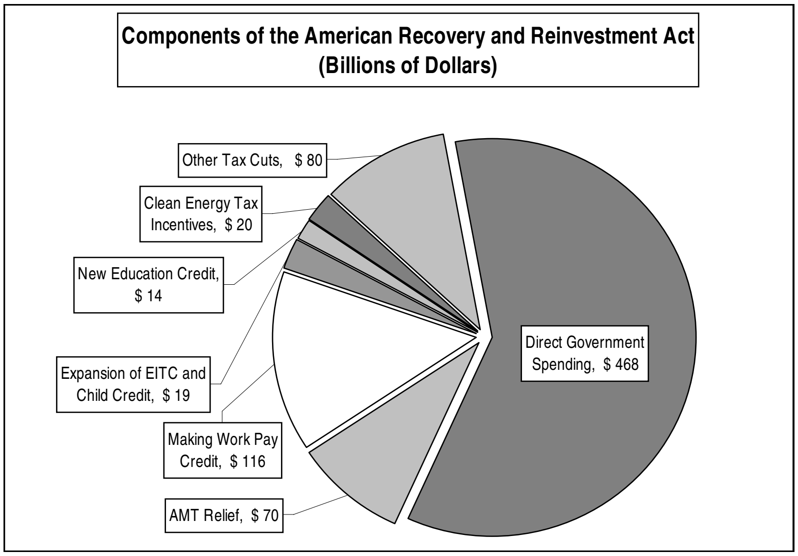
Just Taxes

The CTJ & ITEP Newsletter April 2009

How President Obama Won the Battle Over the Economic Recovery Act

It would have been comical if the stakes were not so high. Allies of former President Bush, who cut taxes on the wealthy investor class in 2001, 2002, 2003, 2004 and 2006, argued that the only way to improve our economy was to... cut taxes for the wealthy investor class. Even before Barack Obama took the oath of office in front of two million Americans on that cold, clear day in January, his opponents in Congress insisted that the problem was not collapsing consumer demand but America's insufficient devotion to cutting taxes for investors. Given that such tax cuts had been in place for years under Bush and failed to prevent the worst economic collapse in decades, the argument demonstrated a certain shamelessness, or perhaps an honest, blinding monomania on the part of the lawmakers who are part of the anti-tax movement.



They lost the argument. In mid-February, President Obama prevailed and signed the American Recovery and Reinvestment Act of 2009, a major victory for progressives. This economic stimulus bill is projected to cost a grand total of $787 billion. About 40 percent goes to tax cuts. While some of these are ill-advised, the majority of the new tax cuts are targeted to working-class families.

Tax cuts classified by Congress as "business tax cuts" only make up one percent of the cost of the bill. Even if we expand the definition to include all those provisions that will benefit companies (like energy incentives and provisions relating to tax-exempt bonds, for example), business tax cuts still only make up 7 percent of the cost of the bill. How did Obama get members of Congress to break their addiction to giveaways for the business lobby long enough to approve this law?

In This Issue:

Economists Agreed Progressive Policies Would Work

One thing that helped the new President make his case was the fact that most economists were in agreement with his approach.

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Cover Story Continued

Experts agreed that the most important goal is to stop the downward spiral of falling consumer demand causing companies to lay off workers, which leads to more falling consumer demand and more layoffs. Government measures that lead to immediate spending could pump money into the economy and prevent consumer demand from falling further. That could be done partly through direct spending by the government itself. Since the list of public investments that have been neglected over the previous eight years is so long, this sounded pretty reasonable.

But it could also be accomplished partly by putting money in the hands of people who are most likely to spend it immediately. Immediate consumer spending would boost demand for goods and services and make it less likely that companies find themselves unable to sell their products. And that would mean companies would be less likely to lay off workers.

Tax cuts could put money in the hands of families, but which families should receive them? Economists argued that tax cuts for low- and middle-income families are more likely to result in immediate spending, since these families are more likely to have many unmet needs. Tax cuts for high-income families, on the other hand, would probably be directed towards savings and thus would fail to provide an immediate boost to the economy. In other words, progressive tax cuts could be part of the answer to our economic recovery.

Obama's Initial Proposal: Not Perfect, But a Major Step Forward

The President's economic stimulus proposal largely, but not completely, followed the advice of economists. It called for federal aid to states that would be used immediately to prevent cuts in public services, much needed investments in infrastructure and refundable tax credits that would put money in the hands of low- and middle-income families who were more likely than wealthy families to spend it right away. The biggest change for working families would be the two-year refundable "Making Work Pay Credit" (MWPC).

The President's proposal did include some tax cuts for business that seemed geared more towards buying off corporate lobbyists than actually stimulating the economy. For example, a proposal to make it easier for companies to use current year losses to receive a refund of taxes paid in the past promised to put cash in the hands of business

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owners without any strings attached. The proposal would not even change the incentives of business owners to invest or create jobs. Of course, a smart business person will invest and hire employees only when she thinks that her products will sell. Simply putting money in her hands would not change that. Citizens for Tax Justice called attention to these troubling details while still promoting the overall thrust of an economic recovery plan that focused mostly on stimulating consumer demand, partly through direct government spending and partly by putting money in the hands of working-class families.

The Opposition: More Tax Cuts for the Wealthy Investor Class!

The President's opponents in Congress had some very different, and very peculiar, ideas about how to stimulate the economy. First, about 50 conservative members of the House of Representatives proposed a plan that consisted entirely of tax cuts. Most of these would be permanent, including making permanent parts of the Bush tax cuts. Since the Bush tax cuts do not even expire until the end of 2010, this obviously would do nothing to provide an immediate boost to the economy, and was instead a repackaging of the same goals this group of lawmakers had always pursued. Their plan also included new tax cuts for businesses and families. The tax cuts for families would not increase refundable credits, meaning those families who work and pay federal payroll taxes but not federal income taxes would not see any benefit.

Citizens for Tax Justice estimated the impacts in 2009 of the House GOP plan as well as the plan introduced by House Democrats. The House Democrats' plan largely mirrored President Obama's proposal, including the MWPC and an expansion of the Child Tax Credit and Earned Income Tax Credit for low-income families. All three of these tax credits are refundable.

As the nearby tables illustrate, most of the benefits of the main income tax cuts proposed by the House Democrats would go to the poorest 60 percent of Americans, while less than 5 percent of the benefits of the House GOP tax cuts would go to this group. The contrast was embarrassingly obvious.

So embarrassingly obvious, in fact, that House GOP leaders then proposed a new stimulus plan which also consisted entirely of tax cuts, but ones slightly less concentrated on the wealthy elite who have benefitted the most from America's dysfunctional economy.

Benefits of Selected Tax Cuts in the House Democratic Stimulus Proposal in 2009 in United States

Income group	Ave. 2009 Income	Combined MWPC, EITC, CTC: Ave. tax cuts	% of tax cut
Lowest 20%	$12,100	$ –460	16.0%
Second 20%	24,500	–538	18.7%
Middle 20%	39,900	–579	20.1%
Fourth 20%	65,400	–687	23.9%
Next 15%	113,400	–756	19.7%
Next 4%	244,200	–209	1.5%
Top 1%	1,314,600	–7	0.0%
ALL	**$ 67,200**	**$ –567**	**100.0%**
Bottom 60%	$25,500	$ –525	54.8%

Benefits of Selected Tax Cuts in the House Republican Stimulus Proposal in 2009 in United States

Income group	Ave. 2009 Income	Combined Rates Cut, AMT, CTC: Avrg tax cuts	% of tax cut
Lowest 20%	$12,100	$ –5	0.1%
Second 20%	24,500	–40	0.8%
Middle 20%	39,900	–211	4.1%
Fourth 20%	65,400	–907	17.5%
Next 15%	113,400	–2,333	33.9%
Next 4%	244,200	–5,285	20.5%
Top 1%	1,314,600	–23,935	23.2%
ALL	**$ 67,200**	**$ –1,018**	**100.0%**
Bottom 60%	$25,500	$ –85	4.9%

Under the new House GOP plan, a full quarter of the benefits of the proposed tax cuts (rather than just five percent) would go to the poorest 60 percent of Americans. GOP leaders seemed to think this was awfully generous of them, but it seemed to only reinforce the fact that they simply did not have the same goals in mind as President Obama. CTJ produced a report (including the bar graph on the following page) concluding that the House Democrats' plan would direct more benefits towards low- and middle-income families while the House GOP plan was still focused on relatively well-off Americans.

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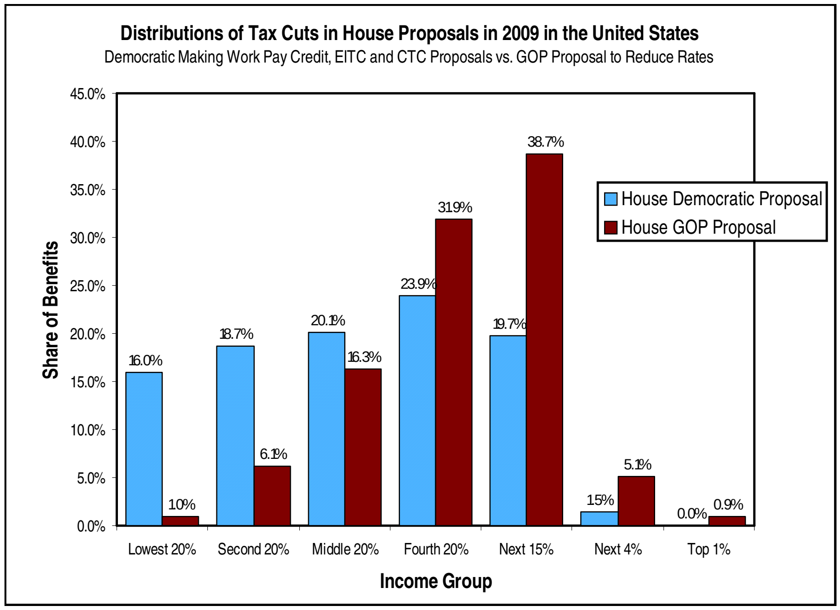
Their new plan would reduce the two lowest individual income tax rates from 15% to 10% and from 10% to 5%. To get the maximum tax cut of about $3,400 from this rate reduction, taxpayers would have to have enough taxable income to reach the start of the third income tax bracket. For example, a married couple with two children would typically need to earn more than $100,000. As we pointed out in our publications and communications with lawmakers, that's considerably more than most people earn. In fact, only one in five of all taxpayers has enough income to reach the third income tax bracket and receive the full benefit of the proposed tax rate reduction.

The House GOP plan boasted that this tax break would result in "every taxpaying-family in America" enjoying an "immediate increase in their income." Architects of this proposal excluded from their definition of a "taxpaying-family" those who pay federal payroll and excise taxes but who do not earn enough to owe federal income taxes. The income tax rate reduction would provide *no* benefits to a family unless their earnings are high enough to place them in the 10 percent income tax rate bracket. For a family of four, this means pretax income must be over $26,000. The same family's pretax income would have to exceed $42,700 to place them in the 15% bracket.



The President's opponents in Congress repeatedly claimed that refundable tax credits (which Obama hoped to increase) amount to tax breaks for "people who don't pay taxes." This completely ignored the fact that all of the families receiving these refundable credits do work (since they're unavailable for families without earnings) and therefore pay federal payroll taxes, even if they are too poor to owe federal income taxes.

The Senate Tries to Lard Up the Economic Recovery Bill with Handouts for Businesses and the Well-Off

Over in the Senate, lawmakers of both parties attempted to load down the stimulus bill with tax cuts that had absolutely nothing to do with stimulating the economy. To take just one example, Senator Barbara Boxer (D-CA) offered an outrageous amendment that would provide a tax amnesty for corporations that had moved profits offshore (often only on paper to avoid taxes). Profits that were "repatriated" to the United States would be subject to an almost non-existent 5.25 percent tax rate instead of the usual 35 percent tax rate.

As explained in a CTJ report on "repatriation," this idea was tried five years ago and did not lead to any of the job creation that was promised. Worse, repeating this debacle would only encourage companies to move profits offshore, since they would figure that if they waited a few years, Congress would once again be in the mood to enact a tax amnesty. Fortunately, a solid majority of senators saw that this was terrible tax policy and rejected this amendment.

In the end, most of the Senate's really bad ideas were either rejected altogether (like the tax amnesty for offshore corporate profits) or were whittled down to the point where they were of little consequence.

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One significant bad idea from the Senate did make its way into the final bill. The Senate decided to include a reduction in the Alternative Minimum Tax (AMT) to benefit relatively well-off families. This provision, which costs $70 billion, will prevent the AMT from expanding its reach to tens of millions of families who have previously been unaffected by it, for one year. This is probably something Congress would do anyway at some point this year, but as economic stimulus it would be ineffective because almost 70 percent of the benefits would go to the best-off ten percent of taxpayers. CTJ published the nearby figures showing that the poorest 60 percent of taxpayers would get only half a percent of the benefits of this provision. Unfortunately, the allure of a big tax cut for well-off families was simply too much for the Senate to resist.

Effects of AMT Relief Provision in Senate Stimulus Bill (increase in AMT exemptions for tax year 2009)

Income Group	Income Range	Average Income	# with tax cut	% with tax cut	Ave. tax cut for those with	Ave. tax cut for all	% of total tax cut
Lowest 20%	Less than $18,500	$ 12,140	—	—	$ —	$ —	—
Second 20%	$18,500 to $31,000	24,526	—	—	—	—	—
Middle 20%	$31,000 to $50,500	39,875	465,000	1.6%	726	12	0.5%
Fourth 20%	$50,500 to $84,000	65,440	4,712,000	16.5%	947	157	6.9%
Next 15%	$84,000 to $169,000	113,398	14,679,000	68.6%	2,195	1,506	49.6%
Next 4%	$169,000 to $436,000	244,172	5,277,000	92.5%	4,980	4,604	40.5%
Top 1%	Over $436,000	1,314,582	391,000	27.4%	4,123	1,132	2.5%
ALL		**$ 67,224**	**25,524,000**	**17.7%**	**$ 2,542**	**$ 449**	**100.0%**
Bottom 60%	Less than $50,500	$ 25,514	465,000	0.6%	$ 723	$ 4	0.5%

Source: ITEP Microsimulation Model, February 2009

Obama Wins the Battle

Nevertheless, the bulk of the tax cuts in the final economic recovery law are quite progressive. It includes the refundable Making Work Pay Credit of up to $400 ($800 for married couples), an expansion in the EITC and Child Tax Credit and a new refundable credit for higher education. It also includes tax incentives for renewable energy. The sum of these accounts for the majority of the tax cuts in the law. In the end, President Obama did not get a bill that was exactly as he (or the progressive community) would have crafted. But, for the first time in years, Washington enacted a measure to address the economy focusing on middle-America instead of the elite, and that's worth celebrating. ◆

What States Should *Not* Do With Stimulus Funds

The following op-ed by ITEP Northeast Regional Director Jeff McLynch was printed in the Providence Business News on March 14, 2009.

In recent remarks, first to a gathering of the nation's mayors and then again before a collection of governors from across the country, President Barack Obama issued stern warnings to local officials about the use of the billions of dollars in federal stimulus funds they are about to receive.

He pledged that, "if a federal agency proposes a project that will waste that money, I will put a stop to it …. If a state government does the same, then I will call them out on it and use the full power of my office and our administration to stop it."

Gov. Donald L. Carcieri's ears surely must have been burning during those speeches, for one of his top priorities

What States Should *Not* Do With Stimulus Funds

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for the use of federal stimulus funds — tax cuts, tax cuts and more tax cuts — would be among the most wasteful purposes to which those funds could be put.

Carcieri's intentions have been clear for some time. Back in January, in introducing legislation to cut spending by $240 million in the five months remaining of fiscal 2009, he argued that, should Rhode Island "receive federal stimulus funds, we must… plan on using most of these funds to lower taxes for individuals and businesses, create jobs and stimulate growth."

Still, getting one's plan out early is no substitute for getting it right — and using federal funds to slash state taxes gets it wrong in a variety of ways.

At its core, the purpose of the $630 million that Rhode Island will receive over the next few years via an enhanced Federal Medical Assistance Percentage (FMAP) and the State Fiscal Stabilization Fund is to help it shrink its expected budget gap. In turn, these transfers will enable Rhode Island to preserve the public services — such as health care and job training — that will mitigate the impact of the recession on those families most directly affected by it.

After all, to respond to budget deficits, states have just two options — lowering spending or raising taxes. Each of these options will, taken on their own, reduce demand and slow an economic recovery. But, by providing fiscal relief to the states, the federal government can minimize the extent to which states must rely on such options. Using federal fiscal relief for any purpose other than mitigating spending reductions or tax increases — as the governor seeks to do — limits its effectiveness.

> **"[Rhode Island] Gov. Donald L. Carcieri's ears surely must have been burning during those [Obama] speeches, for one of his top priorities for the use of federal stimulus funds — tax cuts, tax cuts and more tax cuts — would be among the most wasteful purposes to which those funds could be put. "**

The governor has asserted that using federal stimulus funds for anything other than reducing taxes "would be irresponsible." To the contrary, it is the governor's tax-cut plan itself that meets the definition of irresponsible.

It would not simply waste the opportunity to put Rhode Island's fiscal house in order and to prepare for the eventual expiration of federal assistance. Rather, it would leave Rhode Island in a materially worse position for addressing the fiscal and economic challenges ahead.

As a recent report from the Rockefeller Institute concludes, "under any likely scenario… major fiscal problems for states will return when the new aid from Washington runs out."

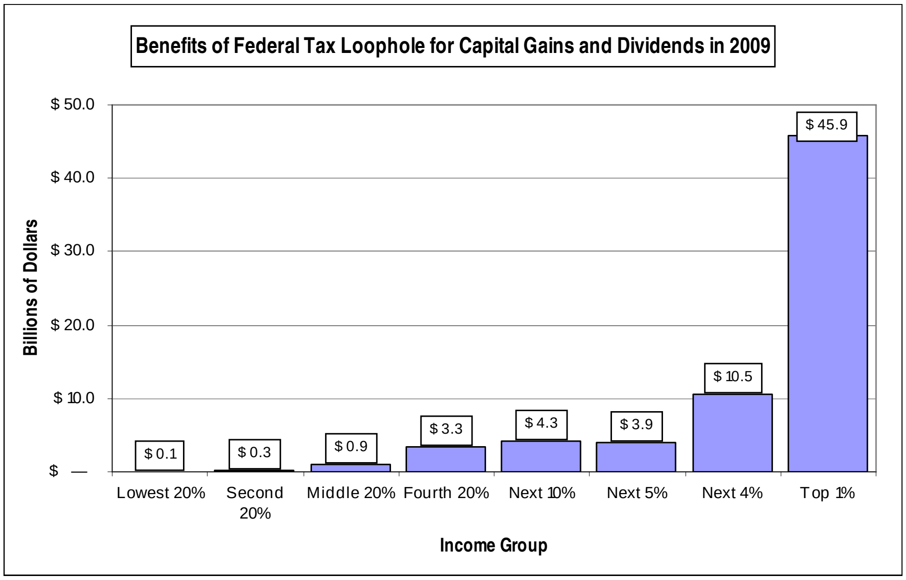
Needless to say, this conclusion assumes that, between now and 2012, states will not do anything to actively reduce the yield of their tax systems, but that is precisely what Carcieri seems ready to do.

In sum, in response to the worst economic crisis in decades, the federal government will send more than $1.5 billion to the Ocean State over the next two years, some $630 million of which is meant to close projected budget deficits and to support desperately needed public services. Carcieri has a response of his own — a poorly targeted tax plan that would count wealthy heirs and profitable businesses among its principal beneficiaries; that would do little to improve the condition of Rhode Island's economy in the short term; and that would add to the strains on its budget over the long term.

Here's hoping that the president makes good on his pledge. ◆

ITEP Issues Report on State Capital Gains Tax Breaks

One would think that Congress ought to be ready to stop subsidizing investors and the Wall Street brokers who work for them. President Bush and his allies in Congress expanded the subsidy in the income tax for capital gains (and created a new one for corporate stock dividends) in 2003. It would be quite an understatement to say that the promised explosion of prosperity didn't quite materialize. It would be one thing if this mistake wasn't so costly. The graph below shows that the existing subsidy in the income tax for capital gains and dividends will funnel over $45 billion to the richest one percent of taxpayers this year, while middle-class Americans receive almost no benefit.



Unfortunately, many state governments have made the same mistake. At least nine states are currently digging their fiscal hole deeper by allowing lavish capital gains tax cuts for upper-income families, as explained in a new ITEP report titled "A Capital Idea: Repealing Tax Breaks for Capital Gains Would Ease Budget Woes and Improve Tax Fairness." The report shows that some states are reducing their income tax collections by more than 5 percent each year this way. (In tax year 2008, these nine states are expected to lose a total of $663 million due to such misguided policies.) The timely report shines light on these costly, inequitable, and ineffective tax breaks that, if repealed, could be an important response to projected state budget deficits. ◆

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