back the PEP and Pease limitation, then my strong recommendation would be consistent with your point, Senator Grassley, which is, you should do it explicitly by simply raising the marginal income tax rates on the effective taxpayers and eliminating the PEP and Pease mechanism for getting to that level of redistribution.

Senator GRASSLEY. I was going to ask Mr. Viard and lead into a question, but I think you are already shaking your head. So would you comment at this point? Then I will not have to ask my question.

Mr. VIARD. Yes. I agree that, if these marginal rate increases are to occur, they certainly should be done in a transparent manner. The proliferation of income-based phase-outs of credits and deductions in the code has been a major loss of transparency and a major increase in complexity in the code, which I think allows greater disincentives to be introduced, with less political attention to the consequences of it.

I do think that by putting marginal rate increases at the top, which is what the Pease provision clearly does, the PEP provision also applies at relatively high income levels but does not increase marginal rates at the very top, but with the Pease provision especially, you are causing a significant disincentive effect, which will cause an adverse effect on economic activity, including small business activity, for example, but not limited to that.

I do disagree, in significant part, with some of the comments Mr. Greenstein made on small business. But I think it is preferable to avoid putting disincentives at these income ranges, and, if disincentives are introduced, they should be done honestly, openly, in the light of day.

Senator GRASSLEY. My last question I will have to have short answers on, because it is to the whole panel. The administration has called for the reinstatement of PEP and Pease for singles with incomes over \$200,000 and married couples over \$250,000. So this sounds to me like it is going to reinstate the marriage penalty. Do you agree? Is it true that PEP, especially, hits families with more children?

I will start with you, Mr. Taylor.

Mr. TAYLOR. Again, this is not my domain.

Senator GRASSLEY. Then let us go on to Professor Yin.

Mr. TAYLOR. Let us go on. Sure.

Mr. YIN. I am going to have to look at the analysis a little more closely to be able to give you a specific answer. I would be happy to convey that to you or through your staff.

Senator GRASSLEY. Mr. Greenstein?

Mr. GREENSTEIN. I would put what are the best and worst alternatives in different orders. To me, the worst alternative would be to extend the repeal of Pease and PEP, losing large amounts of revenue and worsening the fiscal condition of the country. I think if we look at the experience when they were in effect in the 1990s, the economy did very well: people at the top did not lack for incentives to save or invest; income grew much more among the top 1 percent in the 1990s than among anybody else.

I do agree that it would be preferable to raise the same amount of money more explicitly through dealing with the rates directly, but, if that is not possible, given the revenue that Pease and PEP raise and its importance for the deficit, then I would adopt the President's proposal.

Senator GRASSLEY. So then, if it does affect the marriage penalty and reestablishes a marriage penalty, that would be all right with you?

Mr. GREENSTEIN. The evidence that the marriage penalty has any effect on marital behavior among people who make half a million, a million, or \$5 million a year is near zero. The proposal that I understand the President has made is to make permanent marriage penalty relief where it does have an effect, at low- and middle-income levels of the income scale. It has virtually no effect on behavior that high up on the income scale.

Senator GRASSLEY. Mr. Viard?

Mr. VIARD. I have not looked specifically at how Pease and PEP affect the marriage penalty, but the reinstatement of the top two brackets, going back up to 36 and 39.6 percent, would have some impact numerically on the size of marriage penalties and marriage bonuses at that income level. The majority of households at the very top do face a marriage penalty because the income cut-off at which the top bracket starts is the same for unmarried taxpayers as for married couples, which is contrary to the practice with the other brackets. So you have a majority of taxpayers, I think, in those income levels facing a marriage penalty. There are some taxpayers who face a marriage bonus if all of the income, or most of the income of the couple, is earned by one spouse.

If you have those two top brackets increased, it basically magnifies the size of the marriage penalties and also magnifies the size of the marriage bonuses, so the net impact, I think, is an increase in the marriage penalty. I do agree with Mr. Greenstein, however, that any impact on marriage behavior or decisions to get married would be extremely minuscule or non-existent.

Senator GRASSLEY. I guess what bothers me is such a cavalier attitude towards the institution of marriage.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Next, Senator Menendez. He is not here.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

To go back to the issue, Mr. Greenstein, of the impact on small businesses, as the ranking member of the Small Business Committee, I am certainly concerned about that. It still seems to be, I think, a confusing subject in terms of exactly what effect it would have on small business. We are trying to get data from the Small Business Administration; they are in the process of conducting a study that should be shortly released that could confirm some of the issues that you have raised here today.

But also, we are guided by the definition of the IRS, which is on gross receipts of \$10 million or less. Yet on the other hand, when we measured job growth, again, it looks at the number of employees of a small business, which generally is the traditional definition of 500 or fewer.

Is it fair to use the \$10 million gross receipts, because many are small manufacturers, for example, and so the issue of taxation certainly could have a direct impact on small manufacturers?

Mr. GREENSTEIN. I would like to consult with people on my staff who have more expertise on this question of what is the best definition to use and get back to you.

In the data we looked at in my testimony, where we looked at rates of small business job growth, we looked at the traditional definition, as you mention, of under 500 employees. But I would be happy to look into the pros and cons of the different definitions and get back to you or your staff.

Senator SNOWE. Yes. Mr. Yin, do you have any comments on that?

Mr. YIN. I am afraid I do not have anything to share in terms of the definition of small business at this point.

Senator SNOWE. Mr. Viard?

Mr. VIARD. I cannot speak to the definition of small business, Senator. If you wish, I can make some comments with respect to how increases in the top two brackets would affect small businesses.

Senator SNOWE. I would appreciate that.

Mr. VIARD. All right. I think that Mr. Greenstein has made some good points, but most of his data refer to the number of small business owners who would be affected by the increases in the top two brackets. Of course, that is relatively small. But I think that is not the relevant economic variable. What we care about is the volume of income and economic activity that would be affected by those top two brackets. I think it is clear that that would be substantial, under any definition of small business.

Some interesting numbers are actually provided by the Tax Foundation, Fiscal Fact 152, released October of 2008, written by Robert Carroll. He shows that households with adjusted gross income of \$200,000 or more account for 67 percent of the total small business income. So you have a definite concentration of small business income at that level. Obviously, many of those households will be affected by increases in the top two brackets, but not all of them, because some would be on the AMT and some would be in the third-from-highest bracket.

Mr. Greenstein also pointed out that a large number of small business owners benefit from the Earned Income Tax Credit and the Child Credit and other middle-income relief. I think that is ab-

solutely true. However, those provisions in general are not going to provide an incentive for increased investment by small businesses. They are not going to reduce the marginal tax rate.

In fact, for example, some of those small business owners who are on the Earned Income Tax Credit might be in the phase-out range of the credit and would therefore face disincentives, rather than incentives, to invest. So I think the real incentives to investment do affect the top rates.

Senator SNOWE. I appreciate that.

Mr. Greenstein?

Mr. GREENSTEIN. Our analysis, looking at the Tax Policy Center data and the data that underlie the study that Mr. Viard just cited, the Tax Foundation study, suggests that the large majority of those businesses Mr. Viard just cited actually are not affected because they are either on the AMT or in a bracket lower than the top two brackets. Of course, it is also the case that, if small businesses invest, the money spent on investment does not come out of after-tax income, it is business expenses. You only pay taxes on the profits.

How does one put all this together? I would suggest that perhaps the most relevant data involve looking at what happened to small business job growth during the period in the 1990s when the higher tax rates at the top were in effect, as compared to the period from 2001 to 2006—I am excluding the recent recession—when the lower rates were in effect.

That is where we find that the rate of small business job growth was twice as high in the 1990s when the top rates were in effect as in the more recent period when the lower rates were in effect. The bottom line, I think, is that the connection between whether the top rate is 35 or 39.6 and small business investment and job growth is very weak.

The negative effect on small business from much higher deficits and debt and the impact on the capital stock, and thereby on interest rates and other things, would be much greater. I think the impact on small business would be more harmful from making all the tax cuts, including those at the top, permanent and not paying for them and looking at the long-term and mid-term effects on the economy of levels of deficits and debt at that level.

Senator SNOWE. Could Mr. Viard just respond?

The CHAIRMAN. Go ahead. Go ahead.

Mr. VIARD. May I respond, quickly?

The CHAIRMAN. Go ahead.

Mr. VIARD. Thank you, Mr. Chairman. I appreciate your indulgence. I need to correct a statement I made, Senator. I misspoke in saying that 67 percent of the small business income was \$200,000 or more; rather, the study says that 67 percent of the returns in that category had small business income. But Mr. Carroll does cite the Treasury finding that over 70 percent of small business income goes to taxpayers in the top two brackets.

But Mr. Greenstein stated that investment is made from before-tax income. That is only true under a consumption tax where investment can be immediately expensed. We have an income tax system in this country. Except for provisions like section 179, investment is not expensed and depreciation is deducted over time.

The income tax does reduce the net rate of return from investment and does penalize investment.

Senator SNOWE. Thank you.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. I thank our panel.

For middle-class Americans at this time of the year, the American tax system is just bureaucrat water torture, and it is easy to see why. There have been thousands and thousands of tax changes to the code made in just the last few years. It comes to three for every working day, three tax changes for every working day, year in and year out. It is my view that it is time to fix this out-of-control system. That is what I want to ask you all about.

To me, the model for tax reform is 1986, where you go in there and you clean out the clutter, you close these loopholes, broaden the tax base, and hold down everybody's rates, while at the same time keeping progressivity. My view is, you take those principles and add a 30-line 1040 form, which is in legislation that I have had for some time with Rahm Emanuel, when he was in the House, and you are ready to go. So I just want to go down the row. The chairman and Senator Grassley have indulged me over the years, because I think I have asked 20 witnesses this over the years.

Starting with you, Mr. Taylor, in terms of the fundamentals of tax reform, not the specific rates and the amounts, is it your view that the 1986 model that I have outlined, cleaning out the clutter, broadening the base, holding down the rates, keeping progressivity, is still a pretty good model to guide the Senate Finance Committee on tax reform? Let us just go right down the row on the question about whether it is a good model.

Mr. TAYLOR. As I said earlier, I am not an expert witness on tax policy, but I am a citizen of the United States and it sounds pretty good to me.

Senator WYDEN. All right.

Mr. YIN. Senator Wyden, the answer is yes.

Senator WYDEN. Mr. Greenstein?

Mr. GREENSTEIN. Yes, with one asterisk, the asterisk being, given how much worse the fiscal condition is now looking forward than it was in 1986 when we had a lot more time before the baby boomers' retirement, ideally a 1986-style tax reform that had some net revenue increases as part of a larger budget deal that also made changes on the spending side of the budget. But basically, the answer is yes.

Senator WYDEN. All right.

Mr. VIARD. It is certainly a better model than the current income tax system, although it is not as good as a progressive consumption tax along the lines of a Bradford X tax.

Senator WYDEN. I probably ought to quit while I am ahead. Certainly what you have said, Mr. Greenstein, and you also, Mr. Viard, I think are sensible points. Those are, I think, fair for debate. I mean, people are going to talk about a variety of other issues. Bob Greenstein's point about the question of revenue, of course, is very appropriate. But at some point you have to have a place to start.

For the life of me, I look at this broken tax system, and what happens is, every year we just keep pouring more money into it, with more exemptions, deductions, and credits. At some point you have to draw a line in the sand and say, all right, we are going to make a break with something that is failing the people of this country.

Let me close, and maybe we will just take you, Mr. Yin, and Mr. Greenstein. What other advice would you have for the President's panel that is, I guess, about to be named? I am so pleased that the President of the United States is interested in tax reform. He and I have talked about it many times. At the same time, I know that a lot of members of Congress still have not made their way through the report of the last presidential commission on tax reform, the Bush report.

So Chairman Baucus and Senator Grassley are going to have to do the heavy lifting on this issue again, and I would like to know if you have any other thoughts with respect to what the President's panel and our committee ought to look at as we get into tax reform.

Mr. YIN. Thank you, Senator Wyden. I do have one comment, which is—as I understand the two conditions that the President placed on his panel—one was that there would not be any tax increases in the next couple of years. I do not disagree with that. I mention in my testimony that there should not be any tax increases until some target level of economic growth has been achieved. The second condition was that there should not be any tax increases on people earning less than, I believe it was, \$250,000.

I would disagree with that condition. The one piece of advice that I could give to the President, if I were able to, is to advise him to remove that condition from his panel. Essentially if the panel were to adhere to that, it would be limiting any possible tax changes to essentially the top 2 percent or so of the country. I presented in my testimony the fiscal needs of this country. They are much too great to put on the backs of 2 percent of the country. Any way that you slice it, it simply cannot be done. So my strong advice to the President would be to relax that condition, but obviously retain the first one.

Senator WYDEN. My time is up. Mr. Chairman, can Bob Greenstein just answer very briefly?

The CHAIRMAN. Go ahead.

Senator WYDEN. Thank you very much, Mr. Chairman.

Mr. GREENSTEIN. I would agree with everything Mr. Yin just said. I would only add to it to urge the panel that the President appointed, as well as this committee and your counterpart in the House, to be willing to be bold and have courage. There were changes made in 1986 that were considered politically unthinkable and impossible. The bill nearly died, as you will recall, several times. At the end of the day, it was done.

We are in a period now where, for example, the President's proposal to cap itemized deductions at 28 percent, our analysis suggests if you did it and you got universal health care, the charitable sector would actually be a net beneficiary on the whole. This sort of thing is considered almost non-discussable now, even though



President Bush's tax reform panel proposed capping the mortgage interest deduction at 15 percent.

I would suggest that we say that nothing is off the table. Nothing seemed to be off the table in 1986, and we ended up with an excellent product. Let us start by saying everything can be considered, nothing is off the table, no sacred cows, at least for starters, and let us see if we can get a better tax code.

Senator WYDEN. Thank you for the extra time, Mr. Chairman.

The CHAIRMAN. You bet. Thank you.

Senator Nelson, you are next.

Senator NELSON. Thank you, Mr. Chairman.

There is a lot of talk about taxing small business into oblivion, and putting them into the 39.6-percent bracket would be income in small business exceeding—now, that is taxable income—\$372,000. In reality, their gross income could be millions of dollars, with the deductions of all of the expenses, payroll, depreciation of capital, and other deductions. So I want to ask you all, for small business to be in that top bracket, how many small businesses actually would have the net income that would put them into that top bracket? Do we have any idea?

Mr. GREENSTEIN. Just this week, the Urban Institute-Brookings Tax Policy Center, with its updated model, just updated in the last 2 weeks, ran precisely those numbers. Their finding is that 2.2 percent of small business filers would be in either of the top two brackets. The number in just the top bracket is smaller. I do not know if I have with me the precise figure, but 2.2 percent is the top two brackets combined.

It would take us back to the treatment we had in the 1990s, when we had actually a rate of small business job growth more than double what we have had in recent years with lower rates. There is another figure that has been cited. Mr. Viard cited some figures from a Tax Foundation report. The problem with those figures is that they are based on a Treasury study that looked at how small business filers would be distributed by tax bracket if there were no Alternative Minimum Tax. But there is.

If you are under the AMT, you are at the 28-percent marginal rate. You are not in the two top brackets. When you do it right—the Tax Policy Center did it right—it assumes that the AMT patch is continued. You are clearly going to do that. What percentage of filers, small business filers, would then be in those top two brackets? Again, the answer is 2.2 percent of the total.

One last, quick point. Mr. Viard and I have said similar things differently, and it sounds like a big disagreement. I noted, as you just have, that the rate is paid on after-tax income. He said, well, if you make an investment you do not get to deduct the whole thing, because we have depreciation. You do not get to deduct the whole thing in the first year, you get to deduct pretty much the whole thing over the life of the asset. In any given year, you are deducting, as a small business, a share of the cost of the equipment you bought in that year, but you are also deducting a share of the cost of equipment you bought in previous years, because it is depreciated over a number of years. We do not end up taxing people on income that is not part of the profit.

Senator NELSON. Right.

I wanted to ask you about the actual amount of additional tax that we are getting. The *Wall Street Journal* recently had said that taxpayers making over \$1 million, in doing an audit, that the average amount of the additional tax that the IRS found in the audit was over \$250,000. Specifically, \$258,836 was the average amount of tax that was owed that was not paid, as a result of an audit of taxpayers making over \$1 million.

Now, that seems to me to be a staggering admission of taxpayers underpaying their taxes. Of course, that means that the rest of the middle-class taxpayers are footing the bill. So I would like to know, particularly Professor Yin, if you have thoughts on how we can reduce this tax avoidance and, in some cases, evasion.

Mr. YIN. Thank you, Senator Nelson. I am not familiar with that specific study that you referred to, but if I heard you correctly, they were referring to the average amount of tax owed, which would incorporate some extremely wealthy people who were audited, say a billionaire, who may indeed have owed millions of dollars of additional tax liability. That amount is going to be averaged in, so the ordinary person in that pool who is being audited would not have an additional tax liability of \$258,000. So I think that the figure may be a little bit misleading in that respect.

Senator NELSON. Nevertheless, it is large.

Mr. YIN. It is a large figure. Certainly one additional step that could be taken is to improve enforcement across the board, including at the upper income levels where the greater amounts of taxes are. I think that that would certainly be an appropriate step that one could take.

I do, however, emphasize again the point I make in my basic testimony, which is that, although I compliment the chairman and the committee for taking a very tough stance on improving compliance and reducing the tax gap—and I certainly encourage you to continue to do that with great vigor—I think that it is misleading and irresponsible to think that somehow we are going to get out of the fiscal crisis by simply reducing the tax gap and doing some of the other things I mention. I think that you are going to need to do all of that and more—much more—and therefore, from the standpoint of options for you, it seems that letting the tax cuts expire is the right thing to do.

The CHAIRMAN. Thank you, Senator.

Senator NELSON. Mr. Chairman, may we put that *Wall Street Journal* article in the record?

The CHAIRMAN. Without objection.

[The article appears in the appendix on p. 47.]

The CHAIRMAN. But clearly, closing the tax gap would be a good thing to do. All right.

Senator Menendez?

Senator MENENDEZ. Thank you, Mr. Chairman. I want to thank you for what is an important hearing, and I know that you are working towards figuring out what type of middle-class tax relief we can afford and make useful for our families and our communities. For a State like mine, Mr. Chairman, that is right on target, so I appreciate you holding this hearing.

Mr. Taylor, New Jersey has one of the highest costs of living of any State in the country. For example, our definition of middle-

class is very important to us. It is difficult to have the one-size-fits-all. For example, in New Jersey, \$77,000 gives you the same purchasing power as \$55,800 in Kentucky, or \$61,000 in North Carolina. It is an unfortunate reality that New Jersey families that are struggling to pay the same universe of bills as millions of other families across the country will not have the same purchasing power or parity to cover the cost of raising a family.

So, when conducting your survey, did you have any sense or did you find that the geographic costs of living affect the self-definition of middle-class?

Mr. TAYLOR. Very much so. This was a national survey of about 2,400 people. We asked them their zip code so we could look at where they live, and then we made an analysis. We divided the respondents into high-income areas, such as New Jersey, or many parts of New Jersey, middle-income areas, and low-income areas. Then we looked at what they told us it took for a family of four to lead a middle-class lifestyle in their community. Somewhat predictably, as you note in your question, there is a rising scale. If you live in a more expensive community, you believe it takes more to lead a middle-class lifestyle than if you live in a less expensive one. It sort of confirms common sense.

It is part of this whole definitional question of what it takes to be middle-class. "Middle-class" is a universally familiar word, but it is actually devilishly difficult to pin down. Chairman Baucus said in his opening remarks that virtually everyone considers themselves middle-class.

In our survey, we gave people five categories. We said, do you consider yourself upper class, upper middle, middle, lower middle, or lower? We then took the 53 percent who just said they were middle and we used that as the universe of people defining themselves as middle. But, if we were to add the folks who said they were upper middle and lower middle, you get over 90 percent. So basically at that point the word ceases to have much meaning. You have got a middle that is 90 percent of the country.

But in some ways, in terms of an expression of aspiration, an expression of state of mind and a belief in your status in society, that broader number is probably more accurate.

Senator MENENDEZ. Mr. Greenstein, I hope your wife is well soon. I appreciate your service in many different ways in terms of your testimony over time, in many different locations, even from my days in the House.

I want to talk about the Child Tax Credit. It seems to me that it provides relief that is needed the most, which is for families trying to find ways to pay their bills that are more expensive every year, and it also speaks to some of our values in terms of the belief in family and the strength of it, and therefore helping our families be able to strengthen their possibilities.

The phase-in of the Child Tax Credit currently stands at \$3,000, and that is good for millions of low-income families across America. It is a tremendous boost from the \$12,550 that it used to stand at. That is a good development. But my question is, is there any legitimacy to that all working families, at the end of the day, should be able to benefit from the Child Tax Credit? Second, the current

phase-out is not indexed for inflation, which pushes thousands of taxpayers out of eligibility in places like New Jersey.

Do you see the appropriateness of indexing the Child Tax Credit or expanding the thresholds so that more middle-class families are eligible, or can remain eligible?

Mr. GREENSTEIN. I think Congress took a very important step in the Recovery Act when, as you said, it temporarily lowered the threshold to \$3,000. I would certainly favor, were it politically feasible, starting the phase-in with the first dollar of earnings rather than \$3,000. We talked earlier, when Senator Wyden was here, about tax reform. I think in this vein, it is worth looking at whether the Child Tax Credit and the Earned Income Credit should perhaps be consolidated; they serve a similar purpose. The Earned Income Credit does start with the first dollar in earnings.

That is a larger change. I do hope that, when you look at extending those tax cuts that expire at the end of 2010, you look very seriously at least at extending the \$3,000 threshold you just passed.

Interestingly enough, the families that benefits the most, in many ways, are people above \$10,000 a year, because under the current situation they get a tiny credit. Our analysis is that 80 percent of the benefit of setting the threshold at \$3,000 rather than at \$12,550 goes to families with kids between \$10,000 and \$30,000 a year. These are families that are working a lot for very low wages.

In the ideal world, one would index the credit at the top as well. One does have to be concerned about costs and the deficit. My higher priority would be at the bottom than the indexing at the top. I do think that all these changes ought to be paid for, but I do certainly hope that you make permanent and offset the costs of at least setting the threshold permanently at the \$3,000 level.

Senator MENENDEZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator.

Senator Carper, you are next. You can run this hearing. I have to run. So, stay as long as you want.

Senator CARPER. Thank you. We will take a break for lunch around 1 and reconvene around 2:30. [Laughter.] Thank you very much for being here, and for your testimony today, and for the confidence you have placed in me, Mr. Chairman. It is a big risk. Senator Menendez says I can ask unanimous consent for anything. Maybe we can rewrite the whole tax bill while we are here before lunch. [Laughter.]

I want to just ask, when we have a panel like this, we have some really smart people here, very thoughtful people. One of the things I would like to ask, just to start off, you have probably testified with one another in other forums. We have to develop consensus here, or at least we try to. One of the things I like about this committee is working with Senator Baucus and Senator Grassley, who like each other, respect each other, and really do try to work together across the aisle.

What are some areas where you see consensus among your own views that you would suggest to us, as we go forward, we might try to mirror in what we do? We will just start with Mr. Viard. Do you want to go first, since you are closest here?

Mr. VIARD. I think one area of consensus, certainly, is the existence of the long-term fiscal imbalance and the need to address it. I am not sure if there is any other issue on which there is a really strong consensus. There are probably other points that we have touched on where there is certainly a general agreement. I think we both realize that distribution is important and that efficiency is important; we disagree, I think, on exactly how to balance those. But the strongest consensus is on the need to address the fiscal imbalance.

Senator CARPER. All right. Thank you.

Mr. Greenstein?

Mr. GREENSTEIN. Well, the irony is, I think there is—I am not including Paul here, who, as he said, does not really opine on these tax policy issues. The irony, Senator Carper, is I think there is an additional area, it appears, an agreement of sorts across Mr. Yin, myself, and Mr. Viard, but it is an area that puts all of us in disagreement with nearly all of you on both sides of the aisle. All of us would either not extend the tax cuts or pay for those we would extend. I would extend some of them, but I ideally would have paid for anything you wanted to extend under the pay-as-you-go rules.

As you may know, for years our center, the Concord Coalition, the Committee for Economic Development, and the like, we held these press conferences that did not seem to accomplish a whole lot, saying everything, the prescription drug bill should have been paid for, the 2001 and 2003 tax cuts—you want to extend them—should be paid for. There seems to be essentially a consensus here that the middle-income tax cuts should be made permanent without being paid for.

So I find myself pleading that anything beyond that should be paid for. You want to go one dollar beyond making the 2009 estate tax parameters permanent? Please pay for it. You want to go \$1 beyond what the President has proposed on the 2001 and 2003 tax cuts? Please pay for it. The gentlemen on either side of me would say, if you are not paying for it, do not do it at all.

Senator CARPER. All right. Good. Thank you.

Mr. Yin?

Mr. YIN. Senator Carper, I just would like to disagree with one point that Mr. Greenstein said. If he interpreted my testimony as saying that the middle-income tax cut should be made permanent without paying for it, then he misunderstood my testimony, because my testimony would be exactly the opposite.

Senator CARPER. They are saying no, that is not—

Mr. YIN. That is fine.

On the broader point, Senator Carper, I think that most people would view the current financial crisis as a very unfortunate series of events that makes the long-term situation even worse, and I am sure that that is true. On the other hand, I think that if you look at the bright side, it actually provides a “teaching moment.” The American public is now seeing just a tiny little glimpse of the future that we will face, a much more dire situation than we face now, if we do not take serious steps very soon to address it.

And so I think that you, as our Nation’s leaders, have an opportunity to use this very difficult moment for all of us to say, look, we are not going to do anything. We are going to try to get the

economy rolling again as quickly as we can. We understand the need to do that. But in terms of longer-term policies, including the issues before us today, if we do not take these steps, this experience right now is nothing compared to the hardship that you all are going to face in the future.

It is obviously going to take leadership. I am not suggesting that this is an easy thing to do, and I am not suggesting that you and your colleagues will be able to develop consensus very quickly, but it does give you an opportunity to make that point.

Senator CARPER. Thank you.

Mr. Taylor, you are not exactly a disinterested visitor here. So is there anything you want to add to it, or take away?

Mr. TAYLOR. Well, again, I cannot report on any consensus on tax policy, but we do survey research. We take the temperature of the American public. We did a major survey on these questions a little over a year ago, really just at the eve of the onset of the current recession. We asked people, in your view, is it more or less difficult for middle-class people to maintain their standard of living now versus 5 years ago. Eight in 10 said it is more difficult.

So all I would suggest to you is, there is a consensus in public opinion that life for the middle-class has gotten more difficult in this decade. I think inevitably, as you elected officials make your determinations on all of these matters, that will have to be a factor you take into account.

Senator CARPER. All right. Thank you.

The last question I want to ask on the record deals with the estate tax. In speaking to that, or asking you to speak to it, I want to reflect on what we did when we developed the Alternative Minimum Tax a number of years ago. When we created that, we did not index it to inflation. As we take up the tax code later this year, one of the items that we will probably address is the estate tax.

I started suggesting a number of years ago that what we might want to do is preserve an exemption of \$7 million per couple, which is pretty much where we are now, and to sort of freeze in place the rate on that, which is not exempted at 45 percent, but to index the exemption by some deflator, CPI or some deflator, as we go forward. We probably should have done something like this in, I guess, 1986 when we adopted the AMT, because now we have some 30 million Americans whom I think are facing the threat of having to pay the Alternative Minimum Tax, and that is not what we had in mind.

So my question of the panel is, if we do take an approach—and I think the administration actually suggested something similar to what I offered a couple of years ago—and we actually do that, freeze in place the 45-percent rate, take the exemption at \$7 million per couple and then index it, or do not index it. Should we index it? I think if we do not, we invite what happened with the AMT, in time.

Mr. Yin?

Mr. YIN. Senator Carper, I do not know whether \$7 million is the right figure or not, but whatever the figure is, assuming that that is the consensus of the Congress, it does make sense to index it. Without indexing it, you are in effect saying, well, this is the figure, but we are going to gradually let that figure erode. If, in fact,

\$7 million is the appropriate level that you have determined, then you should make it meaningful by indexing it.

Senator CARPER. Thanks so much.

Mr. Greenstein?

Mr. GREENSTEIN. I think you are referring to the 2009 parameter of \$3.5 million for an individual, effectively \$7 million per couple.

Senator CARPER. Yes.

Mr. GREENSTEIN. I agree conceptually that, if you are setting a level, it makes sense to index it. My recommendation would be—again, it is getting back to the fiscal concern, which I know you very much share—to try to pay for the indexing cost by getting into the guts of the estate tax. There are lots of special rules and things. Look for a few things to tighten—we would be happy to give you a list of options—to offset the cost of the indexing. There are a few areas that really can be tightened; things may be a little looser than they should be.

Senator CARPER. Thank you for that offer. We accept. We accept.

Mr. Viard? Last word.

Mr. VIARD. Yes. I agree conceptually that any exemption amount should be indexed. From a conceptual standpoint, pretty much any dollar value in the tax code should be indexed.

From the standpoint of capital accumulation, I do think that the rate of the estate tax is more important than where the exemption level is set at. I do share Mr. Greenstein's views that, if the estate tax is retained, there are plenty of ways it could be reformed to make it more efficient and limit some of the tax avoidance opportunities.

Senator CARPER. That is great. All right.

Well, this has been helpful for me. I apologize. I have to let you know, we are also on a number of committees, and another one of my committees was meeting, and it was important for me to be there. I could not be here and missed your testimony, but I will have a chance to review it.

Thank you so much for your very thoughtful responses and for your efforts to help us try to find common ground. Thanks so much.

Now, I do not have a gavel to bang, but if I did, I would do that and say we are adjourned. Thank you.

[Whereupon, at 11:33 a.m., the hearing was concluded.]





# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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### **Hearing Statement of Senator Max Baucus (D-Mont.) Regarding Middle Class Tax Policies**

In his work entitled *Politics*, Aristotle wrote: "The best political community is formed by citizens of the middle class."

What was true in Aristotle's analysis has proven all the more true in America. America's great strength lies in the broad American middle class.

In 2001, this Committee led the way to easing the tax burdens of the American middle class.

Now there have been different views about the 2001 tax cuts. But whatever differences there have been, there is pretty wide agreement that working families have welcomed the relief. Tax cuts like the child tax credit, the lower middle-income tax rates, and marriage penalty relief have helped working moms and dads to pay the bills and raise their families.

For example, in 2001, we increased the child tax credit from \$500 per child to \$1,000 per child. And then we also made the credit partially refundable, so that working families can get some money back.

And in 2001, we provided marriage penalty relief. That way, a married couple does not get penalized with higher taxes when they take their wedding vows.

But on the horizon, we have a challenge. Those tax cuts, and a lot of other ones, expire at the end of 2010. Allowing these tax cuts to expire would mean a drastic tax increase for tens of millions of American families. Pretty soon, we need to decide which of these tax cuts to make permanent.

On top of that, we have the ever-looming alternative minimum tax. The AMT creeps forward every year, snaring more and more taxpayers in its grasp.

The AMT was meant to make sure that 155 wealthy taxpayers paid their fair share. But now it ensnares millions of middle-income families.

Frankly, the AMT fills many taxpayers with dread. People have to calculate their taxes under the regular tax system. And then they have to do it again under this alternative system. They have to worry whether this will be the year that they fall prey to the AMT.

Over and over again, Congress has passed a one-year fix. The fix — also known as the “AMT patch” — is holding the number of taxpayers subject to the tax at just over four million. Without the fix, more than 26 million taxpayers would be paying higher taxes.

Another question is: Who are these middle income taxpayers? People throw the term “middle class” around a lot. But different people have different ideas about who’s included.

Judith Martin, who has long written the “Miss Manners” column, once said: “There are three social classes in America: upper middle class, middle class, and lower middle class.”

Today we will hear some thoughts about just who is in the middle class. We will hear about how the middle class has fared over the last few decades. In particular, we will hear how they have fared over the last couple of years. And we will hear about how our tax laws affect the middle class.

And we’ll discuss the temporary nature of several other tax provisions. And we’ll consider whether some of these provisions should be made permanent.

Today, I am introducing a bill to make the middle-income 2001 tax cuts permanent. My bill would make permanent the middle-income tax rates, child tax credit, and marriage penalty relief in the 2001 tax law. I am hopeful that we can move legislation along these lines this year.

And so, let us examine ways to help the great strength of America. Let us look for ways to continue tax relief for the broad American middle class. And let us see how we can extend these welcome tax cuts for America’s working families.

*United States Senate*  
*Committee on Finance*



*Sen. Chuck Grassley · Iowa*  
*Ranking Member*

Statement of Senator Chuck Grassley:  
Finance Committee Hearing, "The Middle Income Tax Relief Question: Extend, Modify, or  
Expire?"  
Thursday, March 26, 2009

The answers we eventually come to in responding to the questions we are asking in this hearing will in part determine whether the U.S. is able to continue to rely on the spirit and ingenuity of a dynamic middle-class, or if the middle-class is to be shredded by the tax code and parceled out to fund corporate welfare and benefits for people who don't pay income taxes. Under current law Americans will be subject to the largest tax increase in history in 2011 if Congress does nothing. This chart shows what will happen to a family of four with \$50,000 in annual income. They will be subject to a tax increase of \$2,300. This next chart shows the tax increase faced by a single parent household with two kids and \$30,000 in income; which is \$1,100. Keep in mind that these tax increases are only what is now built into current law. They do not include items in the President's budget like a cap-and-trade tax that would increase energy prices on these families as well.

For a long time now, I have been urging the Democratic leadership to "Tear down this wall!" And it seems my message has finally been heard. President Obama's budget makes most of the bipartisan tax relief from 2001 and 2003 permanent. We now have agreement on issues like the marriage penalty. Working families will be able to continue to count on lower rates. Low-income seniors who are counting on their capital gains and dividend income can sleep a little easier. The ravenous monster that is the Alternative Minimum Tax will be held back from the middle class. If Democrats in Congress share President Obama's commitment to tearing down at least part of this wall, they will find many allies on my side of the aisle.

As pleased as I am to find that the new President has come to agree with me on these issues, there is still more that we need to do, especially in these formidable economic times. President Obama intends to allow parts of the 2001 and 2003 tax relief to expire that, if extended, will continue to provide incentives for the creation of jobs and the resuscitation of our economy. These provisions are the marginal rate reductions in the top two income tax brackets, the repeal of phase-outs of personal exemptions and itemized deductions, and dividend and capital gains reductions for everyone. These provisions helped grow the economy when they were put into effect. These provisions could be a valuable tool in our recovery if we don't cast them aside.

Many of my colleagues are skeptical of any income source that isn't a check from the federal government, but the 2001 and 2003 tax relief packages did not benefit the rich, or didn't benefit just the rich. In fact, those packages are part of a broad trend where our tax system has become more progressive over the past several decades.

Recent tax relief has continued to shift more of the federal tax burden onto wealthy households while lowering rates, and in some cases eliminating federal income tax liability, for many middle and lower-income households. One of today's witnesses cites Congressional Budget Office data in showing that income taxes as a percentage of income have fallen more for low-income and middle-income households over the past several decades than they have fallen for wealthy households.

This indicates that as a percentage of federal income tax revenues, the tax burden on our wealthiest citizens has steadily increased over time, while it has decreased for lower and middle-income households.

This chart derived from CBO data shows how effective federal tax rates have changed for 1979 through 2005. It shows those changes for two groups. One group is Americans in the top 5% percent in terms of income and the other is everyone else. The blue line represents the top 5% and the red line represents the remaining 95%. The vertical line shows where rates were in 2000. According to an analysis of CBO data, the effective tax rate for the top 5% of earners was around 31% in 2000 and the effective rate was around 20% for everyone else. In 2005 the effective rate had decreased to around 29% for the highest earners and 17% for the remaining.

In a period where effective tax rates declined by roughly 2% for the top 5% of earners, rates decreased by 3% for the remaining 95% of Americans. The tax relief enacted in 2001 and 2003 decreased effective federal tax rates for the bottom 95% more than it did for the top 5%. What has been maligned as "tax cuts for the rich" increased the share of federal taxes paid by that category.

What we as a Committee take from this hearing will be very important. I hope my colleagues come away with a better understanding of what we need to do to drive our economy out of the hole we are in, and that we fully extend and make permanent the 2001 and 2003 bipartisan tax relief so that we are able to offer everyone a ladder to productivity and prosperity.

**TESTIMONY OF ROBERT GREENSTEIN  
EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES**

before the

**SENATE COMMITTEE ON FINANCE**

**March 26, 2009**

I appreciate the invitation to appear before the Committee today. I am Robert Greenstein, Executive Director of the Center on Budget and Policy Priorities, a policy institute that focuses on fiscal policy issues and issues affecting low- and moderate-income families.

This testimony makes the following points:

- As the Congressional Budget Office report issued last Friday shows, the nation faces serious mid-term and long-term fiscal problems. Strong action will be needed on both the revenue and spending sides of the budget.
- It seems clear that the tax cuts enacted in 2001 and 2003 affecting people with incomes up to \$250,000 will be made permanent, without their costs being offset. The major question regarding the 2001 and 2003 tax cuts concerns the disposition of the tax cuts for people making over \$250,000 (over \$200,000 for single filers).
- Given the nation's fiscal position, extending the upper-income tax cuts would be unwise for both the budget and the economy. Research suggests that extending these tax cuts without paying for them would likely reduce long-term economic growth because of the corrosive effects of the increased debt. This is a conclusion that emerges from the work of the Congressional Budget Office, the Joint Committee on Taxation, and other leading economists and fiscal policy experts.
- President Obama's tax proposals, which would allow some (but not all) tax cuts for households over \$250,000 to expire at the end of 2010, have been criticized as producing a "high-tax" government and imposing crushing tax burdens on high-income Americans in general and on small business owners in particular. These criticisms do not withstand scrutiny.
- Regarding the charge that these proposals would produce high levels of taxation, the Congressional Budget Office finds that under President Obama's proposals — including his proposal to cap itemized deductions at a 28% deduction rate for people making over \$250,000 — total federal revenues would average 18.4% of GDP over the next ten years, just about the average level for the last 30 years, and would not exceed 18.9% of GDP in any year. These are not high levels of taxation. Indeed, there were only four years in the last 30 when the federal budget was balanced, and in every one of them, revenues were between 20% and 21% of GDP.
- Nor would the Obama proposals result in crushing tax burdens on affluent American. Data from the respected Urban Institute-Brookings Institution Tax Policy Center show that *average tax burdens on virtually every income group — including the top 1 percent of Americans — would be lower than they were in the 1990s, a period when the economy boomed.* An often overlooked fact is that people at

Effective Tax Rates (average federal tax rate, 2012)		
Household Income Group	Current law with AMT relief extended (2001/03 tax cuts expire)	Obama Proposal
Poorest fifth	5.7%	0.8%
Next-to-bottom fifth	12.5%	8.4%
Middle fifth	18.2%	15.2%
Next-to-top fifth	20.9%	18.1%
Top fifth	27.7%	26.0%
Top 2 to 5 percent	26.9%	25.3%
Top 1 percent	32.8%	32.6%

Source: Tax Policy Center

the top of the income scale would still gain from the extension of the 10 percent tax bracket, marriage penalty relief, reduction in tax rates in the tax brackets below the top two brackets, and the halving of the top tax rate on dividends from 39.6% in the 1990s to 20% under the Obama proposal. Indeed, high-income households would gain *more on average* than they would lose from the proposed itemized deduction cap, with the result that they would pay a smaller percentage of their income in federal taxes than under the pre-Bush policies.

- Nor would these proposals oppress small businesses. To the contrary, most people with small business income would be net gainers. Tax Policy Center data indicate that only 2.2 percent of people with small business income would be in the two top tax brackets — and hence be affected by the proposal to allow the rate reductions in those brackets to expire for filers with incomes over \$250,000 (over \$200,000 for single filers). (A higher figure that has recently been cited has been misunderstood and misapplied, and is not the correct figure.) The number of small business owners who would benefit from the “middle class” tax cuts that would be extended or from new tax-cut measures that the Administration has proposed would dwarf the number who would face tax increases. Indeed, one little known fact is that ten times as many small business owners receive the Earned Income Tax Credit as are in the top two income tax brackets.
- Moreover, there is little evidence for the claim that a return to Clinton-era rates of taxation at the top of the income scale would seriously injure small businesses and damage U.S. job growth. If this were true, the experience of the last two decades would show that small-business job growth was considerably faster in the years when the Bush tax cuts were in effect than in the Clinton years when the top tax rates were higher. *Yet the opposite is true.* The average rate of small business job growth was twice as high in the Clinton years as under President Bush before the current recession set in.
- Policymakers also should consider the disturbingly large growth in recent years in inequality of after-tax income, especially between those with very high incomes and other Americans. CBO data show that between 1979 and 2005 (the years for which CBO has compiled these data), the after-tax income of the 20 percent of Americans in the middle of the income spectrum grew an average of \$8,700 — or 21 percent — after adjusting for inflation, while the average income of the poorest 20 percent of Americans grew by \$900, or 6 percent. In contrast, the average income of the top 1 percent of households increased by \$745,000, or 228 percent. And other

data show that in 2006, the top 1 percent of Americans secured a larger share of all pre-tax income than in any year since 1928.

The 2001 and 2003 tax cuts exacerbated this trend. CBO data show that these tax cuts further widened inequality. And the Tax Policy Center has estimated that in 2010, households with incomes of over \$1 million will receive an average tax cut from the 2001 and 2003 tax changes of *\$158,000 each* — as compared to \$810 for households in the middle of the income scale. It is difficult to see how the nation can continue to afford providing such massive tax cuts to those at the pinnacle of the income scale.

Finally, this testimony covers two related issues:

- It finds strong merit in the Administration's proposals to extend the expansions in the child tax credit, the EITC, and the American Opportunity Tax Credit that were enacted on a temporary basis in the recent economic recovery legislation, and to pay for those extensions. If paid for, these extensions should better reward work among low-income parents, increase educational attainment and productivity, and reduce child poverty, without enlarging the deficit.
- The nation also needs to address climate change and can do without imposing a large middle-class tax increase. This can be accomplished if emissions permits under a cap-and-trade system are auctioned and the principal (though not the only) use of the auction proceeds is to offset the increased energy costs that low- and middle-income families will incur, primarily through a refundable climate tax credit created for this purpose.

I now examine these issues in more detail.

#### **DEFICIT-FINANCED TAX CUTS HAVE ADVERSE ECONOMIC EFFECTS OVER THE LONG RUN**

In recent years, various respected institutions and experts have examined the impact of permanent deficit-financed tax cut on the long-run health of the economy. Their findings are sobering.

- In a 2005 study, the Joint Committee on Taxation examined the economic effects of reductions in individual and corporate tax rates and an increase in the personal exemption. It found that “Growth effects eventually become negative without offsetting fiscal policy [i.e., without paying] for each of the proposals, because accumulating Federal government debt crowds out private investment.”<sup>1</sup>
- In another 2005 study, Brookings economist William Gale and then-Brookings economist (now OMB director) Peter Orszag examined the effects that extending the 2001 and 2003 tax cuts without paying for them would have on incentives for investment. They found that, under most plausible assumptions, extending the tax cuts without paying for them would reduce incentives for investment. In a separate analysis, Gale and Orszag concluded that making the

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<sup>1</sup> Joint Committee on Taxation, “Macroeconomic Analysis of Various Proposals to Provide (\$500 Billion in Tax Relief,” JSCX-4-05, March 1, 2005, <http://www.house.gov/ct/x-4-05.pdf>.

2001 and 2003 tax cuts permanent without offsetting their cost would be “likely to reduce, not increase, national income in the long term.”<sup>2,3</sup>

- Finally, in 2005, the Congressional Budget Office examined the economic effects of a 10 percent across-the-board cut in income-tax rates. It found that, if deficit-financed, the rate reduction could potentially reduce economic output. CBO considered the claim that tax cuts generate sufficient economic growth to boost revenues by enough to pay for themselves. It found, instead, that the increased deficits resulting from the tax cuts might be enough of a drag on the economy that the tax cuts actually would *lose more revenue* than if one assumed they had no effect on the economy. In other words, deficit-financed tax cuts could be even more expensive than officially “scored,” rather than less expensive.<sup>4</sup>

In short, making the tax cuts for people above \$250,000 permanent without offsetting the cost would not only enlarge debt and inequality but also would likely reduce long-term economic growth because of the corrosive effects of the higher levels of debt.

### **TAX BURDENS ON HIGH-INCOME HOUSEHOLDS WOULD BE THE SAME OR LOWER THAN IN THE 1990S**

Some who attack the Obama tax proposals portray them as “soak the rich” proposals that would impose high and enormously damaging tax burdens on those at the top of the income scale. These charges are uninformed.

The best way to measure tax burdens is to examine *effective tax rates* — i.e., how much people pay in federal taxes as a share of their incomes. A comparison of effective tax rates on high-income people under the policies in effect in the late 1990s to the effective rates that would prevail under the Obama tax proposals shows the following (all of these data come from the Tax Policy Center):

- Under current law (except for the continuation of AMT relief) — that is, under tax law if the 2001 and 2003 tax cuts are allowed to expire — the average effective tax rate in 2012 for the top one percent of households would be 32.8 percent. In other words, this group, which has average income of \$1.6 million a year, would pay an average of 32.8 percent of its income in federal taxes.
- Under the Obama plan, the effective rate for this group would be 32.6 percent, or slightly lower. This means that the average tax burden for very high income people would be slightly less under the Obama plan than under Clinton-era policies.

<sup>2</sup> William Gale and Peter Orszag, “Deficits, Interest Rates, and the User Cost of Capital: A Reconsideration of the Effects of Tax Policy on Investment,” Urban-Brookings Tax Policy Center Discussion Paper No. 27, August 2005, [http://www.urban.org/UploadedPDF/311211\\_TPC\\_DiscussionPaper\\_27.pdf](http://www.urban.org/UploadedPDF/311211_TPC_DiscussionPaper_27.pdf).

<sup>3</sup> William Gale and Peter Orszag, “Bush Administration Tax Policy: Effects on Long-Term Growth,” Tax Notes, October 18, 2004, [http://www.dbo.gov/ftpdocs/69xx/doc6908/12-001-10Percent\\_TaxCut.pdf](http://www.dbo.gov/ftpdocs/69xx/doc6908/12-001-10Percent_TaxCut.pdf).

<sup>4</sup> Congressional Budget Office, “analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income tax Rates,” December 1, 2005, [http://www.cbo.gov/ftpdocs/69xxdoc6908/12-01-10Percent\\_Tax\\_Cut.pdf](http://www.cbo.gov/ftpdocs/69xxdoc6908/12-01-10Percent_Tax_Cut.pdf).



- Furthermore, the size of the reduction in tax burdens under the Obama proposals, as compared to tax burdens under the pre-Bush tax policies, grows significantly larger even if one goes only a small way down the income scale. For example, the most affluent 2% to 5% of households (that is, the households in the top 5 percent of the income distribution, except for those in the top 1%) would face an effective federal tax rate of 25.3% under the Obama proposals, compared to 26.9% under a return to pre-2001 law with AMT relief extended. And for those right in the middle of the income scale, the total federal tax burden would be 15.2 percent of income under the Obama proposals, compared to 18.2 percent under the policies of the 1990s.

Some who hear these figures may be surprised. They may assume that when one couples the Obama proposal to roll back tax cuts at the top of the income scale with the Obama proposal to limit itemized deductions for high-income households to a 28% deduction rate, the result is *higher* tax burdens on affluent people than under the policies of the 1990s. But that is not the case. Many of the 2001 tax-cut provisions that would become permanent under the Obama plan benefit high-income households, including the creation of the 10 percent tax bracket, marriage penalty relief, and the reduction in tax rates in what used to be the 28 and 31 percent brackets and now are the 25 percent and 28 percent brackets.

Furthermore, the benefit to high-income individuals from the Obama proposal to set the top tax rate on dividends at 20 percent — or about *half* the 39.6 percent tax rate on dividends that prevailed in the 1990s — is especially large. According to the Tax Policy Center, the lower rate on dividends would provide an average tax cut of \$10,408 to the top one percent of households.

I would add that the itemized deduction proposal is hardly a radical one. The Tax Policy Center's analysis finds that it would affect only 1.4 percent of households. It would mean that the subsidy the federal government provides to these households for their deductible expenditures would be *a little less than double* the subsidy the tax code provides for the same expenditures when middle-class households make them (a subsidy of 28 cents per dollar of deductible expenditure for those at the top of the income scale, as compared to a 15 cent subsidy for people in the 15 percent tax bracket), rather than being *more than* double the subsidy. Moreover, the 28 percent deduction rate would be the same as in the final years of the Reagan Administration. The Bush Administration's tax reform panel actually proposed to go further, recommending in 2005 that the value of the mortgage interest deduction be set at 15 percent for everyone.

I also would note that the much-talked about impact on charitable contributions would be modest. The best data and research indicate that total charitable contributions would be expected to decline by about 1.9 percent. If such a change were part of a package with health care reform that achieved universal coverage and cost containment, the charitable sector as a whole would come out ahead, due to the reduction that would ensure in the burdens placed on the sector to provide charity health care and the relief that that would go to small nonprofits that currently pay high costs to insure their employees because they must buy coverage in the small-group insurance market. (Moreover, if one is concerned about the tax policy incentives for charitable giving, the estate tax warrants primary focus. CBO has estimated that repealing the estate tax would reduce bequests by 16 to 28 percent and charitable giving during life by 6 to 11 percent.)

### WOULD THESE TAX BURDENS DAMAGE THE ECONOMY?

Some also argue that the tax burdens on people over \$250,000 that would result from the President's proposals would damage economic and job growth, by depressing incentives for the highest-earning Americans to work, save, and invest. To sustain this claim, critics must show that such results marked the Clinton years. And in fact, they did not.

The economy did well in those years. And high-income people did even better, greatly increasing both their pre-tax and after-tax incomes. They clearly worked hard and invested substantial sums. According to CBO, the average after-tax income of people in the top 1 percent of the population grew 78 percent between 1992 and 2000, after adjusting for inflation, or six times the 13 percent increase that people in the middle of the income spectrum secured.

### EFFECT ON SMALL BUSINESSES

There has been considerable discussion of the effects of the Obama tax proposals on small business. There may be more misunderstanding on this issue than any other.

Some claim that most small business owners would be affected by allowing high-income tax cuts to lapse. But Tax Policy Center data show that only 2.2 percent of people with small business income would be in the two top tax brackets in 2012 if the top two rates revert to their pre-2001 levels.<sup>5</sup> The number of small business owners who would benefit from extending the middle-class tax cuts and the proposed expansions of the EITC and the saver's credit dwarfs the number who would be affected by allowing the tax cuts at the top to expire.

In addition, some criticisms of the Obama tax proposal imply that the investments that small business owners make in staff or equipment are made out of *after-tax* income, with the income tax being applied to small business receipts *before* such expenses are taken into account. That is incorrect. Business owners pay tax on the profit that a firm produces after such expenses are taken into account, *not* on the receipts the firm takes in. And the Obama proposals would not limit or reduce the deductions that business owners claim for business expenses (which are above-the-line deductions).

Moreover, if the Obama proposals really would damage small-business job growth seriously, such job growth should have suffered grievously in the Clinton years and rebounded smartly in the Bush years, after the top income tax rates were cut. The economy's response to changes in tax policy since the enactment of increases in the top rates in 1993 provides something of a natural experiment to test this thesis. What the data show are that the rate of small business job growth was twice as large in the Clinton years, when the top tax rates were higher, as in the Bush years (prior to the onset of the current recession).

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<sup>5</sup> Some filers have incomes over \$250,000 but are in a lower tax bracket or are subject to the AMT, which has a 28 percent top rate. Some of these filers would be affected by the Obama proposal to set the top rate on capital gains and dividends at 20 percent for filers with incomes over \$250,000. Tax Policy Center data show that 5.6 percent of small business filers would be affected by this provision.

<b>Average Annual Small Business Job Growth (20-499 Employees)</b>				
	<b>Base</b>	<b>End</b>	<b>Ave. % Growth</b>	<b>Ave. Job Growth</b>
Clinton	31,245,872	36,536,659	2.4%	755,827
Bush	36,780,814	38,614,220	1.0%	366,681

Source: Small Business Administration, U.S. Census Bureau  
Clinton Base Year: 1993, End Year 2000; Bush Base Year: 2001, End Year 2006 (latest available)  
Note: An analysis of job growth for all small businesses with less than 500 employees shows a similar disparity, with the pace of job growth during the Clinton years being twice the pace from 2001 to 2006. Firms with 20-499 employees are highlighted here because critics of the Obama proposal have focused on this group. See Taxing Success: President Obama's Tax Increases on Small Business are Bad for Job Creation, Senate Republican Policy Committee, March 17, 2009.

Finally, small businesses should benefit substantially from health care reform. Today, many small firms either cannot afford to purchase health insurance for their employees or must pay much higher premiums than large corporations do. They thus are placed at a competitive disadvantage. Well-designed national health care reform can address these problems, which would be very beneficial for small business.

#### **EXTENDING CERTAIN TAX PROVISIONS INCLUDED IN THE RECOVERY LEGISLATION AND PAYING FOR THEM**

The 2001 and 2003 tax cuts are not the only tax cuts affecting lower- and middle-income households that are scheduled to expire at the end of 2010. The expansions of the child tax credit, the EITC, and the American Opportunity Tax Credit included in the recently enacted recovery legislation also are scheduled to expire at that time. The President's budget proposes to extend these measures and to offset the cost of doing so. The budget also would expand the Saver's Credit, originally enacted in 2001 due in no small part to the efforts of Chairman Baucus, and pay for that reform as well.

These are excellent proposals, and I urge their adoption. Making the child tax credit improvement permanent would benefit nearly 16 million children in low-income working families, reducing poverty among children who constitute an important part of the workforce of the future. It also would better reward the work effort of their parents, with 80 percent of the benefit going to the children of hard-working parents who make between \$10,000 and \$30,000 a year and otherwise would receive only a partial child tax credit or no child tax credit at all.

It is instructive to examine who the affected parents would be. They include large numbers of preschool and kindergarten teachers, child care workers, nursing home workers, home health aides, janitor and custodians in schools or office buildings, cashiers, waiters, waitresses, kitchen workers in restaurants, agricultural workers, and the like.

Our analysis of Census data yields another noteworthy finding as well — the child tax credit and EITC provisions in the economic recovery legislation will lift 800,000 children — and 1.4 million people of all ages — out of poverty. We ought not to slide backward on that front.

In addition, the expansion of the American Opportunity Tax Credit included in the recovery legislation will help 4 million low-income students go to college who previously were shut out of this

### INCREASED INEQUALITY AND FEDERAL TAX POLICY

The increase in income inequality in recent decades provides some important context for discussions of tax policy. From the end of World War II through the mid-1970s, the gains from economic growth were broadly shared across the U.S. population. Congressional Budget Office data show that in recent decades, however, this has changed. Since the 1970s, income inequality has grown sharply, and the bulk of the gains from economic growth have accrued to those high up on the income scale.

The CBO data, which cover the years from 1979 through 2005, show that after adjusting for inflation, the average after-tax income of those in the middle of the income scale rose by \$8,700 — or 21 percent — over the 26 years from 1979 to 2005. For those in the bottom fifth of the population, average income was only \$900 — or 6 percent — higher in 2005 than in 1979. (Note: This measure of income counts food stamps, housing assistance, and various other means-tested benefits, as well as the EITC.) In contrast, the average income of the top 1 percent of households soared by \$745,000 — or 228 percent — between 1979 and 2005.

Data compiled by economists Thomas Piketty and Emanuel Saez and based on IRS data on pre-tax income extend one year further, into 2006. These data show that the share of pre-tax income going to the top 1 percent of households was greater in 2006 than in any year since 1928, and that just between 2005 and 2006, average pre-tax income rose by almost \$60,000 (or 5.8 percent) for the top 1 percent of households, after adjusting for inflation, while rising by less than \$450 (or 1.4 percent) for the bottom 90 percent of the population.

To be sure, we are likely to see a temporary decline in the concentration of income over the next year or so, given the sharp decline in the stock market. But there was a similar development when the dot.com bubble burst a few years ago — income at the top of the income scale fell sharply — and it turned out to be just a speed bump. Incomes at the top more than made up the lost ground from 2004 to 2006. The long-term trend toward increasing inequality has been quite strong.

#### The Role of the 2001 and 2003 Tax Cuts

The 2001 and 2003 tax cuts exacerbated the trend toward growing inequality. Economists generally agree that the single best measure of whether a change in tax policy is regressive is whether it increases after-tax income by a larger percentage for those at the top of the income scale than for those at the middle and bottom. A policy that does so further widens after-tax income inequality. This is precisely what the 2001 and 2003 tax cuts did.

Some have tried to argue that the 2001 and 2003 tax cuts were progressive because the share of taxes that people at the top pay has increased. This share increased, however, *not* because the tax code has become more progressive but because the share of total income that households at the top get increased sharply. The income gains at the top were so large that high-income households pay a larger share of the taxes *even though* they have received much larger tax cuts, measured as a share of their income, than anyone else and *even though* the percentage of income they pay in federal taxes went down by more than it declined for anyone else.

Finally, in light of the daunting budget deficits the nation faces and the increase in inequality it has experienced, the magnitude of the tax cuts for those at the very pinnacle of the income scale is breathtaking. The Tax Policy Center has estimated that when the 2001 and 2003 tax cuts are phased in fully in 2010, households with annual incomes of more than \$1 million will receive tax cuts that average \$158,000 apiece, compared to an average tax cut of \$810 for Americans in the middle of the income scale. It is difficult to see how our nation can continue to afford such munificent tax cuts for those who are at the apex of American society and are far better off than everyone else.

tax credit. For our future competitiveness, we need to lessen financial barriers to college attendance among children from low-income families. We will need the best educated workforce possible in order to compete in an economy that is going to continue to become even more global.

Finally, the improvements in the Saver's Credit that the President's budget proposes would not only help millions of middle- and low-income workers in retirement but would also benefit the economy by boosting national savings.

Accordingly, I recommend that Congress move these provisions, and the offsets to pay for them, together with the legislation to make the 2001/2003 "middle-class" tax cuts permanent. Both sets of measures are slated to expire at the end of 2010, and they should be considered and move as a package.

#### **CLIMATE CHANGE LEGISLATION AND MIDDLE-CLASS TAX BURDENS**

Lastly, there is the question of whether cap-and-trade legislation would constitute a "tax increase" because an emissions cap would raise prices of fossil-fuel energy and energy products. As CBO has explained in various reports, how low- and middle-income households are affected under an emissions cap depends primarily on the decisions that policymakers make on two key policy questions: whether emissions permits are given away free or are auctioned, and if they are auctioned, what is done with the auction proceeds. Simply stated, auction proceeds can be used to compensate low- and middle-income consumers for the average increase in costs they will incur for energy and energy-related products. As a recent Center on Budget and Policy Priorities' paper concludes, the optimal approach is to auction the permits and to devote a substantial share of the proceeds to a new refundable climate tax credit that offsets the increase in energy costs for low- and middle-income households, supplemented by other mechanisms for those who do not file income tax returns, such as many Social Security beneficiaries and people at the bottom of the income scale.

Suffice it to say, the notion that cap-and-trade legislation necessarily imposes a tax increase or its equivalent on poor and average families is mistaken. Well-designed climate legislation should not have that effect.

**Questions for the Record From Robert Greenstein  
March 26, 2007**

***Questions From Senator Grassley***

*(1) Mr. Greenstein, in your written testimony you assert that decisions made by small-business owners are based primarily on pre-tax income and not after-tax income. While it is true that certain expenses are accounted for in pre-tax income, as the attached chart illustrates, after-tax income plays a substantial role in small-business decision making. By impacting returns to investors and financial institutions, this in turn impacts the availability of credit and capital to entrepreneurs and small businesses. Our nation's recent financial troubles have illustrated the dire consequences to small-businesses of inadequate access to credit. Do you disagree with my analysis, and if so, please explain how my chart is inaccurate. If you believe my chart is inaccurate, please detail what changes you would make, paying special attention to access to credit and capital.*

In my testimony, I made the point that small businesses are able to deduct businesses expenses just to make sure there was no confusion on the part of those watching the hearing. As far as the chart, one point you may want to consider is whether the arrow from after-tax profits to the bank implies that interest paid to banks is on an after-tax basis.

My main point, however, is that I do not believe that the sunset of the top rates will suppress job creation. Consider the contrast between the Clinton and Bush years. The rate of small business job growth was more than double during the Clinton years what it was in the Bush years, even though the top rates were higher.

One additional minor point to keep in mind is that these flow-through businesses enjoy a tax advantage compared to their C-corporation competitors.

*(2) In your oral remarks you stated that data from a Treasury report issued on July 26, 2007, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper" have been misused. Please elaborate on this point. Are you referring specifically to Table 3.3 of this publication, on page 20? My understanding is that the Treasury data contained in this report is based on an analysis of unpublished IRS data, and is not based on projections or economic modeling. If this data is simply an accounting of what actually happened during 2006, how can it be incorrect while a projection reaching a different conclusion is deemed to be correct? In 2006 an AMT patch was in effect that protected many people who would have been caught by the AMT. Do you believe it is relevant to this study that people who might have been subject to the AMT without a patch were not subject to the AMT? I have been using this data since last September, and I have quoted directly from the study. Please describe in detail how you believe this data has been misused. Consider also that the use of the data has consisted of direct quotes from the Treasury publication.*

The figures I was referring to come from Table 3.3 on page 15 of the Treasury report you reference. As may know, the Treasury Department has clarified the meaning of these numbers in a letter to Senator Baucus dated March 31. The table appears to show that, by one definition of small business owners — those with active, positive flow-through income — 7 percent are in the

top two brackets. The Treasury letter indicates that this 7-percent figure includes filers who are not in fact in the top two brackets but rather pay the Alternative Minimum Tax, and who therefore “would not be affected by an increase in top regular income tax rates.” The other figures in the table also seem to discount the existence of the AMT.

Upon further review of the Treasury report, I regret using the word “misuse” to describe your interpretation. The Treasury report was misleading; Table 3.3, as well as the surrounding text, suggests that it refers to the rates filers actually pay. There is no way for a reader to know that this is not the case, and I regret saying that the report was misused. I should have said that this table was presented in a non-transparent way that misled people trying to use these data.

*(3) Disputes over the accuracy of the Treasury report chiefly concern a dispute over the number of small-business owners impacted by rate increases for the top two income tax brackets. Regardless of the exact percentage of small business owners who ultimately end up in the top two income tax brackets. Do you agree that these particular individuals are more likely to own the larger small-businesses more likely to add or cut employment in response to changes in their financial situation?*

People in the top two brackets are more likely to own larger small businesses than those at lower income levels. But it’s not clear that these larger small businesses are more likely to make a decision to add or cut employees in response to changes in their financial situations. Most important, the experience of the tax systems under Presidents Clinton and Bush suggests that restoring top rates to their level under Clinton would not be harmful to small business job creation. Small business job growth was twice as high during the Clinton years — when effective tax rates at the top were similar to those proposed by President Obama — as it was during the Bush years, even excluding the downturn at the end of the Bush presidency. (For further information about the impact of the President’s budget proposal on small businesses, please see Jason Levitis and Chuck Marr, “History Contradicts Claim That President’s Budget Would Harm Small Business Job Creation” CBPP, March 26, 2009. <http://www.cbpp.org/cms/index.cfm?fa=view&id=2742>.)

*(4) Senator Baucus and I have in recent years supported holding the number of taxpayers that owe Alternative Minimum Tax (“AMT”) the same from year to year, 4.2 million taxpayers. Although we are sketchy on the details, it appears that President Obama wants to patch the AMT by merely indexing the AMT exemption amounts, and other relevant AMT numbers, for inflation. Could the President’s proposed way of patching the AMT result in more taxpayers paying the AMT? And what is the preferred way to patch the AMT? Put another way, shouldn’t we insure that no more taxpayers are added to the AMT population?*

The AMT is intended to ensure that upper-income taxpayers do not avoid taxation unfairly by taking excessive advantage of tax breaks. An unindexed AMT is a problem because it pulls in more and more filers at lower real incomes with each successive year. But ensuring that the number of AMT taxpayers does not increase would likely be extremely costly. If more upper-income filers are taking advantage of tax breaks to reduce inordinately their effective tax rates, the AMT has an important role in ensuring that they pay their fair share. Our preferred solution would be to undertake an overall tax reform that would close tax loopholes and thus render the AMT unnecessary. Until that can happen, we suggest a permanent — and paid for — AMT patch, so the exemption holds its value over time.

**Questions From Senator Hatch**

*(1) Mr. Greenstein, you indicated in your testimony that the best way to measure tax burdens is to examine effective tax rates. May I say that one way to measure tax burdens is to examine effective tax rates, but it certainly is not the only way nor is it necessarily the best way. For example, another way to measure tax burdens, and I believe a better way, is to examine the percentage of total taxes paid by a particular group.*

The percentage of taxes paid ignores how much income different groups have and, therefore, is an incomplete measure of "burden." Effective tax rates measure actual taxes paid as a share of income. This, to me, is a more accurate measure of burden.

*(2) According to Dr. Viard's testimony, the top 5 percent of all taxpayers pay 44 percent of all federal taxes while earning only 31 percent of the income. At the same time, the bottom 40 percent of income earners paid only 5 percent of all federal taxes while earning 13 percent of the national income.*

I believe Dr. Viard is referring to CBO data for 2005 which shows that the top five percent of income earners received 31 percent of overall pre-tax income. The data also shows that this same group received 28 percent of total after-tax income. This implies a modest amount of tax progressivity, with the emphasis on modest.

*(3) Moreover, according to a 2007 study by the Tax Foundation looks at both the tax and the spending sides of the equation, the average household in the lowest earning quintile paid about \$1,700 in federal taxes but received nearly \$25,000 in federal spending, while the average household in the top earning quintile paid \$57,500 in federal taxes but received only \$18,600 in federal spending. These other analyses tell quite a different story than what you are portraying. Have you looked at the Obama tax proposals in light of these other ways of measuring tax burden, and why do you believe that an examination of effective tax rates alone is the best way to measure tax burden?*

We look at many measures of the fairness and adequacy of different tax policies. Effective tax rates are frequently the best measure because they take into account taxpayers' actual taxes paid as a percentage of their income. But we look at other measures as well. For example, marginal tax rates can be useful for analyzing a tax system's impact at the margin. And looking at the benefits that various taxpayers receive from the government, as the Tax Foundation suggests, can also be useful, though we might not agree with the Tax Foundation's analysis of the distribution of these benefits.

*(4) Mr. Greenstein, in your testimony, you analyze the Obama tax plan compared against what you call "current law," which you define as the tax law if the 2001 and 2003 tax cuts are allowed to expire. Now, I agree that current law does provide for the expiration of this tax relief. However, in my judgment, it is hardly fair to compare the Obama tax plan against the tax law if the tax relief is allowed to expire. After all, allowing the tax relief to expire is also a choice. Rather, we should be comparing the Obama plan against 2009 law, or today's tax rates. Under such an apples-to-apples comparison, is it not true that the tax burden on those in the top two brackets would be much higher under the Obama plan?*



I do not agree that using the current-policy baseline is a fairer, more “apples-to-apples” comparison. Both the current-policy baseline and the current-law baseline are useful measures against which to analyze tax policy proposals. As you note, using the current-policy baseline shows changes compared to today’s tax rates. Current-law baseline is the basis for CBO scoring and the application of budget rules, and reflects what the law will be unless Congress acts to change it.

As for your question about taxes in the top two income tax brackets, it is true that the President’s budget would increase effective tax rates on filers at the very top of the income scale compared to current policy, back to just below the levels these filers faced taxes under President Clinton. According to data from the Tax Policy Center, the average effective rate would be lower for virtually every income group — including the top 1 percent — under the President’s proposal than it was if the Clinton tax law was still in effect. I would note that the economy did quite well during the Clinton years. By virtually every measure, including small business job growth, it performed better during the Clinton years than it did under the tax system put in place by President Bush. Considering the fiscal challenges we face and the tax windfalls that those at the top of the income scale have received over the past 8 years, I believe the President’s proposal to allow the tax cuts at the top to expire on schedule is prudent.

*(5) Mr. Greenstein, you indicated your belief that the President’s charitable contributions proposal is “hardly a radical one,” and then went on to indicate that it would affect only 1.4 percent of households. I do not know if this is true or not, but even if it is true, aren’t these 1.4 percent of households responsible for a significant amount of charitable giving in our society?*

Taxpayers affected by the proposal account for only about 17 percent of total charitable giving. We estimate that total charitable giving would decline by about 1.9 percent. These estimates are described in a recent paper by the Center on Budget and Policy Priorities, “Proposal to Cap Deductions for High-Income Households Would Reduce Charitable Contributions by Only 1.9 Percent” (revised March 31, 2009).

*(6) In an op-ed article in the Washington Post this week, noted economist Martin Feldstein estimates that the effect on charitable giving would be about 10 percent. When it comes to charitable giving, I would consider a 10 percent drop pretty significant and quite harmful, wouldn’t you?*

Dr. Feldstein estimated that the proposal would reduce the total giving of those donors affected by the proposal by 10 percent. Since those donors account for only about 17 percent of total giving, the proposal’s effect on total charitable giving would be much less — a reduction of about 1.9 percent of total charitable contributions. Dr. Feldstein’s estimates and ours are very similar.

*(7) Mr. Greenstein, you quotes the Tax Policy Center figures that only 2.2 percent of people with small business income would be in the top tax brackets in 2012 if the top two rates revert to their pre-2001 levels. I have seen other figures that indicate that the number is much higher than this, but assuming you are correct, is it not true that those 2.2 percent of people affected account for a much larger share of total small business income? Aren’t these entrepreneurs who would be most affected also the ones who are most likely to be the owners of the larger small businesses that have been or have the potential to grow the fastest and create the most jobs right away?*

We do not have a precise figure for the share of small business income this 2.2 percent of filers represents, but we would agree that, due to the unequal distribution of income, it's higher than 2.2 percent. We do not have any reason to believe that small businesses in the top brackets are most likely to grow quickly. Indeed, it may be that older, more established small businesses are both less likely to expand quickly and more likely to make large distributions to their shareholders. Also, it's worth noting that small business job growth was twice as high during the Clinton years — when effective tax rates at the top were close to those proposed by President Obama — as it was during the Bush years, even excluding the downturn at the end of the Bush presidency. For further information about the impact of the President's budget proposal on small businesses, please see Jason Levitis and Chuck Marr, "History Contradicts Claim That President's Budget Would Harm Small Business Job Creation" CBPP, March 26, 2009; <http://www.cbpp.org/cms/index.cfm?fa=view&id=2742>.

*(8) Mr. Greenstein, you indicate in your testimony that cap and trade legislation, if done correctly (meaning low- and middle-income consumers are adequately compensated from the proceeds of the auctions) would not have the effect of a tax increase on poor and average families. In coming to this conclusion, have you taken into account the very real possibility that the companies affected by the increased costs of a cap and trade regime might not be able to pass on all of the additional costs to the consumer, and that significant job loss in our economy is a very possible result of such legislation? Isn't the loss of one's job perhaps the worst form of taxation?*

Cap and trade legislation to reduce greenhouse gas emissions will change the way energy is produced and consumed in the United States. If you are asking whether climate legislation will have a significant long-term negative impact on U.S. economic growth and job creation, the answer is no. The U.S. economy has shown throughout its history that it can change and grow at the same time, and the evidence I have seen suggests that the macroeconomic effects of climate change legislation are very modest. That said, there can be some short run transitional impacts on some industries, and it is appropriate for climate change legislation to include, in addition to consumer relief, measures to use some of the allowance value in a cap-and-trade system to assist particularly hard-hit workers and communities.

## SUBMITTED BY SENATOR NELSON

## WALL STREET JOURNAL

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**No Pity for Rich Tax Cheats**

*Yet IRS Says the Wealthy Have Fewer Errors on Returns*

By *Martin Vaughan*

The swiftness with which former Sen. Tom Daschle withdrew his bid for a place on President Barack Obama's cabinet underscores how potent public outrage can be when elites do not pay the taxes they owe.

A recent survey released by the IRS Oversight Board confirms this fervor to make sure Uncle Sam isn't shortchanged—especially by the wealthy. According to the results, 82% of 1,000 Americans surveyed said it is “very important” for the IRS to ensure that high-income taxpayers play by the rules, a high-water mark since the Oversight Board began asking the question in 2002.

The IRS Oversight Board survey also found public opinion growing less tolerant of tax cheating for people of all incomes, not just the rich. This year, 70% said it was “very important” for the IRS to ensure that low-income taxpayers are honest, while that number in past surveys has hovered in the low-60% range.

“The results seem to show that taxpayers have little tolerance for those who would push the bounds of legality, whether it's the plumber or the CEO,” says Paul Cherecwich, chairman of the Oversight Board.

The survey was based on interviews conducted last August—long before the tax problems of Obama cabinet nominees Mr. Daschle, Timothy Geithner and Nancy Killefer brought tax compliance into the public eye.

“The general public could get the sense that wealthy, well-connected people aren't paying their fair share,” says Daniel Shaviro, professor of taxation at New York University School of Law. “If I was the IRS, I would be very alarmed about Geithner and Daschle, and what effect that could have on people's willingness to pay.”

***Filing Errors***

Yet the latest available IRS data suggest that the less-well-heeled are more likely to have errors on their returns than the wealthy. That should come as no surprise, since the rich

are several times more likely to get audited—nearly 1 in 10 taxpayers with income over \$1 million were audited in 2007. And given the increased chance of audit, wealthy taxpayers often employ a cadre of accountants, advisers and attorneys to ensure their returns are up to snuff.

IRS data from income-tax returns filed in 2006 show that for taxpayers making over \$1 million and who underwent a field audit, the IRS recommended a change in 76% of cases. That compares to 83% for taxpayers making less than \$200,000.

But the amounts in dispute, when the IRS did uncover a discrepancy, may come as a surprise to some. The average amount of additional tax IRS recommended for the \$1 million-and-up income group was \$258,836, compared to an average of \$9,521 for those making less than \$200,000.

“I would lay down under my desk and sob if [a client] had an adjustment like that,” says Victoria Serles, national director of the wealth-management practice at accounting firm BDO Seidman. Ms. Serles says that in her experience, additional amounts owed by high-net-worth clients have rarely even reached the tens of thousands.

Ms. Serles also says that if the IRS uncovers a mistake on an audit that she was responsible for, she offers to pay any penalties. “I have a vested interest in making sure the return is 100% accurate,” she says.

In most cases when the IRS slaps the wealthy with additional tax, it is not because of a mistake of law—as was reported in the case with Mr. Daschle, who owed taxes on income that was clearly taxable but unreported. More common are errors of “fact and circumstance,” such as the proper valuation of a piece of real property that is donated to charity and then deducted, tax advisers say.

“Common matters that can end up surfacing most frequently relate to items that were deducted, such as charitable contributions of property in kind, or stock in a family business, or deductions that were taken with respect to certain family trusts,” says Larry Richman, head of the private wealth services group at Chicago law firm Neal, Gerber, & Eisenberg LLP.

The IRS in recent years has pushed for increased third-party reporting of information, which is aimed at squeezing out errors and misrepresentations that result in some paying less than they owe. For example, brokers in 2011 will have to begin reporting the basis of stock that is acquired after that date, which will give the IRS a clearer picture of taxable gains on investments.

### ***Shifting Tax Burden***

Beyond issues of tax compliance, recent data on the effective income tax rates paid by the wealthy are fueling calls for a redistribution of the tax burden. The IRS released data this

month showing that the effective income tax rate on the 400 highest-income individual returns fell to just over 17% in 2006, down from 22% before President George W. Bush took office.

That drop is largely due to the effect of the 15% preferential rate on capital-gains income, which came into effect in 2003. Someone who is among the 400 highest-paid taxpayers in any given year is likely to have had a large capital gain, for instance from selling a business or a large long-term investment.

That could be fodder for Democrats to argue for letting the capital-gains tax cut expire on Jan. 1, 2011, when it is scheduled to revert to 20%. But other tax increases that affect the wealthy—long considered Democratic targets—might be a dicier proposition in the current economy.

While some Democrats have advocated raising tax rates on the “carried interest” of private-equity fund managers and venture capitalists, the ailing economy might cause them to think twice. “In today’s economic environment, those carried interests don’t have anywhere close to the same value as the government once thought they had,” Mr. Richman says.

\* \* \*

IN DECEMBER, we told you about new tax credits for home energy-efficiency improvements in effect for 2009. For homeowners who still aren’t convinced, Congress is preparing to once again sweeten the deal in the pending economic stimulus legislation.

Both House and Senate versions of the bill would increase the tax credit from 10% to 30% of the cost of adding insulation or installing energy-efficient furnaces, boilers or wood-pellet stoves. Under current law, energy-efficiency tax credits may not total more than \$500 for the same home.

*But both economic stimulus proposals would increase that per-home cap to \$1,500 for all improvements made in 2009 and 2010.*

**Testimony of Paul Taylor**  
**Executive Vice President, Pew Research Center**  
**Senate Finance Committee, March 26, 2009**

Chairman Baucus, Ranking Member Grassley and members of this Committee, thank you for the opportunity to testify at this hearing on middle class tax relief, and allow me to make one thing clear at the outset: I am not a tax policy expert. Nor am I an economist, though I have colleagues who are. I am appearing before you today as the principal author of a report the Pew Research Center released last year entitled, "Inside the Middle Class: Bad Times Hit the Good Life" ([www.pewsocialtrends.org/pubs/706/middle-class-poll](http://www.pewsocialtrends.org/pubs/706/middle-class-poll)). The report combines findings of one of our major national public opinion surveys with the Center's analysis of four decades of demographic and economic trends from the Census Bureau and other sources.

The Pew Research Center does not take positions on policy issues. We are a nonpartisan "fact tank" that generates information we hope will be of value to policymakers. My testimony today summarizes and updates some of the key findings of our 169 page report. Among them:

- About half of all Americans think of themselves as middle class. Economically and demographically, they are a surprisingly varied group.
- Middle-class Americans believe they've stagnated in the past five years. But they also believe they have a higher standard of living than their parents had.
- Income data from the Census say they're right on both fronts. Even before the onset of the current recession, this decade had witnessed the longest stretch in modern U.S. economic history in which median household income failed to surpass an earlier peak (in 1999). However, over a longer haul --since 1969 -- median household income has risen by 41%, after adjusting both for inflation and changes in household size.
- For middle-income Americans, the past several decades have been characterized by *rising prosperity and rising inequality*. The middle income tier has fallen farther behind the upper income group in both income and wealth.
- For the past two decades -- until the current recession -- middle income Americans had been spending more and, relative to their income, borrowing much more. Housing was the key driver of both trends.

**About Half of Americans Say They're Middle Class**  
**Percentage of Americans who identify themselves as...**

	All
	%
Upper class (NET)	21
<i>Upper</i>	2
<i>Upper-middle</i>	19
Middle class	53
Lower class (NET)	25
<i>Lower-middle</i>	19
<i>Lower</i>	6
Don't know/Refused	1
	100

Number of respondents 2413

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- Since 1970, the middle income tier in America has shrunk by about 5 percentage points. This small but notable hollowing out has been accompanied by an increase in the share of adults in *both* the upper and lower income tiers.
- Since 1970, the demography of the middle-income tier has changed in much the same way that the composition of the U.S. population as a whole has changed. It is older, better educated, less likely to be white and less likely to be married.

**I. How the Middle Class Defines Itself**

"Middle class" is a term that is universally familiar but devilishly difficult to pin down. It is both a social and economic construct, and because these domains don't always align, its borders are fuzzy. Is a \$30,000-a-year resident in brain surgery lower class? Is a \$100,000-a-year plumber upper-middle class? One way to sidestep riddles of this sort is to ask people to label themselves. That's what we did in a telephone survey of a nationally representative sample of 2,413 adults last year.<sup>1</sup> It produced a straightforward-seeming result: about half (53%) of all adults in America say they are middle class; and the median annual family income of this group of respondents is \$52,285.

But beyond the simplicity of these numbers lies a nest of anomalies. For example, about four-in-ten (41%) adults with \$100,000 or more in annual household income say they are middle class. So do nearly half (46%) of those whose household incomes are below \$40,000. As for those in between, about a third say they're *not* in the middle class.

In short, when it comes to self-identifying as middle class, different groups of Americans use different yardsticks. Some cases in point: younger adults and older adults are both more likely than middle-aged adults to describe themselves as middle class, even though, on average, their income levels are lower. Meantime, middle-aged middle-class adults are more likely than

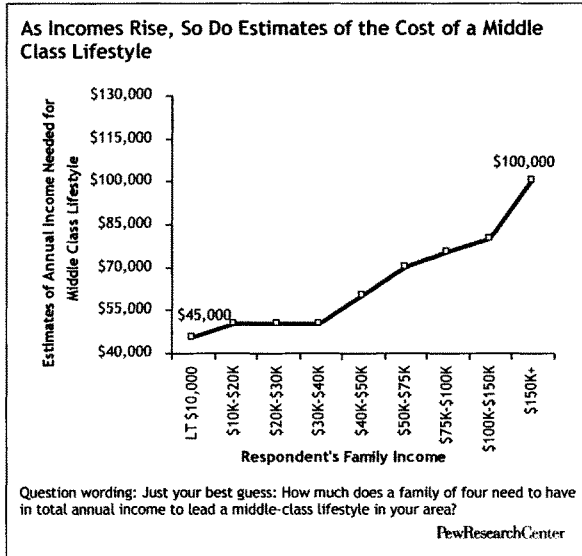
<b>Middle Class Incomes</b>	
Percentage in each income group that identify as middle class	
	<b>% in Middle class</b>
	<b>%</b>
Less than \$19,999	41
\$20,000-\$29,999	49
\$30,000-\$39,999	50
\$40,000-\$49,999	59
\$50,000-\$74,999	68
\$75,000-\$99,999	63
\$100,000-\$149,999	47
\$150,000 or more	33
Number of respondents	2413
PewResearchCenter	

<b>Middle Class Incomes</b>	
Percentage of middle class with family incomes of...	
	<b>Middle class</b>
	<b>%</b>
Less than \$19,999	12
\$20,000-\$29,999	9
\$30,000-\$39,999	9
\$40,000-\$49,999	11
\$50,000-\$74,999	18
\$75,000-\$99,999	14
\$100,000-\$149,999	8
\$150,000 or more	4
Don't know/Refused	15
	100
Number of respondents	1276
Note: Based on respondents who identified themselves as belonging to the middle class.	
PewResearchCenter	

<sup>1</sup> The survey was conducted from Jan. 24 through Feb. 19, 2008 among a nationally representative sample of 2,413 adults. The survey design included an over-sample of blacks and Hispanics, as well as a dual sample frame of respondents reached via landline (1,659) or cell (754) phone. All data are weighted to produce results from a representative sample of the full adult population. Margin of sampling error is plus or minus 2.5 percentage points for results based on the total sample at the 95% confidence level.

those who are younger and older to report financial stresses, even though they have more income. Also, roughly the same percentages of whites (53%), blacks (50%) and Hispanics (54%) self-identify as middle class, despite the fact that the income and wealth of blacks and Hispanics who say they are middle class is much lower than that of whites who say they are middle class. Clearly, declaring oneself to be middle class is more than a statement about income and assets. It's also a state of mind.

Along these same lines, when survey respondents are asked how much money they think it takes for a family of four to lead a "middle-class lifestyle" in their area, their answers array along a sliding scale that correlates with their income. The greater the income, the higher the estimate. Thus, adults in families whose income is between \$100,000 and \$150,000 a year believe, on average, that it takes \$80,000 to live a middle-class life in their area. By contrast, adults in families whose income is less than \$30,000 a year believe that a middle-



class lifestyle can be had for about \$50,000 a year. Analyzing these estimates by the ZIP codes of the respondents yields a similar finding: people who live in communities with a high cost of living think it takes, on average, about \$15,000 more to be in the middle class than do people who live in communities with a low cost of living.

The bottom line is that while about half the country considers itself middle class, their judgments are influenced by the laws of relativity. Bearing this in mind, our report undertook a parallel analysis of what it means to be middle class -- this one driven by economic and demographic data rather than by self-definition. Using Census figures, we divided Americans into three income tiers -- low, middle and high. We defined the middle income tier as consisting of adults who live in a household where the annual income falls within 75% to 150% of the national median, a common set of boundaries for analyses of income dispersion.<sup>2</sup>

<sup>2</sup> The boundaries of this middle tier vary by household size; in 2007, they were \$45,676 to \$91,351 for a family of three, which is close to the typical household size in the U.S. All dollar figures inflation-adjusted to January 2009.

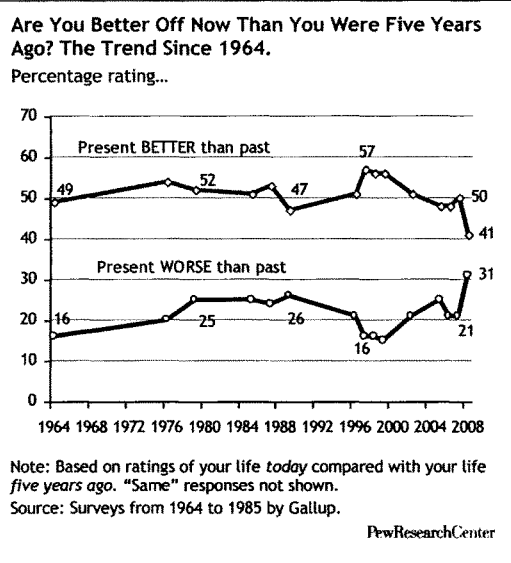


This analytical frame enabled us to examine how the middle income tier has changed over time in its size, demographic traits and standard of living. Has it gotten smaller or larger since 1970? How has it fared economically – both in absolute terms, and relative to the income tiers below and above? Also, by lining up these Census-based trends alongside our survey results, we were able to make some judgments about how well public perceptions square with the underlying economic realities.

**II. The Middle Class Sees Short-Term Stagnation, Long Term Progress**

Even before the current recession settled in, the American middle class felt stuck in its tracks. The Pew Research survey was conducted in January and February of 2008, during the early days of what was then a still-not-yet officially declared recession. Even so, a majority of self-identified middle class survey respondents said then that in the past five years, they either hadn't moved forward in life or had actually fallen backward. Though there are some differences by income class, the total U.S. population, in the aggregate, felt essentially the same way: some 25% said they hadn't moved forward in life, and 31% said they had fallen backward. This was the most downbeat short-term assessment of personal progress in nearly half a century of polling by the Pew Research Center and the Gallup organization.

However, the public's judgments about its



**Intergenerational Upward Mobility**

	All	Upper class	Middle class	Lower class
<b>My standard of living compared to my parents' is...</b>	%	%	%	%
Much better	38	57	38	22
Somewhat better	27	23	29	27
About the same	19	13	21	19
Somewhat worse	9	5	7	17
Much worse	5	1	3	13
Don't know/Refused	2	1	2	2
	100	100	100	100
Number of respondents	2413	522	1276	588

Question wording: Compared to your parents, when they were the age you are now, do you think your own standard of living now is much better, somewhat better, about the same, somewhat worse or much worse than theirs was?  
Note: Based on respondents who identified themselves as belonging to the lower, middle, or upper class.  
PewResearchCenter

economic mobility aren't all negative. When we asked respondents to measure their progress over a longer time frame, their glasses became more than half full. Two-thirds of all respondents said they had a higher standard of living than their parents had when their parents were their age. Just 14% said their standard of living was lower.

In both of these sets of judgments – short term stagnation, long term progress – those who self-identify as middle class fall out where one would expect on the socio-economic ladder. They are more upbeat about their progress than are those who self-identify with the lower class, but less upbeat than those who self-identify with the upper class.<sup>3</sup> This pattern repeats itself on a wide range of questions about personal finances that we posed in this survey. For example, the percentage of people who said they “live comfortably” ranges from 66% of the self-defined upper class to 39% of the self-defined middle class to just 9% of the self-defined lower class. And when we asked people if they had cut back on household spending in the past year because money was tight, 75% of the lower class said they had, compared with 53% of the middle class and just 36% of the upper class.

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<sup>3</sup> Throughout this report, we combine respondents who say they are “upper” and “upper middle” into a single “upper class” category and we combine respondents who say they are “lower middle” and “lower” into a single “lower class” category.

### III. Trends in Household Income, 1970-2007

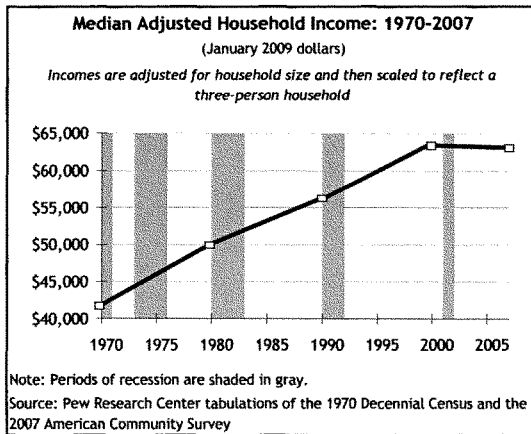
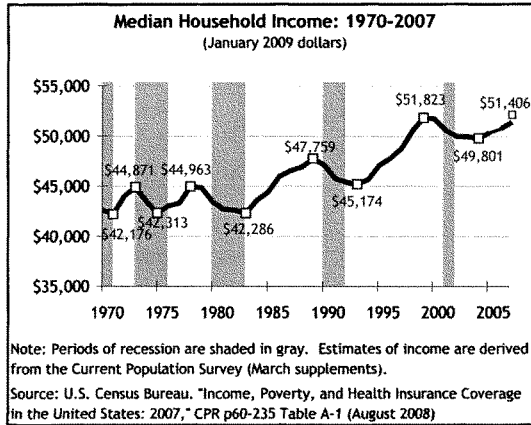
One of the most robust findings of our report is how closely people's perceptions of their economic progress over time square with economic trends from the Census and other key government data sources. When people in the middle class say they haven't moved forward in life in recent years, the economic data say they're right. And when they say that they're doing better than their parents did when they were the same age, the economic data once again say they're right.

Let's first look at the long term trends.

From 1970 through 2007, median annual household income increased by a total of 41%, after adjusting both for inflation and for the decline in household size.<sup>4</sup> Most economists agree that trends in inflation-adjusted median household income are the best single indicator of a population's changing standard of living. But they are not the only measure. Our report also examined changes over time in household wealth and household expenditures. All three indicators tell essentially the same story: over the past several decades, there has been measurable progress in America's standard of living.

However, trends for the population as a whole do not always explain what has happened to different sub-groups within the population. Have some done better than others? And, in particular, how has the middle-income tier fared since 1970 compared with groups above and below?

When it comes to household income, the middle income group has not fared quite as well as the lower income group (those in households with annual



<sup>4</sup> In 1970, the typical household had 3.1 people. In 2007, the typical household had just 2.5 people. This trend is the result of a decline in fertility (leading to smaller families) and a decline in the years that adults spend being married (leading to more single person households). Without making an adjustment for this change, the increase in median household income from 1970-2007 would be just 21%. For more on how we made this adjustment, see appendix.

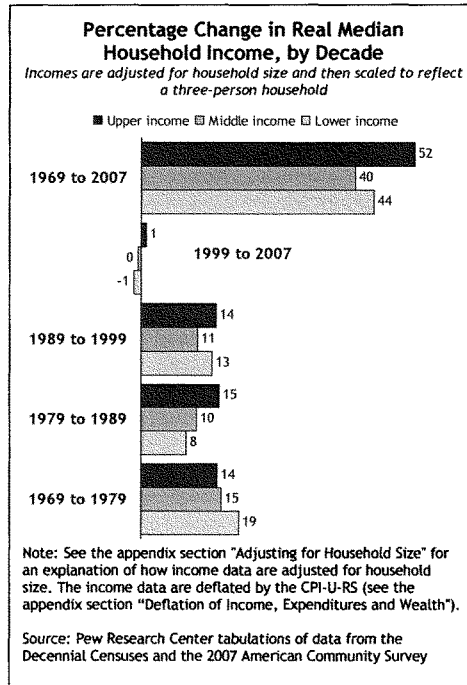
incomes below 75% of the median) or nearly as well as the upper income group (those in households with annual incomes above 150% of the median). Since 1970, the median income of the middle group has risen by 40%, compared with 44% for the lower group and 52% for the upper group (all rates adjusted both for inflation and changes in household size).

A similar analysis of the change over time in the median net worth of these three income tiers produces a more pronounced contrast in fortunes. The median net worth of the upper income tier rose by 115% from 1983 to 2007, compared with a rise of just 68% for the middle income tier and 44% for the lower tier. Thus, over several decades, the middle and lower income groups have been making absolute economic progress while experiencing relative decline.

There is one more trend analysis that fills out the story line. When we look at changes in median household income by individual decade rather than over the 40-year span, we can see why so many Americans feel they are stuck in their tracks – and why they felt this way even before the onset of the current recession.

As the chart to the right illustrates, the middle income tier has made virtually no gains at all in median household income during this decade (at least not through the end of 2007, the last year for which data for this analysis are available), and neither have the groups above or below them. For the typical American household, the Great Recession that began in December 2007 was preceded by a less dramatic but equally unusual economic phenomenon: a Phantom Recovery. Inflation-adjusted median household income has remained below its 1999 peak in every year since then, first during the shallow recession at the start of this decade and later during the economic “recovery” that ran from the end of 2001 through the end of 2007. In fact, the eight-year period from 1999 to 2007 is the longest in modern U.S. economic history in which median household income failed to surpass an earlier peak. The Census Bureau has not yet released household income data for 2008, but the recession has likely kept this indicator below its 1999 peak for another year, and may keep it there on into the next decade.

The bottom line is that the middle class has it right. Over the long haul, its standard of living has risen. But over the course of the past decade, it hasn't.



**IV. The Middle Class Borrows More and Consumes More**

One of the important changes in the economic life of the middle class over the past quarter century has been the extent to which it has engaged in higher levels of consumption and taken on a higher burden of debt. At least until the current recession, housing was the key driver of both trends.

From 1980 through 2006, middle income families increased their inflation-adjusted expenditures by 15%. In part, that's because the cost of many of the anchors of a middle class lifestyle – housing, health care, education – rose more sharply than inflation. It's also because many new goods and services that didn't exist a few decades ago – high speed internet, cable and satellite subscriptions, high definition television, among others -- have become commonplace consumer items. (As the chart to the right illustrates, many in the middle class tend to overestimate just how commonplace these items are – creating a "possessions perception gap" that may have fueled some of this consumption).

The 15% growth in real consumption by the middle income over this time period is about the same at the change experienced by lower income families (16%) but only about half the rate of growth experienced by upper income families (32%).

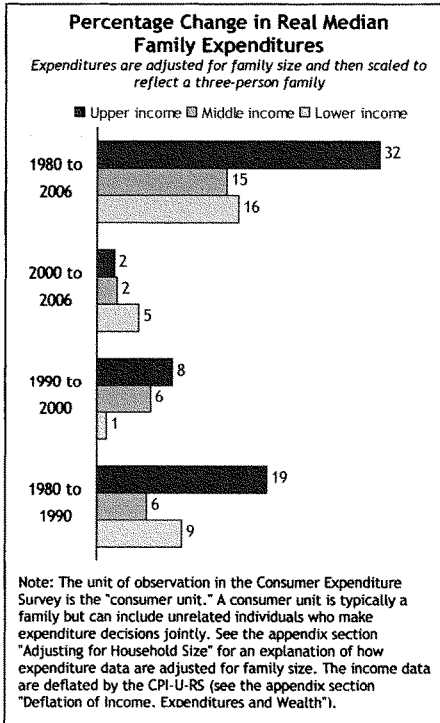
Somewhat more so than for the income groups above and below them, the middle tier paid for its increased consumption by taking on more debt, most typically in the form of bigger mortgages and second mortgages. Thus, the median debt-to-income ratio of middle income households more than doubled from 1983 to 2004; these rates also rose for the other lower and upper income

**What I Have, What Most People Have**  
Based on middle-class respondents

	Most families have	My family has
	%	%
Cable or satellite service*	91	71
Two or more cars	90	72
High-speed Internet	87	67
High-def or flat screen TV	63	42
Child in private school**	25	14
Paid household help	22	13
A vacation home	12	9

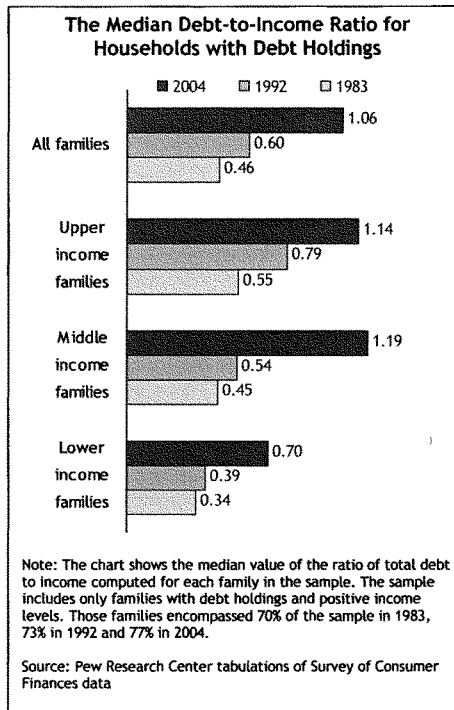
Note: \*Beyond the basic service. \*\*Based on respondents with minor age children.

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groups, but not quite at the accelerated pace of the middle group.

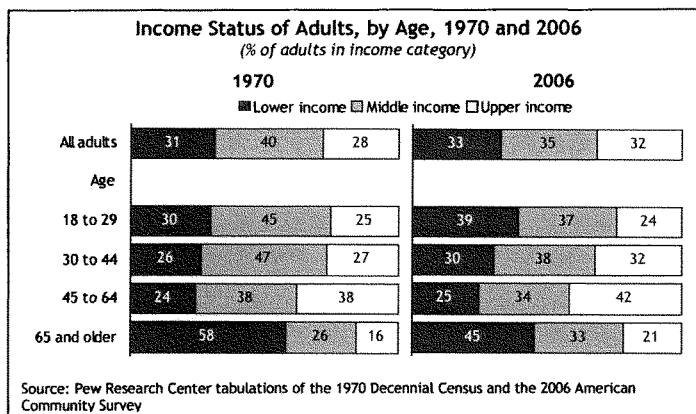
Obviously, housing values, expenditure patterns and debt habits are much different today than they had been just a few years ago. It's beyond the scope of this report to analyze these more recent developments, in part because of the lag time in the availability of some of the key data. The story told by the numbers presented here essentially ends before the start of the current recession. But it helps to provide a context for – and perhaps to foreshadow – current developments.



## V. The Middle Income Tier: Then and Now

Since 1970, the middle income tier in America has shrunk by about 5 percentage points.

In 1970, 40% of all adults in this country lived in a middle income household, with "middle" defined as one where the income falls within 75% to 150% of the median. By 2006, just 35% of adults were in the middle income tier.

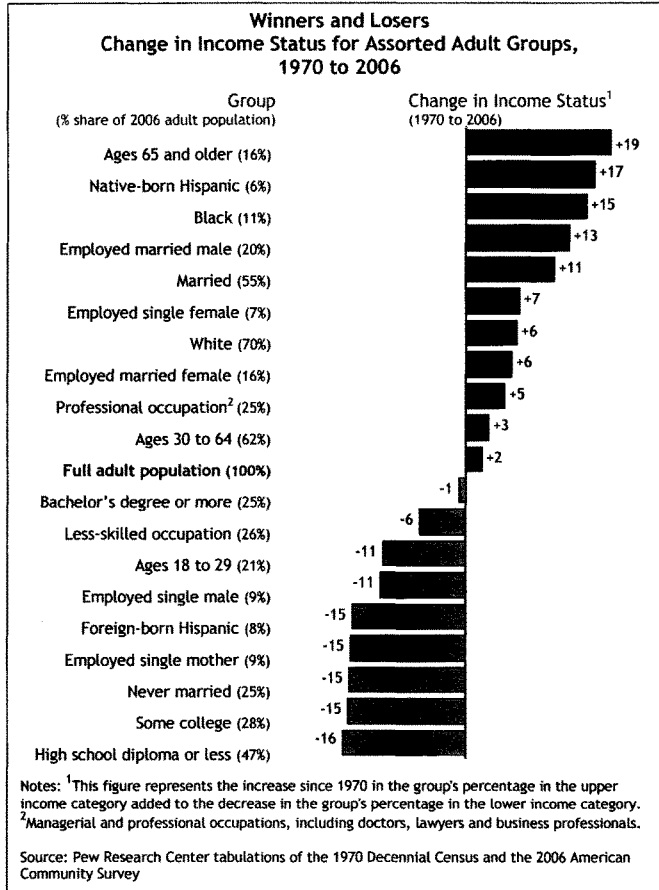


This small but notable hollowing out of the middle has been accompanied by an increase in the share of adults in both the lower income category and the upper income category. The rise in share has been greater over this time period for the upper group (to 32% in 2006 from 28% in 1970) than for the lower income tier (to 33% in 2006 from 31% in 1970). Looking at these changes by age group shows that the trends have been very different for the youngest and oldest adults. The 65 and older group has moved ahead during the past 36 years; the 18-to-29 year old group has fallen behind. Among the older group, just 45% were in the lower income tier in 2006, down from 58% in 1970. Among the younger group, 39% were lower income in 2006, up from 30% in 1970.

Some demographic groups have improved their income status since 1970; others have fallen behind.

The period since 1970 has seen a distinct sorting of many different demographic groups into different income tiers. In addition to the elderly, the groups that have gained the most include blacks and native-born Hispanics. Married adults have also done well, while the never-married have fallen behind.

On the gender front, men and women have moved in different directions, depending on marital and work status.



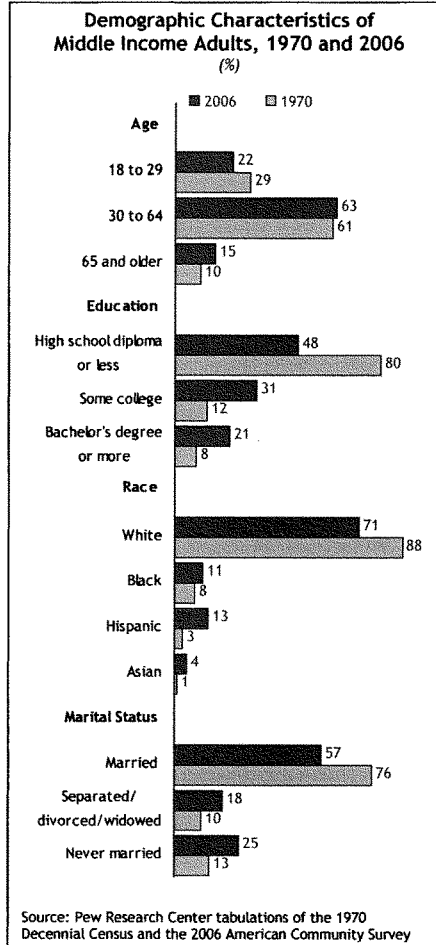
Working husbands and working wives both have seen their income positions improve since 1970, but the gains have been greater for working husbands. Among those who are not married, the gender pattern is reversed: single working women's income position has improved since 1970, while single working men's income position has declined. Other groups that have not fared well are young adults, people in lower-skilled jobs, people with less educational attainment, and immigrant Hispanics. The decline for this last group is mainly the result of a heavy influx of low-skilled immigrants, rather than downward mobility among immigrants already in the U.S.



**Since 1970, the middle income tier has gotten older, better educated, less likely to be white and less likely to be married.**

Demographic changes in the middle income tier since 1970 are very similar to the changes in the U.S. adult population as a whole. The average age for middle income adults was 45 in 2006, up from 41 in 1970 (comparable figures for the full adult population are 46 in 2006 and 44 in 1970). In 1970, 88% of the middle income group was white; by 2006, just 71% was white (comparable figures for the full adult population are 86% in 1970 and 70% in 2006). The ethnic group that moved heavily into the middle income tier during this period was Hispanics: in 1970, they made up just 3% of the middle tier; by 2006, they were 13%.

In 1970, more than three-quarters (76%) of the middle income group were married; by 2006, just 57% were married. But the biggest demographic change has come in levels of educational attainment. In 1970, just one-in-five middle income adults had at least some college education; by 2006, more than half did. As noted on the previous page, never married adults and those with less educational attainment have been among the groups suffering the biggest losses in income status over this period.



**Appendix: Adjusting for Household Size**

Household income data reported in this study are adjusted for the number of persons in a household. That is done in recognition of the reality that a four-person household with an income of, say, \$50,000 faces a tighter budget constraint than a two-person household with the same income. In addition to comparisons across households at a given point in time, this adjustment is useful for measuring changes in the income of households over time. That is because average household size in the United States has decreased from 3.1 persons in 1970 to 2.5 persons in 2007, a drop of 19%. Ignoring this demographic change would mean ignoring a commensurate loosening of the household budget constraint.

Following the practice of other researchers, this study does not make this adjustment on a simple per capita basis – on the theory that it does not cost twice as much to run a four-person household as it does to run a two-person household. Instead, it adjusts by using a ratio based on the square root of household size. In practical terms, this means that the cost of a one-person house is set at 100; the cost of a two person household is set at 141; the cost of three-person household is set at 173, the cost of a four-person household is set at 200, etc.

As discussed in the main body of the report, adjusting for household size has an effect on trends over time in income since 1970. However, once the adjustment has been made, it is immaterial whether one scales incomes to one-, two-, three- or four-person households. Regardless of the choice of household size, exactly the same results would emerge with respect to the trends in the well-being of lower, middle and upper income groups.

For a more detailed discussion of this and other methodological issues that arose in our research, go to the Appendix on Page 163 of our 2008 Middle Class report at [www.pewsocialtrends.org/pubs/706/middle-class-poll](http://www.pewsocialtrends.org/pubs/706/middle-class-poll).

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April 8, 2009

The Honorable Orrin G. Hatch  
United States Senate Committee On Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510-6200

Dear Senator Hatch:

Thank you again for the opportunity to testify before the Senate Finance Committee on March 26, 2009 at its hearing on Middle Class Tax Relief.

Following the hearing, you posed four written questions to me. Here are my responses:

*Q1. Mr. Taylor, in your testimony you indicated that most economists agree that trends in inflation-adjusted median household income are the best single indicator of a population's changing standard of living. Why isn't the measure of changes in household wealth a better measure? For example, if a family inherited a substantial amount of money, this would not show up as income but would appear as an increase in wealth. Wouldn't this better show an increase in standard of living?*

A. Inflation-adjusted median household income is the best available single indicator. Income is easier to measure and reported more regularly than is consumption and wealth. But as we note on page 142 of our report, "Inside the Middle Class: Bad Times Hit the Good Life," in order to get the fullest possible picture of a population's changing standard of living, it is important to look at patterns in wealth and expenditures as well as patterns in income.

Ideally, one would like a measure that accounts for all current and future sources of consumption, abstracting from short-term fluctuations in income. Such a measure would account for how consumption is smoothed over time via the accumulation of savings/wealth, retirement income, windfalls, etc. Since no such measure is available, one should consider changes over time in income, consumption and wealth to gauge overall changes in the standard of living. That is what we have done in our analysis.

*Q2. Your chart titled "Income Status of Adults, by Age, 1970 and 2006", seems to imply that there is some degree of mobility between the lower income, middle income, and upper income classes. Can you explain this mobility and how it might affect some of the tax decisions Congress must make?*

In the long-run, there will always be movement of different individual and groups in and out of various income tiers; and there is also always the potential that the population as a whole will experience upward or downward mobility. Our report shows that during the period we studied (1970-2006) the U.S. experienced a rise in inflation-adjusted median household income – meaning that the population as a whole was upwardly mobile during these decades. But this overall growth was not equally shared among all groups during this time period, leading to rising inequality and to slightly higher shares of the population being situated in *both* the upper and lower income tiers in 2006 than was the case in 1970. Some of the factors behind rising inequality are technological change that favors the college educated, decline of unions, international trade and immigration. The relative contribution of these and other factors is the subject of debate.

In the short-run, the mobility of a given individual or household is the consequence of income volatility, as demonstrated by the chart on Page 26 of our report, "Inside the Middle Class: Bad Times Hit the Good Life." Short-term factors typically revolve around a change in job status — unemployment, child bearing/raising, return to school, career advancement, etc.

As for the impact of these mobility patterns on tax policy, let me reiterate what I stated during my testimony. I am not an expert on tax policy, and the organization I represent — the Pew Research Center — does not take positions on policy matters. So I must take a pass on that question.

*Q3. Mr. Taylor, how does the Pew Research Center define middle class in the report you cited?*

Our report offered two different definitions. First, we asked the American public to identify what class they were in, and we found that 53% of a nationally- representative sample of 2,413 adults described themselves as middle class. (For more details see Page 28 of the report). Our second definition was based on a standard range often employed in economic analyses of income dispersion. Using U.S. Census Bureau data, we identified the median household income of the U.S. population, and we then defined the middle income tier as one made up of anyone who lives in a household where the annual income falls within 75% to 150% of this national median. In order to satisfy ourselves that this 75%/150% boundary was not producing distorted findings, we also ran analyses in which we fixed the boundaries of the middle income tier with ranges that were both wider and narrower. These analyses all yielded the same basic conclusions regarding both the absolute and relative change over time in the middle income standard of living. In other words, even if the precise boundaries we chose had been different, our findings would have been essentially the same.

*Q4. Your study shows that since 1970, the middle income tier has gotten older, better educated, less likely to be white and less likely to be married? Can the same be said for the upper income tier?*

Yes, as with those in the middle income group, adults in upper-income households in 2006 were older, better educated, less likely to be white, and less likely to be married than they were in 1970. The education profile of upper-income individuals has changed dramatically. In 2006 three quarters of upper-income persons had completed at least some college education beyond high school, up from just over a third of upper-income persons in 1970. The share of the upper-income tier who had finished at least a bachelor's degree increased from one-in-five in 1970 to nearly half by 2006.

I hope these responses are helpful. If I can be of any further assistance, please don't hesitate to be back in touch.

Sincerely,

Paul Taylor  
Executive Vice President  
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April 8, 2009

The Honorable Chuck Grassley  
United States Senate Committee On Finance  
219 Dirksen Senate Office Building  
Washington, DC 20510-6200

Dear Senator Grassley:

Thank you again for the opportunity to testify before the Senate Finance Committee on March 26, 2009 at its hearing on Middle Class Tax Relief.

Following the hearing, you posed some written questions to me and all other members of the witness panel regarding proposed changes to the Alternative Minimum Tax.

As I stated during my testimony, I am not an expert on tax policy and the organization I represent – the Pew Research Center – does not take positions on policy questions. So with all due respect, I will take a pass on responding to your inquiry.

Best wishes on your deliberations.

Sincerely,

Paul Taylor  
Executive Vice President  
Pew Research Center



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.

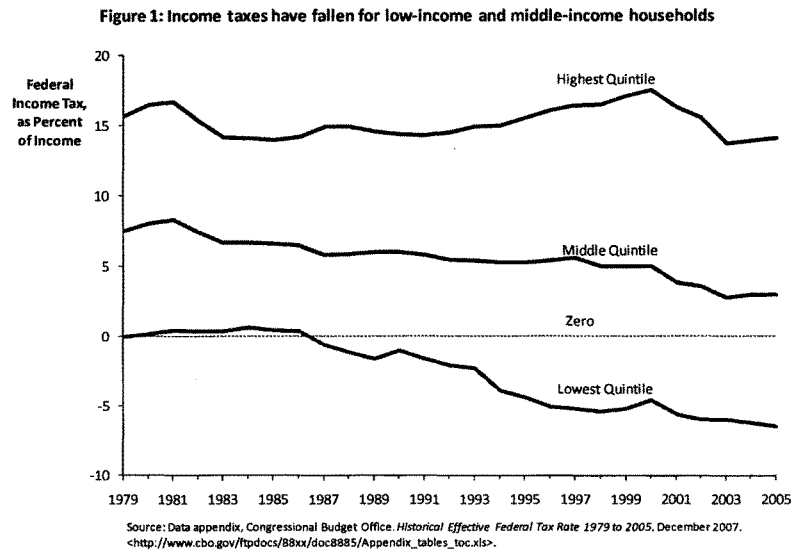
#### **MIDDLE-CLASS TAX BURDENS HAVE FALLEN OVER TIME**

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.<sup>1</sup>



<sup>1</sup> 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.<sup>2</sup>

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.<sup>3</sup>

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.

<sup>2</sup> 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>>.

<sup>3</sup> 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)

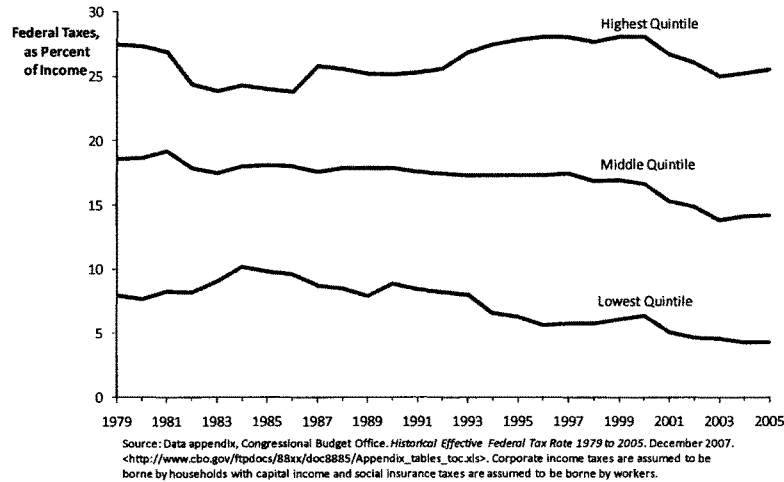


Figure 2 reveals that the following changes occurred from 1979 to 2005:

- 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.

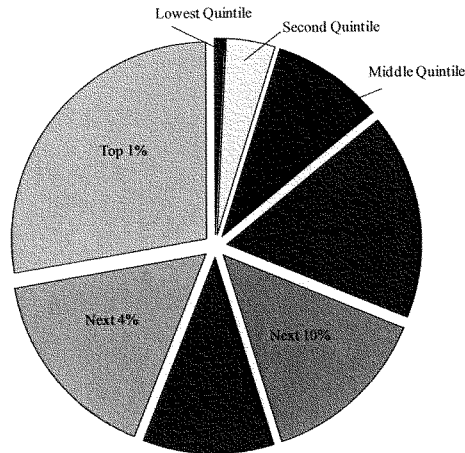
As before, low and middle income groups received the largest reductions, both as a share of income and as a share of initial tax liability.

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.<sup>4</sup>

<sup>4</sup> 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.

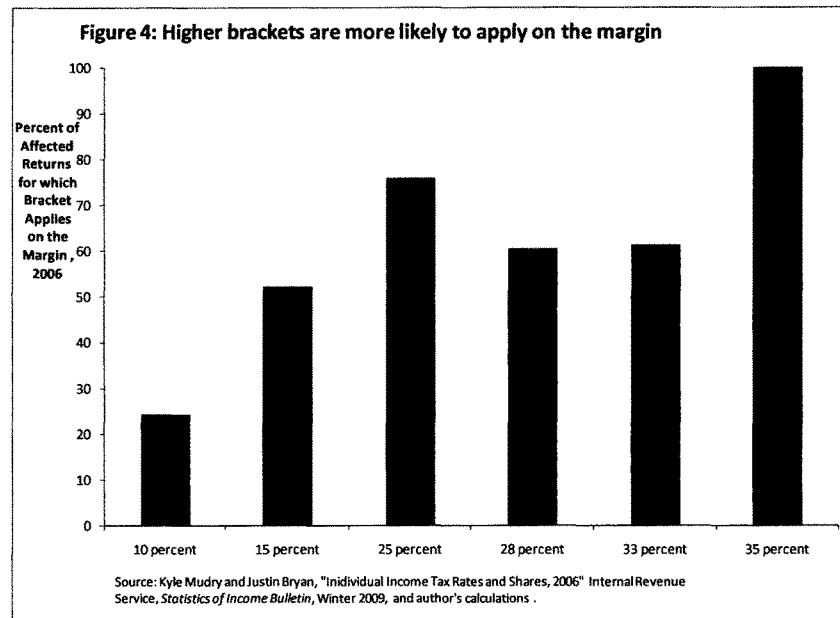
Instead, the relevant consideration is how earning an additional dollar will change the couple's tax. If the couple's income rises from \$75,000 to \$75,001, their tax liability will rise by 25 cents, from \$11,125.00 to \$11,125.25, because the additional dollar is taxed in the 25 percent bracket. (Similarly, 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.

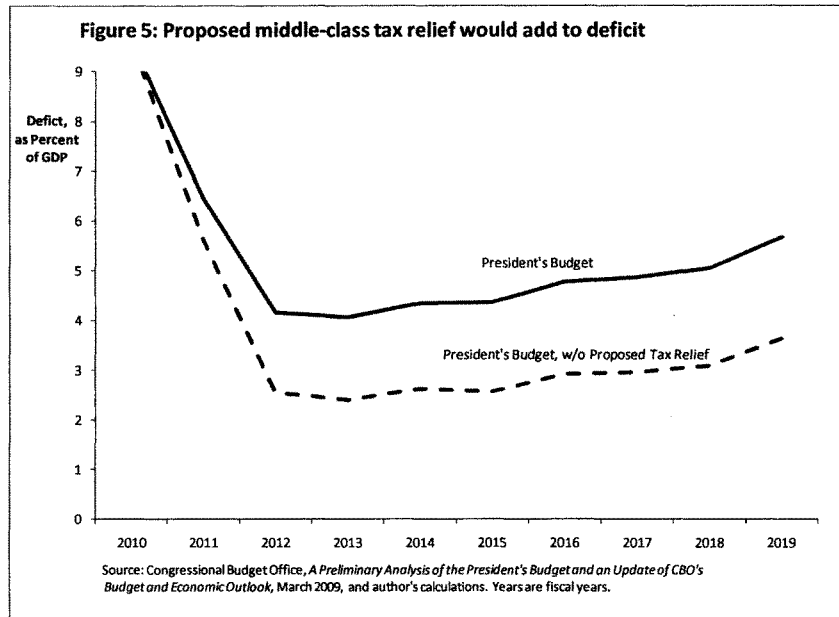
#### **MIDDLE-CLASS TAX RELIEF WIDENS THE FISCAL IMBALANCE**

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.

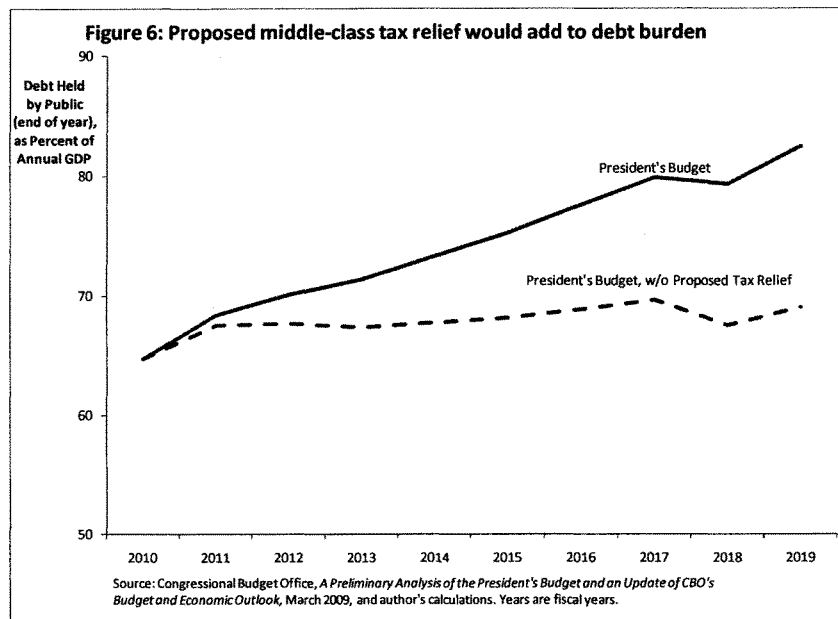
CBO estimates that, in fiscal 2019, President Obama's proposed partial extension of the individual income tax rate provisions of the Bush tax cuts would reduce revenue by \$134 billion, his proposed partial extension of other provisions of the Bush tax cuts (excluding his proposed partial extension of 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 110<sup>th</sup> Congress. Although that bill was not enacted, the 111<sup>th</sup> 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.



April 30, 2009

Re: Questions for the Record from March 26, 2009 hearing, "The Middle Income Tax Relief Question: Extend, Modify, or Expire?"

#### **PART I – RESPONSE TO SENATOR GRASSLEY’S QUESTIONS**

The Honorable Charles Grassley  
Committee on Finance  
U.S. Senate

Senator Grassley:

Thank you for submitting questions for the record. I have set forth my responses below. The views expressed in the responses are solely my own and do not necessarily reflect the views of any other person or any organization.

**1) On November 10, 2006, Goldman Sachs released a study on the effect of letting the 2001 and 2003 bipartisan tax relief sunset at the end of 2010. The Goldman study found that if this tax relief is allowed to expire at the end of 2010, "In the first quarter of 2011, real GDP growth drops more than 3 percentage points below what it would otherwise be. Absent a strong tailwind to growth from some other source, this would almost surely mark the onset of a recession." The study assumed that the Fed would ease monetary policy to lessen the economic blow of letting the tax relief expire. However, with the Fed Funds rate currently targeted at 0% to 0.25%, there is no room to ease monetary policy to lessen this economic blow. Hopefully, the economy will recover well enough so that the interest rates aren't that low, but who knows.**

So long as the recession continues and interest rates remain near zero, there is a strong Keynesian case against tax increases or spending cuts. It is likely, though, that the economy will have recovered by 2011 to the point that that Keynesian considerations can be set aside in setting tax and spending policy. If the recovery has not yet reached that point, then Keynesian considerations would warrant delaying (until the economy improves) any tax increases and spending cuts that might otherwise be adopted.

In any case, Keynesian considerations should not affect long-run tax and spending policy. The proper goal of Keynesian aggregate demand management is not to permanently increase aggregate demand in a futile attempt to permanently increase output, but rather to increase demand during periods of economic weakness and reduce it during periods of economic strength in order to smooth the business cycle.

Long-run tax and spending policy should be based on keeping marginal tax rates (particularly those on saving and investment) low and restraining government spending to keep the federal debt low. Keynesian considerations should not be allowed to alter that focus.

**2) Proponents of these tax hikes have argued in the past that paying down the deficit will reduce the effect of government borrowing “crowding out” private investment. However, the deficit in President Obama’s budget is so large that the reduction in “crowding out” would be minimal. What would be the economic effect of allowing the top two rates to increase to 36% and 39.6%, raising the capital gains and dividends rates to 20% for singles making over \$200,000 and married couples making over \$250,000, as well as fully restoring PEPs and Pease for that class of taxpayers?**

The tax changes would increase marginal tax rates, particularly on saving and investment. All else equal, the increase in marginal tax rates would reduce work, saving, and investment by high-income taxpayers and would also encourage them to shift income into tax-exempt form. As explained in my testimony, increases in the top tax rates impose the greatest economic distortion per dollar of revenue raised because they are more likely to affect taxpayers on the margin. Because of taxpayers’ behavioral responses, the revenue raised by these tax increases is likely to be smaller than expected.

The net economic effect depends on the use of the revenue raised by the tax increases. If the revenue were used to make the deficit lower than it otherwise would have been, at least part of the economic damage would be offset. (Even so, it would have been better for economic growth if the deficit reduction had been achieved through reductions in entitlement spending or through less distortionary tax increases). If, however, the revenue is used to increase entitlement spending or to finance middle-class tax cuts that do little to improve economic incentives, then the net impact on long-run economic growth is clearly negative.

**3) Senator Baucus and I have in recent years supported holding the number of taxpayers that owe Alternative Minimum Tax (“AMT”) the same from year to year, 4.2 million taxpayers. Although we are sketchy on the details, it appears that President Obama wants to patch the AMT by merely indexing the AMT exemption amounts, and other relevant AMT numbers, for inflation. Could the President’s proposed way of patching the AMT result in more taxpayers paying the AMT? And what is the preferred way to patch the AMT? Put another way, shouldn’t we insure that no more taxpayers are added to the AMT population?**

In addition to indexing the AMT exemption amounts to inflation (at their 2009 levels), President Obama also proposes to permanently allow the personal tax credits to be claimed against the AMT. In other words, he is proposing to make permanent both components of the temporary AMT “patches” adopted in recent years.

This approach would certainly prevent the massive spread of the ATM that would occur under the current-law baseline. I have not seen any estimates of the exact number of taxpayers who would be on the AMT under this proposal. It is possible that there would still be a small gradual increase in the AMT population (from its 2009 level of 3.8 million) because real income growth may, on net, cause more people, to move into the income ranges in which the AMT is most likely to apply.

If such a gradual increase does indeed occur under the president's proposal, the problem could easily be corrected by having the exemption amounts rise somewhat faster than inflation.

The only real solution to the AMT problem, however, is the repeal of the AMT. No matter how few taxpayers are subject to the AMT, there is no justification for having two individual income tax systems. To avoid aggravating the long-run fiscal imbalance, the revenue loss from AMT repeal should be offset by broadening the base of the regular income tax.

## **PART II – RESPONSE TO SENATOR HATCH'S QUESTIONS**

The Honorable Orrin Hatch  
Committee on Finance  
U.S. Senate

Senator Hatch:

Thank you for submitting questions for the record. I have set forth my responses below. The views expressed in the responses are solely my own and do not necessarily reflect the views of any other person or any organization.

**1) Dr. Viard, in your testimony you state that extending tax relief for the middle class, while politically popular, may reduce revenue without a commensurate improvement in incentives. I think there is a general misunderstanding that the marginal tax rate is the percentage at which all income is taxed. Instead, for many taxpayers, income is taxed at several rates and the marginal rate is the rate at which the last dollar is taxed. For instance, you point out that a couple with a taxable income of \$75,000 is taxed at three rates: 10 percent, 15 percent and has a marginal tax rate of 25 percent. So, reductions in the 10 and 15 percent brackets would not have a substantial incentive effect on this couple their marginal rate is the one that matters for decision making. Is this correct?**

This statement is absolutely correct, both with respect to how tax rates actually work and with respect to the existence of general misunderstanding about how they work.

**2) Dr. Viard, you also state, along with the Congressional Budget Office, that President Obama's middle income tax relief will add to the deficit. Which income groups will likely have to bear the brunt of the burden of paying back these deficits?**

As I noted in the fall 2008 *Virginia Tax Review*, the middle class will inevitably bear much of the burden of retiring or servicing the federal debt that has been, and is being, issued. This pattern will hold, regardless of whether the fiscal gap is addressed through entitlement reduction or through tax increases or through a mixture of both. Although it may seem appealing to close the fiscal gap by taxing a small set of households with very high incomes, that strategy is not viable in the long run. Although the wealthy earn a large share of national income, only a limited amount of additional revenue can be obtained from them without raising marginal tax rates to prohibitively

high levels. Moreover, to the extent that taxing the wealthy impedes capital accumulation, middle class workers bear part of the burden in the form of lower wages.

A wide range of liberal and conservative economists agree that the fiscal imbalance cannot be addressed by taxing only the very wealthy. Paul Krugman, the 2008 Nobel laureate in economics, made this observation in the February 27, 2009 *New York Times* (<http://www.nytimes.com/2009/02/27/opinion/27krugman.html>). A recent article by Walter Alarcon and Ian Swanson in *The Hill* (<http://thehill.com/leading-the-news/obamas-tax-reckoning-2009-04-14.html>) quotes a number of economists to that effect, as does an article by Joseph J. Thorndike in the March 30, 2009 *Tax Notes*. In an April 10, 2009 editorial, *The Washington Post* reached the same conclusion, (<http://www.washingtonpost.com/wp-dyn/content/article/2009/04/09/AR2009040903915.html>). A number of speakers made this point at an April 3, 2009 conference sponsored by Tax Analysts, as reported by Chuck O'Toole in the April 13, 2009 *Tax Notes*. Also, see David Leonhardt's analysis in the February 25, 2009 *New York Times* ([http://www.nytimes.com/2009/02/25/business/economy/25leonhardt.html?\\_r=1](http://www.nytimes.com/2009/02/25/business/economy/25leonhardt.html?_r=1)).

The proposals by President Obama and others to provide middle-class tax relief are ultimately unsustainable. The relief provided to middle-class households today will add to the burdens on middle-class households tomorrow.

**3) Dr. Viard, you indicate in your written testimony that federal individual tax liabilities, as a percentage of income, is a measure of tax burden. How does this measure compare with other measures, such as the average tax rate that Mr. Greenstein is using?**

Conceptually, the measures are exactly the same; the average tax rate is defined to be tax liability as a share of income. Mr. Greenstein generally used Urban-Brookings Tax Policy Center data and I generally used Congressional Budget Office data; both data sources are of very high quality. The two sources differ slightly on a few points, such as the exact definition of income and the treatment of variations in household size. Nevertheless, both sources paint the same basic picture, as can be seen by comparing my testimony and Mr. Greenstein's testimony.

Sincerely,

Alan D. Viard, Resident Scholar  
American Enterprise Institute for Public Policy Research

**Hearing before U.S. Senate Committee on Finance**  
**on**  
**The Middle-Income Tax Relief Question: Extend, Modify, or Expire?**  
**March 26, 2009**

**Statement of George K. Yin<sup>1</sup>**

Mr. Chairman, Ranking Member Grassley, Members of the Committee,

Thank you for inviting me to testify at this hearing on the question of tax relief for middle-income taxpayers. It is a pleasure to see all of you once again.

**1. *Expiring income tax cuts should lapse.***

The committee will soon have to decide whether to extend the Bush Administration income tax cuts for individuals. In general, they are due to expire at the end of 2010. I urge the committee to allow these cuts to expire.<sup>2</sup>

The reason is simple: the country cannot afford them.

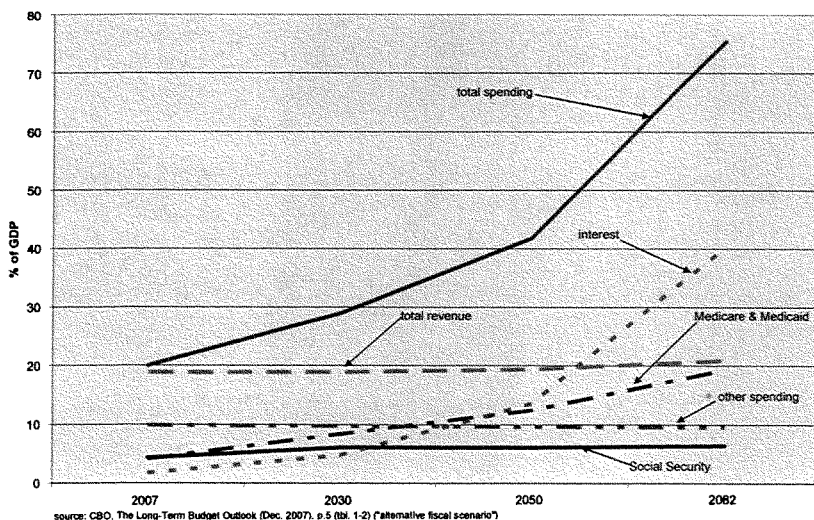
Figure 1 below presents CBO projections of the spending and revenue in the U.S. as a percentage of GDP over approximately the next 75 years. It clearly shows a sharply widening gap between spending and revenue beginning immediately and continuing throughout this period. While revenues are estimated to hover around 20 percent of GDP, or slightly more than the historical average over the last 50 years, total spending is projected to increase dramatically and then to explode in the out-years.

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<sup>1</sup> Edwin S. Cohen Distinguished Professor of Law and Taxation, University of Virginia, and former Chief of Staff, U.S. Joint Committee on Taxation, 2003-05.

<sup>2</sup> In general, the tax cuts referred to in this testimony that should be allowed to lapse are the expiring individual income tax rate reductions and increases to the child tax credit. The committee should also consider letting expire marriage penalty relief and reduced tax rates for dividend and capital gain income, although to some extent, those provisions were enacted to implement structural changes to the tax system and not merely tax relief. In addition, the committee should consider repealing the AMT but *not* providing a resulting tax cut by reforming the regular income tax to collect roughly the same amount of tax as if the AMT had not been repealed. Finally, if the committee decides to revive the "PEP" and "Pease" limitations, it should do so explicitly by raising the marginal income tax rates of the affected taxpayers. Consistent with the focus of this hearing, I do not consider other possible changes to the income tax or other taxes, such as the payroll and estate and gift tax.

Fig. 1: U.S. spending and revenues as % of GDP, CBO projections, 2007, 2030, 2050, and 2082

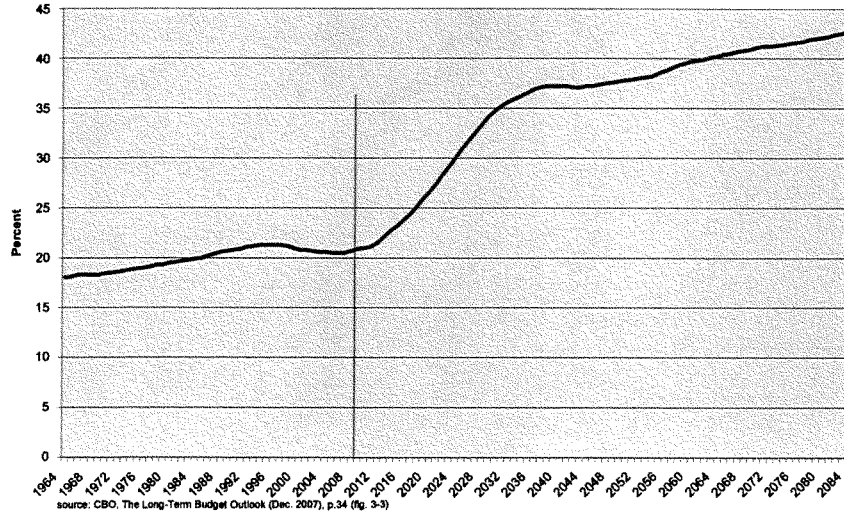


The projected fiscal gap is both unsustainable and *imminent*. The projections show that by 2030, barely two decades from now, the total cost of just Medicare, Medicaid, Social Security, and interest on the national debt, will total 19.3 percent of GDP, or more than the historical average of total revenues. Thus, assuming that that level of revenue were to continue, there would be no money left for national defense, all discretionary non-defense spending, and all other entitlement programs, including federal employee and military retirement programs, food stamps, unemployment compensation, and veterans' benefits. All of that spending has totaled between 11-12 percent of GDP in recent years. Clearly, the nation is on an unsustainable path.

As shown by Figures 2 and 3, below, two of the principal reasons for the trend projected in Figure 1 are the aging of the U.S. population and the rising cost of health care. Figure 2 presents the ratio of the U.S. population age 65 and over to those ages 20-64, roughly the proportion of retirees to workers, from 1964-2084, based on historical data and CBO projections. The vertical line represents 2009, where we are today. The figure clearly shows that we are about to begin a roughly 20-year period during which the ratio will change dramatically, from about one retiree for every five workers to one for every three workers or less. The aging of the U.S. population is a reliable projection, barring some catastrophic event or dramatic change in the country's immigration policy.



**Fig. 2: Ratio of U.S. population 65 or older to U.S. population ages 20-64, 1964-2084, historical data and CBO projections**



**Fig. 3: Medicare, Federal Medicaid, and all other health care spending, as % of GDP, CBO projections, 2007-2082**

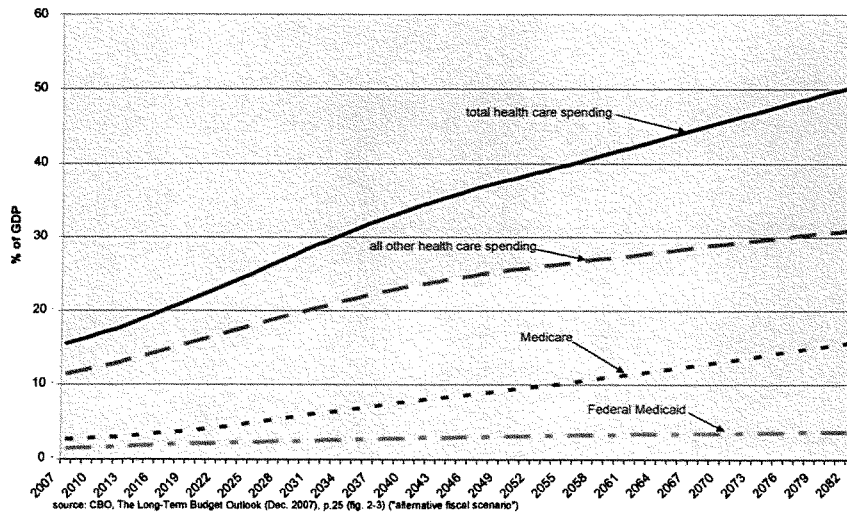


Figure 3 presents CBO projections of the increasing cost of health care in this country over the next 75 years, partly due to the demographic changes shown in Figure 2 and partly attributable to other factors. Although these projections are not as certain as those shown in Figure 2, they represent trends that have been continuing for the last 45 years, ever since Medicare and Medicaid were begun.

The other critical factors contributing to the huge fiscal gap forecast by the CBO are the tax and spending policies assumed to be followed in the future. Here, the CBO projections assume continuation of the exact same major tax and spending policies that the Obama Administration recently pledged to continue, with the sole exception of tax cuts for top-bracket taxpayers which the Administration would allow to lapse. The Administration indicated that it would provide for annual indexing of the AMT, prevent cuts in Medicare physician payments, and continue all of the other major Bush Administration tax cuts.

In short, absent a change in policy direction, essentially all of the factors underlying the doomsday scenario predicted by the CBO are, or shortly will be, in place.

Now for the really bad news: First, the CBO projections do not include any of the new spending and tax initiatives in the recent Administration budget release, including its proposals for health care and climate change. To the extent those initiatives result in net costs, they will make the future scenario even worse than projected.<sup>3</sup>

Second, the CBO projections were made in *December, 2007*, or *before* the financial and housing crisis, TARP, the rescue of Fannie Mae and Freddie Mac, all of the economic stimulus legislation, and the significant, resulting economic downturn. Thus, we should expect the actual fiscal outlook to be even bleaker than that shown in Figure 1, perhaps significantly bleaker.

In conclusion, it is essential that this committee and the Congress take action to *change* the policy path leading to the predicted economic meltdown. An important first step would be to allow all of the Bush Administration income tax cuts, including those affecting middle-income taxpayers, to lapse. Those tax cuts may or may not have been wise in the first place, but that debate is now long past. The country simply cannot afford them in the future.

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<sup>3</sup> Last week's estimate by the CBO that the President's preliminary budget request will more than double the estimated 10-year deficit from \$4.4 trillion to \$9.3 trillion is not additive to the projections contained in Figure 1 because unlike those projections, the recent estimate assumes a "current law" baseline in which all of the Bush tax cuts, the AMT patch, and the freeze on Medicare physician payment rates, expire as scheduled. See CBO, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook (Mar. 2009)*, pp. 2 (tbl. 1-1), 4, 12 (tbl. 1-5), 14-16. Nevertheless, the CBO analysis certainly raises concern that the new policy initiatives will make the overall fiscal situation even worse.

**2. Other options for Congress are supplements, not substitutes, for expiration of income tax cuts.**

There are many other possible ways to address the country's fiscal crisis. On the spending side, options include entitlement program reform, including especially reform of health care expenditures, reductions in military commitments, and reductions in "wasteful" federal spending no longer serving an important policy objective. On the tax side, there are further increases affecting only top bracket taxpayers, reductions in the "tax gap," reform of tax expenditures, and higher taxes on multinational corporations doing business outside the U.S.

Although this committee and the Congress should take all of these options seriously, it would not be responsible to assume that any one of them will be enough to prevent the fiscal crisis. Health care is a good illustration. Although curbing the growth of future health care costs must clearly be part of any solution, that policy prescription has been true for many years yet very little progress has been made. Indeed, thus far in 2009, the few steps taken, including the extension and expansion of the CHIP program, the Obama Administration's recommendation to continue preventing future Medicare physician cuts, and the House's shutting off for all of the 111<sup>th</sup> Congress of the "budget trigger" that might otherwise stimulate cost savings in the Medicare Part D program, all point in a direction *opposite* to reducing health care spending.

Another example is the continuing tax gap problem of collecting appropriate taxes from small businesses which deal mostly in cash transactions. IRS studies have repeatedly shown this to be a major area of noncompliance, yet no initiative thus far has made any significant progress in stemming the problem.<sup>4</sup> The difficulty is the absence of any paper trail as well as reliable third-party reporters to the transactions. Thus, although I applaud the Chairman's commitment to this problem and believe the committee should continue to pursue it with vigor, it is simply unreasonable to expect that the fiscal crisis will be addressed in any significant way through collecting increased taxes from cash businesses.

Moreover, even if I am not correct in that assessment, the fiscal outlook is so bleak that we are really beyond debating which policy option(s) might be the ones to pursue. The truth is that this country will need to make important progress on *all* of the options mentioned and more. The country must find ways to make dramatic reductions in spending and to identify additional revenue sources. In this context, letting the income tax cuts lapse, including those applicable to middle-income taxpayers, is a comparatively easy option, and the committee should take it.

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<sup>4</sup> A positive step was the passage last year of the provision requiring reporting of certain credit card information, estimated to raise about \$9.5 billion over 10 years. See I.R.C. § 6050W; Staff of Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110<sup>th</sup> Congress (2009)*, pp. 249-52, 597.

3. *Fairness considerations do not justify extension of the income tax cuts.*

Some members of Congress may feel that tax cuts for middle-income taxpayers should be continued as a necessary step to achieve fairness. They may believe that the Bush Administration tax cuts disproportionately benefitted the wealthy and that to correct this injustice, only the tax cuts for top-bracket taxpayers should be allowed to expire.

There is evidence of an increasing disparity in the after-tax incomes of Americans. What is not so clear, however, is the role played by *tax policy* in reaching that result.

**Table 1: Average Income Tax Rates, 1986-2006**

year	(1)	(2)	(3)	(4)
	Top 1 percent	Top 5 percent	Second quartile	Bottom 50 percent
1986	21.78%	19.52%	10.17%	5.61%
1987	24.71%	21.15%	9.44%	5.11%
1988	23.15%	20.50%	9.64%	5.09%
1989	22.08%	19.91%	9.80%	5.13%
1990	21.90%	19.54%	9.78%	5.08%
1991	22.54%	19.54%	9.59%	4.64%
1992	22.89%	19.84%	9.46%	4.42%
1993	25.69%	21.35%	9.43%	4.32%
1994	25.90%	21.58%	9.51%	4.38%
1995	26.60%	22.11%	9.57%	4.41%
1996	26.92%	22.65%	9.71%	4.45%
1997	26.03%	22.39%	9.86%	4.55%
1998	24.47%	21.47%	9.35%	4.48%
1999	24.87%	22.14%	9.36%	4.55%
2000	24.99%	22.46%	9.61%	4.65%
2001	25.19%	21.97%	9.27%	4.17%
2002	24.50%	20.98%	7.99%	3.28%
2003	22.10%	19.14%	7.37%	3.02%
2004	21.47%	19.06%	7.31%	3.03%
2005	21.39%	19.20%	7.23%	3.05%
2006	20.85%	18.92%	7.34%	3.10%
% change:				
1986-1996	23.60%	16.03%	-4.51%	-20.68%
1997-2006	-19.89%	-15.50%	-25.51%	-31.86%
2000-2006	-16.54%	-15.78%	-23.60%	-33.27%
1986-2006	-4.26%	-3.08%	-27.80%	-44.73%

source: Kyle Mudry & Justin Bryan, *Individual Income Tax Rates and Shares, 2006*, IRS SOI Bulletin (Winter 2009), pp. 41, 44 (tbls. 7&8), and author's calculations

Table 1, based on IRS income tax return information, shows the average income tax rates over the 21-year period, 1986 – 2006, of four groups of taxpayers, grouped by the amount of income reported on their returns relative to the income reported by all

taxpayers with positive income in those years.<sup>5</sup> The average income tax rate is equal to the total income tax reported by the taxpayers in the group divided by the total income reported by them,<sup>6</sup> and is a measure of the income tax burden of each group. The first two columns show the average income tax rates of the top 1% and top 5% of all taxpayers (by income reported), roughly representing top-bracket taxpayers. The third column consists of the second quartile of taxpayers, those reporting income amounts between the 25<sup>th</sup> and 50<sup>th</sup> percentile of all taxpayers, and roughly represents middle-income taxpayers. Finally, the fourth column shows data for the bottom half of all taxpayers with positive income.<sup>7</sup>

The figures at the bottom of the table show the percentage change in the average income tax rate of these four groups during four periods. The first two periods divide the 21 years into roughly equal segments, reflecting changes in the income tax system between the Reagan and Clinton Administrations (1986-1996) and the Clinton and Bush Administrations (1997-2006). The third period examines the change between 2000 and 2006, to focus specifically on the effect of income tax laws enacted during the Bush Administration. Finally, the last line examines the change over the entire 21-year period.

As can be seen, average income tax rates declined for almost all of the groups during each of the periods examined. The one exception was between 1986 and 1996 when the average income tax rates of the top-bracket taxpayers increased while those of the middle-income and lower-income taxpayers declined. In each of the other periods, including the period focusing specifically on the effect of the Bush Administration income tax changes (2000-2006), the percentage decline in average income tax rates of the middle- and lower-income taxpayers exceeded that of the top-bracket taxpayers.

The data presented is only one way of measuring changes in the income tax burdens of different groups of taxpayers over time. Other analyses might usefully incorporate information on economic income and deduction amounts not showing up on tax returns as well as possible differences between nominal and real tax burdens. But for purposes of measuring the effect of income tax cuts in the form of rate reductions and increased credits, relying on tax return information may not be an unreasonable approach. Overall, Table 1 does *not* provide evidence that changes in the income tax system, including those carried out during the Bush Administration years, disproportionately benefitted upper-income taxpayers.<sup>8</sup>

<sup>5</sup> The income measure is the “1979 Income Concept” developed by the IRS to provide a more uniform measure of income across tax years in order to facilitate comparison of tax results, including average tax rates, over time. It relies strictly on items reported on tax returns. In general, the 1979 Income Concept is similar to adjusted gross income except that it includes some nontaxable amounts of income reported on returns, disallows passive loss deductions, and permits only straight-line depreciation. See Kyle Mudry & Justin Bryan, *Individual Income Tax Rates and Shares, 2006*, IRS SOI Bulletin (Winter 2009), pp. 5-45.

<sup>6</sup> Total income refers to the 1979 Income Concept.

<sup>7</sup> IRS data was not sufficiently differentiated to permit separate analysis of the third quartile of taxpayers.

<sup>8</sup> Table 1 does not reflect the effect of non-income tax changes during the 21-year period.

But just as we are beyond the point of debating whether the Bush Administration tax cuts were wise in the first instance, we are also past the time of worrying about their distributional effect. Letting *all* of the Bush Administration income tax cuts expire across-the-board would return the country approximately to the tax system of the last Democratic Administration.<sup>9</sup> That policy decision would address possible concerns that recent tax cuts have disproportionately benefitted the wealthy, be fiscally responsible, and be consistent with a principle of “shared sacrifice” during this very challenging time for the country.

**4. *Tax cuts should expire as soon as target level of economic growth is achieved.***

Presumably, Congress should hold off allowing any of the tax cuts to expire until the economy is healthy enough to permit that change. This need, however, creates a huge dilemma for the Congress. It exacerbates the extremely difficult challenge of developing political consensus in favor of letting the tax cuts expire. No matter how well and how quickly the economy recovers, there will no doubt be concerns, some bona fide, that the economy remains too fragile to permit an expiration of the tax cuts.

One possible solution would be for the Congress to agree *now* on a target level of economic growth that would have to occur before any tax cuts would be allowed to expire. The agreement would provide for continuation of the cuts until the target is achieved, *but also* expiration of the cuts once the target is met. It may be easier to reach agreement now committing to this balanced and responsible future action, while the committee and the Congress are somewhat blind to the precise timing, than to wait and try to obtain consensus at the future time.

Some might worry that any current announcement of a plan to allow tax cuts to expire in the future would slow the economic recovery. But the exact opposite might occur if forward-looking markets have already anticipated higher future taxes due to the extremely dismal fiscal forecast. In that case, a current announcement might have the positive effect of reducing uncertainty and increasing confidence in the economic stability of the country. Moreover, the sooner taxes are adjusted to meet the looming fiscal challenge, the more gradual and smoother the adjustment can be, which should reduce the distortionary effect of the adjustment.

**5. *“Current law” baseline should be used to measure budget effects of tax changes.***

Finally, I urge the committee to measure the budget effect of any tax changes against a “current law” baseline, as was done in the CBO analysis released last week of the President’s preliminary budget request,<sup>10</sup> rather than the “current policy” baseline

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<sup>9</sup> Some differences would remain, such as those caused by the AMT.

<sup>10</sup> See *supra* note 3.

used by the Obama Administration in its budget release.<sup>11</sup> As explained by then-CBO Director Peter Orszag when he testified *against* the Bush Administration's proposal to switch to a "current policy" baseline, such a switch substantially undermines the integrity of the legislative process by allowing the costs of proposals to disappear from the process.<sup>12</sup>

## 6. *Conclusion.*

I recognize that my policy prescriptions today are politically unappealing. No one likes taking the steps I have advocated; I certainly don't.

*But the core numbers indicative of an imminent fiscal crisis do not lie. We are beyond the point of being able to kick this problem down the road a little further. As our nation's leaders, you must persuade the American public that unless steps like the ones I have described are taken immediately, we risk such serious economic disruption in this country as to make recent events look like child's play, and even worse, we risk the possibility of triggering worldwide instability and geopolitical conflict.*

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I am happy to respond to any questions of the committee.

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<sup>11</sup> See OMB, *A New Era of Responsibility: Renewing America's Promise* (2009), pp. 36, 121 (tbl. S-5).

<sup>12</sup> *Perspectives on Renewing Statutory PAYGO: Hearing before H. Comm. on the Budget, 110th Cong. at 18 n.10 (2007)* (statement of Peter R. Orszag, Director, CBO). For the same reason, the budget effects of changes in spending should be measured in the same way. In particular, the special baseline rule permitting temporary entitlement programs to be scored as if the change were permanent, as was used recently in connection with the temporary extension of the CHIP program, should be abandoned and replaced by the same budget estimating treatment of temporary tax programs. See CBO, *Cost Estimate: H.R. 2—Children's Health Insurance Program Reauthorization Act of 2009*, at 3–4 (2009), available at <http://www.cbo.gov/ftpdocs/99xx/doc9985/hr2paygo.pdf> (explaining application of special baseline rule); George K. Yin, *Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint*, 84 *N.Y.U. L. Rev.* \_\_\_, n. 26, 37, 62 (2009).

**Senate Finance Committee Hearing on Middle-Income Tax Relief  
Responses of George Yin to Questions for the Record  
April 30, 2009**

**Questions from Chairman Baucus:**

**1) Mr. Yin, you note in your written testimony that information reporting is one way to improve tax compliance. I believe collecting the taxes already on the books makes the tax law fairer for everyone, including middle-income taxpayers who have their income reported directly to the IRS on a W-2.**

**a) Please comment on the role that information reporting can play to improve tax compliance and make tax administration fairer for middle-income taxpayers.**

Information reporting improves tax compliance by creating a paper trail of information potentially significant in the determination of tax liabilities. The information is helpful both to taxpayers in assessing their liabilities and to the IRS in enforcing the nation's tax laws. Information reporting also promotes compliance by enhancing the perception that IRS matching and similar programs will be able to detect tax reporting errors more easily and accurately. Thus, taxpayers whose income and deductions are subject to such reporting are encouraged to take greater care in reporting their liabilities correctly. Empirical evidence from IRS research confirms the positive relationship between information reporting and tax compliance. To the extent compliance is improved, all taxpayers, including middle-income taxpayers, benefit.

**b) What types of information reporting would you recommend as the most effective way to improve compliance?**

I briefly describe below several suggested changes to current law to improve or expand information reporting:

1) Limit corporate payee exception – Under current law, persons engaged in a trade or business must generally file an information return with respect to payments of



\$600 or more during a calendar year to a service provider who is not an employee of the service-recipient.<sup>1</sup> However, payments made to a corporation are generally exempt from this requirement.<sup>2</sup> As a result, payments to closely held service-providers organized as “C” or “S” corporations fall outside of this important information reporting requirement even though such service-providers are functionally equivalent to unincorporated businesses whose receipts are reported on information returns. Some number of closely held businesses may actually incorporate simply to take advantage of this corporate payee exception and thereby reduce the visibility of their transactions to the IRS. In 2005, about 60 percent of the approximately 3.7 million S corporations had only a single shareholder and 90 percent had one or two shareholders. In the same year, there were about two million C corporations, the vast majority of which were closely held.

A possible change would be to limit the corporate payee exception to *public* corporations or those having more than some threshold number of shareholders over a given period. Payments to any corporation not qualifying for exemption would be subject to the same information reporting requirement as payments to unincorporated businesses. As described in (2) below, the burden could be placed on the payee-corporation to determine whether it is exempt and to certify such exemption to the payor. In the absence of receiving such certification, the payor would be required to comply with the information reporting requirement.

2) Reduce burdens on payors – Current law places information reporting burdens on the payor even though in some number of cases, the purpose of the reporting is to improve the tax compliance of the payee. Because the payor’s involvement and

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<sup>1</sup> I.R.C., §§ 6041, 6041A.

<sup>2</sup> Reg. §§ 1.6041-3(p)(1) and 1.6049-4(c)(1)(ii)(A).

cooperation is critical in this process, every effort should be made to reduce the burdens placed on the payor.

One change would be to require payees to provide their name, address, and TIN, or a certification of their exemption from information reporting requirements, to payors without the necessity of any request from the payor. For example, payees could be required to include this information automatically on any invoices provided to the payor. This change would eliminate the burden on payors to request such information and to determine whether the payee is exempt from information reporting. The change would be particularly attractive if, as described in (3) below, information reporting were extended to some extent to non-business payors. Another change would be to revise IRS procedures so that information returns could be easily submitted electronically. Current IRS practice apparently places barriers against the making of such submissions.<sup>3</sup> A final change would be to require the IRS, rather than the payor, to furnish applicable information statements to the payee upon receipt by the IRS of the information returns from the payor.<sup>4</sup> This last change might be especially appropriate in the case of information reporting required of non-business payors.

3) Limited extension of information reporting to non-business payors – The current law information reporting requirement could be extended in a limited way to payments made to service-providers by non-business payors. The requirement might apply only for single payments exceeding some threshold amount, such as \$500, and only if the total payments made during the year to such payee exceeded some higher threshold amount, such as \$5,000. The thresholds would be designed to avoid any information

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<sup>3</sup> See GAO-07-1014, July 2007, p. 18.

<sup>4</sup> Cf. I.R.C. §§ 6041(d), 6041A(e).

reporting requirement being imposed with respect to small, common service activities, such as babysitting and minor yard work. On the other hand, payments for larger transactions, such as major home repair or renovation projects, would become subject to information reporting. The advantage of extending information reporting to non-business payors even in only a limited way would be to bring into the tax system an important group of payees who primarily perform work for non-business service-recipients. Such payees could be required to include identifying taxpayer information (or certify exempt status) on their invoices, and they would be encouraged to report their tax liabilities more accurately because of the possibility of enhanced information available to the IRS.

If information reporting were extended to non-business payors, every effort should be made to reduce payor burdens, such as making the changes described in (2) above. In addition, the law should generously forgive inadvertent errors committed by payors. The purpose of the change would be to heighten awareness of payees as to their tax reporting obligations and not to penalize payors for excusable failures to comply with information reporting obligations.

**c) What arguments might be raised against enhanced information reporting and how would you respond to them?**

The major objection would likely relate to the burdens placed on payors, especially if information reporting were extended to some extent to non-business payors who would otherwise have no tax reason to maintain and file a report. The best response is probably education. Most Americans are law-abiding, responsible citizens who pay their required share of taxes. Most also generously provide assistance to their government or a fellow citizen to prevent some wrongdoing or harmful action. Political leaders can build on this exceptional foundation of generosity and responsibility by

fostering a positive attitude towards aiding in the collection of taxes required by law.

Citizens who do so help not only the nation but also themselves by reducing the need for higher taxes or decreased spending on worthwhile initiatives.

**Senate Finance Committee Hearing on Middle-Income Tax Relief  
Responses of George Yin to Questions for the Record  
April 30, 2009**

**Question from Senator Grassley:**

**Senator Baucus and I have in recent years supported holding the number of taxpayers that owe Alternative Minimum Tax (“AMT”) the same from year to year, 4.2 million taxpayers. Although we are sketchy on the details, it appears that President Obama wants to patch the AMT by merely indexing the AMT exemption amounts, and other relevant AMT numbers, for inflation. Could the President’s proposed way of patching the AMT result in more taxpayers paying the AMT? And what is the preferred way to patch the AMT? Put another way, shouldn’t we insure that no more taxpayers are added to the AMT population?**

The number of taxpayers who would owe AMT under the President’s proposal would depend upon a number of factors, including the method of indexation, the parameters that would be indexed, other changes to the AMT (such as the availability of personal credits to reduce AMT liability), and the state of the “regular” income tax system (such as the extension or expiration of tax cuts enacted under President George W. Bush). The Joint Committee on Taxation would be the best source of estimates regarding whether a particular group of changes would increase, decrease, or hold constant the number of AMT taxpayers from one year to the next.

It is not clear, however, why holding the total number of AMT taxpayers roughly constant is an important policy objective. One possible reason is to make sure that no additional taxpayers are forced to bear the compliance cost of calculating their taxes in two different ways. But keeping the total number of AMT taxpayers constant does not achieve this end. Because of changed circumstances, some taxpayers may be required to pay AMT for the first time even though, as a result of an equal number of taxpayers being removed from the AMT, there is no overall change in the total number of AMT taxpayers. Moreover, the total number of taxpayers paying the AMT says nothing about

the number of taxpayers who actually have to calculate their taxes in two ways before finding that they do not owe any AMT.

Another possible reason to limit the number of AMT taxpayers is to cap the amount of tax increases resulting from increased application of the AMT. Here again, however, the legislative solution does not fit the policy goal. The *number* of AMT taxpayers says nothing about the *amount* of resulting tax increase (or decrease) imposed on affected taxpayers.

A legislative solution that would achieve both ends – reduce compliance costs and limit the amount of tax increases – would be to repeal the AMT. If, because of the extremely dismal fiscal situation outlined in my testimony, the country cannot afford the tax cut resulting from an outright repeal, then both goals can still be achieved by repealing the AMT and reforming the regular income tax system to collect the desired amount of offsetting revenue.

**Senate Finance Committee Hearing on Middle-Income Tax Relief  
Responses of George Yin to Questions for the Record  
April 30, 2009**

**Questions from Senator Hatch:**

1) **Professor Yin, in your written testimony, you show a chart of U.S. spending and revenue projections that looks very dire. However, the feature that strikes me the hardest from this chart is the total spending line, which increases much more rapidly than do the other lines, including, of course, the revenue line. What this chart most vividly tells me is that we have a spending problem and not necessarily a tax problem. And yet, your prescription for this seems to be to increase taxes by allowing all the 2001 and 2003 tax cuts to expire. Why shouldn't we cut spending first before resorting to tax increases?**

Figure 1 of my testimony certainly reveals a spending problem, and that problem may be significantly worse than shown due to developments since December, 2007 when the report on which the Figure is based was prepared. However, I believe this spending problem is also a tax problem. Since there is no free lunch, the approval of inadequately financed spending programs in the past is the equivalent of a huge tax increase already adopted by the Congress. The only question is how quickly that increase will go into effect and on whom. Because the fiscal gap is a product of bipartisan decisions made in years past, closing it calls for a bipartisan solution. Delayed action only means that the ultimate spending cuts and tax increases necessary to close the gap will be more harmful to the country; hence, it is time now for policymakers on all sides of these issues to come together and take collective action.

The specific topic of the hearing was whether to extend or let expire the 2001 and 2003 tax cuts applicable to middle-income taxpayers. Once the economy is healthy enough to permit it, letting those cuts expire would have an inframarginal effect for many taxpayers and thus would be less objectionable than many other possible deficit-reducing

options. Hence, the committee should approve that action as one of a number of difficult but necessary steps to address the fiscal crisis.

**2) Professor Yin, your testimony seems to be saying that all the tax relief from the 2001 and 2003 tax acts is about the same and that it should all be allowed to expire. Are you implying that you do not believe that the rate reductions make a difference in economic growth and job creation, as Dr. Viard has clearly indicated?**

Because the question presented by the committee was whether the tax cuts for middle-income taxpayers should be continued, my testimony was not specifically directed at the tax cuts for top-bracket taxpayers. As you know, President Obama campaigned and prevailed on a pledge to end those tax cuts, he has since submitted budget proposals consistent with that promise, and the Congress seems prepared to approve that action. Given that reality and the country's extremely dire fiscal situation, I believe it is sensible to allow all of the Bush era tax cuts to expire.

**3) Professor Yin, you testified that the data do not provide evidence that changes in the income tax system, including those that occurred during the Bush Administration, disproportionately benefitted upper-income taxpayers. I tend to agree. However, Mr. Greenstein seems to believe just the opposite. How can we account for such different conclusions?**

Debate on these issues often confuses at least three separate questions. As you indicate, my testimony focused on whether changes to the individual income tax system during the last 21 years, including those enacted during the Bush Administration, disproportionately benefitted upper-income taxpayers. The data I presented, developed from IRS tax return information, did not support that proposition. I believe that other analysis prepared by the CBO lends further support for my finding.<sup>5</sup>

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<sup>5</sup> See CBO, Effective Individual Income Tax Rate for All Households, by Comprehensive Household Income Quintile, 1979-2006, available at [http://www.cbo.gov/publications/collections/tax/2009/effective\\_rates.pdf](http://www.cbo.gov/publications/collections/tax/2009/effective_rates.pdf).



A separate question is whether *all* changes to the tax system during a particular period, including changes to the payroll tax, individual and corporate income tax, and estate and gift tax, disproportionately benefitted one group or another. This is a more difficult question to resolve since it requires determining the incidence of the corporate and estate and gift taxes, issues about which there is not general consensus. In addition, it may be inappropriate to consider changes to the payroll tax without also considering the distributional effect of benefit changes tied to those tax changes.

Finally, an entirely separate question concerns changes in the distribution of after-tax income among households of different income levels. As I indicated in my testimony, there is evidence of an increasing disparity of such income among Americans. Although tax law changes *could* be a factor contributing to such trend, many other changes, affecting the *pre-tax* income levels of households, could also be contributing factors. Thus, changes in the distribution of after-tax income do not isolate the possible effect of tax law changes. The latest CBO data shows that high-income households experienced a much faster growth in pre-tax income than lower-income households during the period 1979-2006.<sup>6</sup>

In addition to these different questions, the effect of a change is sometimes expressed in absolute, rather than percentage, terms. To illustrate, consider two families who before any change owe tax liability of \$100 and \$10, respectively. Assume that a tax law change reduces the first family's liability to \$95 and the second one's to \$9. If

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<sup>6</sup> For data showing changes in pre-tax and after-tax income of households of different income levels since 1979, see CBO, Average Pre-Tax Income for All Households, by Household Income Category, 1979-2006, available at [http://www.cbo.gov/publications/collections/tax/2009/average\\_before-tax\\_income.pdf](http://www.cbo.gov/publications/collections/tax/2009/average_before-tax_income.pdf) and CBO, Average After-Tax Income for All Households, by Household Income Category, 1979-2006, available at [http://www.cbo.gov/publications/collections/tax/2009/average\\_after-tax\\_income.pdf](http://www.cbo.gov/publications/collections/tax/2009/average_after-tax_income.pdf).

expressed in percentage terms, the second family has obtained a greater tax cut (10%) than the first family (5%). But if expressed in absolute terms, the first family's tax cut (\$5) is five times larger than the second family's (\$1). While in any given case, it may be appropriate to focus on the absolute rather than percentage change, doing so obviously ignores the disparity in pre-change circumstances. It also means, given our progressive income tax rate structure, that virtually any tax cut legislation can be portrayed as disproportionately benefitting those with higher incomes (and, similarly, virtually any tax increase legislation can be portrayed as disproportionately hurting those with higher incomes).

