INCOME TAX SAVINGS FOR MIDDLE-INCOME FAMILIES

A JOINT ECONOMIC COMMITTEE STUDY

Vice Chairman Jim Saxton (R-NJ)

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Executive Summary

Tax legislation enacted since 2001 has provided families with a broad array of tax relief. Over the four-year period 2001 to 2004, the effect of just three of these provisions is tax savings of $5,480 for a typical family of four making $36,400 or more and claiming the standard deduction. Families all along the income spectrum face the prospect of considerably higher tax burdens unless action is taken to avoid the expiration of these tax reductions.

This estimate is not based on any specific income level, but indicates the benefit amount available to most families with income of more than $36,400 in 2004, with two children and who claim the standard deduction. The tax benefits, however, begin accruing at income of $10,750 in 2004, thus benefiting many families who currently pay little or no income taxes.

The estimate of $5,480 should be considered conservative, since it does not include potential savings from the dozens of additional tax relief provisions available to many families. In addition, the calculations presented here do not take into account the indirect benefits that result from the economic growth stimulated by the tax reductions of the last three years.

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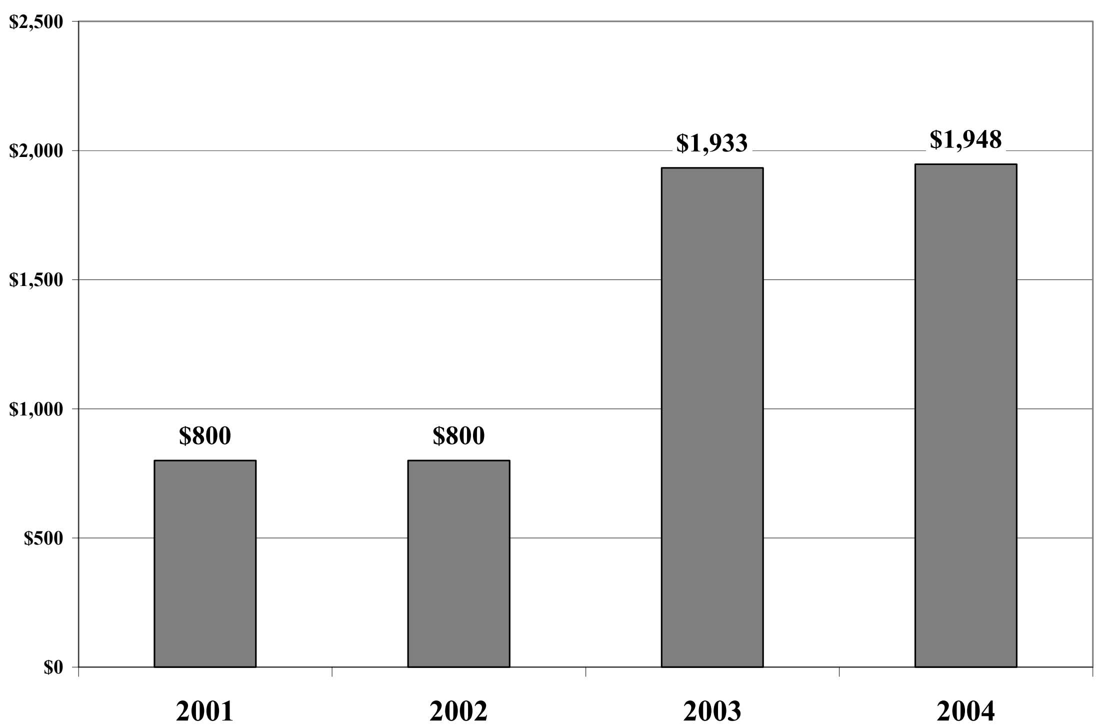
Introduction

The Congress and the Bush Administration enacted significant income tax relief legislation in 2001 and 2003. Over the four-year period 2001 to 2004, the effect of just three of these provisions is tax savings of $5,480 for a typical family of four making $36,400 or more (Figure 1). This estimate is based on just three tax relief provisions: a new 10 percent tax bracket, an increase in the child tax credit, and marriage penalty relief. The estimate of $5,480 is deliberately conservative, as there are dozens of additional tax benefits available to taxpayers from the tax relief legislation, but are not explicitly included in the calculations presented here. Since all three of the tax relief provisions considered here expire after 2010, these calculations underscore the importance of making tax relief permanent.

Figure 1. Middle-Income Savings from Enacted Tax Relief, 2001-2004



Note: Calculations assume a married couple with a joint return, two children and a standard deduction.
Source: Joint Economic Committee calculations.

Savings per Tax Provision

Two tax relief packages implemented major reductions in the individual income tax in the last three years. The centerpiece of President Bush's tax policy was the 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA).[1] More recently, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) implemented additional tax relief provisions for 2003 and 2004.[2]

The present analysis considers the effects of three key pieces of tax relief in these bills generally of benefit to lower- and middle-income families (see Table 1). First, the creation of a new 10 percent marginal tax bracket will save many taxpayers $2,615 during its first four years. Second, the increase in the child tax credit from $500 per child to $1,000 per child by 2003 will generate benefits worth $2,400 for a family with two children over the same period. Finally, new relief from the marriage tax penalty will yield savings of $465 in 2003 and 2004 for affected taxpayers. In total, such families with incomes of $36,400 or more in 2004 will save $5,480 over four years.

Table 1. Tax Savings 2001-2004

	2001	2002	2003	2004	Total
New 10% Tax Bracket	$600	$600	$700	$715	$2,615
Child Tax Credit (2 Children)	$200	$200	$1,000	$1,000	$2,400
Marriage Penalty Relief	$0	$0	$233	$233	$465
Total	**$800**	**$800**	**$1,933**	**$1,948**	**$5,480**

Note: Figures may not sum due to rounding. Assumes married couple claiming the standard deduction.
Source: Joint Economic Committee calculations.

These calculations quantify the tax savings that a middle-income family of four with two children would receive over 2001 to 2004. These estimates are independent of a specific income level and are valid for families with a wide range of incomes. The calculations assume a married couple with a joint tax return and two dependent children under the age of 17. The analysis also assumes that the tax return uses the standard deduction and claims no other credits or deductions, including the Earned Income Tax Credit. In 2004, a family needs income of at least $36,400 to receive the full measure of tax benefits listed in Table 1, including the refundable portion of the child tax credit. However, tax relief benefits begin accruing at incomes above $10,750.[3]

New 10 Percent Tax Bracket

One of the central features of EGTRAA is the creation of a new 10 percent marginal tax bracket. This new tax bracket will save typical taxpayers $2,615 over 2001 to 2004. Table 2 displays the calculations behind this estimate.

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[1] H.R. 1836 became Public Law 107-16 on June 7, 2001.
[2] H.R. 2 became Public Law 108-27 on May 28, 2003.
[3] The child tax credit is at least partially refundable for families with earned income of more than $10,750 in 2004. In effect, any such refundable tax credit represents not a tax cut in the traditional sense (since no income tax is owed at this level), but rather a transfer payment. See also *infra* note 7.

The 2001 tax act specified that the new 10 percent rate applied to the first $12,000 of income (for joint returns) for 2001 and 2002. JGTRRA increased the bracket threshold to $14,000 for 2003, and adjusted it for inflation thereafter. The Internal Revenue Service (IRS) has announced that the inflation-adjusted bracket level is $14,300 for 2004.[4]

Table 2. Tax Savings from New 10% Tax Bracket

	2001	2002	2003	2004	Total
Tax Liability Assuming No 10% Tax Bracket (pre-2001 law)					
Income in Bracket	$12,000	$12,000	$14,000	$14,300	
* Tax Rate	15%	15%	15%	15%	
= Tax Liability	$1,800	$1,800	$2,100	$2,145	
Tax Liability with New Tax Bracket (current law)					
Income in Bracket	$12,000	$12,000	$14,000	$14,300	
* Tax Rate	10%	10%	10%	10%	
= Tax Liability	$1,200	$1,200	$1,400	$1,430	
Tax Savings	**$600**	**$600**	**$700**	**$715**	**$2,615**

Source: Joint Economic Committee calculations.

The tax savings calculations are straightforward. The first three rows of data in Table 2 show what the tax liability would be on income in this new bracket if it were taxed at the pre-2001 rate of 15 percent (i.e., assuming that there had been no new tax bracket).[5] The following three rows of data show what the actual tax liability on the same income is with the new 10 percent tax bracket. The difference, shown in the last row, indicates the tax reduction attributable to the creation of the new tax bracket.

Increase in the Child Tax Credit

Since 1998, taxpayers have been eligible to claim a tax credit for each child under the age of 17. Prior to 2001, the amount of the credit was $500 per child, but was not refundable for families with one or two children.[6] The 2001 tax act increased the child tax credit to $600 per child through 2004, eventually raising it to $1,000 per child by 2010. Subsequently, the 2003 tax act expanded the benefit of the child tax credit by further increasing the credit amount from $600 to $1,000 for 2003 and 2004. Taken together, the two tax acts raised the child tax credit by $100

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[4] Internal Revenue Service, "Rev. Proc. 2003-85, page 1184: Cost of Living Adjustments for 2004," *Internal Revenue Bulletin*, Bulletin No. 2003-49, 12/8/2003.

[5] In order to provide immediate economic stimulus, this provision was structured as a tax credit for tax year 2001, not as a new tax bracket. For married taxpayers filing jointly, the credit was set equal to the amount of tax savings that would have resulted if there had been a 10 percent tax bracket. Structured this way, taxpayers could receive advance refund checks for some or all of the tax credit during 2001, rather than waiting until filing their 2001 return in April 2002.

[6] The child tax credit is gradually reduced to zero after adjusted gross income exceeds $110,000 for married taxpayers filing jointly. Greg Esenwein, "Child Tax Credit," *CRS Taxation Briefing Book*, 7/1/2003.

per child for 2001 and 2002, and by $500 per child for 2003 and 2004. In addition, EGTRRA expanded the refundability of the child tax credit to include families with one or two dependent children, thereby expanding eligibility to many lower income tax filers.[7]

Table 3. Tax Savings from Increase in Child Tax Credit

	2001	2002	2003	2004	Total
Child Tax Credit (pre-2001 law)	$500	$500	$500	$500	
Child Tax Credit (current law)	$600	$600	$1,000	$1,000	
Difference per Child	$100	$100	$500	$500	
Tax Savings for 2 Children	**$200**	**$200**	**$1,000**	**$1,000**	**$2,400**

Source: Joint Economic Committee calculations.

Table 3 shows the tax savings from the increased child tax credit. For a family with two children, the total additional tax relief from the increase in the child tax credit is $2,400 over 2001 to 2004. Because the child tax credit is refundable even if income tax liability is zero, the benefits of this provision extend to many lower-income families. Families are eligible for the refundable portion of the child tax credit starting at earned income over $10,750 in 2004.

Marriage Penalty Relief

A long-standing deficiency in the tax system is the so-called “marriage penalty.” The marriage penalty refers to the fact that a married couple filing a joint return often pays more in income taxes than the same individuals would if they had simply filed as single individuals. One reason the marriage penalty arises is that the standard deduction for a married-filing-jointly return is smaller than two single standard deductions combined.

Table 4. Tax Savings from Marriage Penalty Relief

	2001	2002	2003	2004	Total
Standard Deduction (pre-2003 law)	$7,600	$7,850	$7,950	$8,150	
Tax Benefit @ 15% Tax Rate	$1,140	$1,177	$1,192	$1,222	
Standard Deduction (current law)	$7,600	$7,850	$9,500	$9,700	
Tax Benefit @ 15% Tax Rate	$1,140	$1,177	$1,425	$1,455	
Tax Savings	**$0**	**$0**	**$233**	**$233**	**$465**

Note: Figures may not sum due to rounding.
Source: Joint Economic Committee calculations.

[7] The child tax credit refund is calculated as 10 percent of the tax filer’s earned income over a certain threshold, net of any tax liability. In 2004, the threshold is $10,750. Thus, a tax return with income of $12,000, for example, might have no income tax liability, but could receive a child tax credit refund of $125.

The 2001 and 2003 tax acts attempted to alleviate the marriage tax penalty by reducing the inequity in standard deductions.[8] For 2003 and 2004, the standard deduction for married-filing-jointly returns is set to twice the standard deduction for single taxpayers. This change increased the standard deduction for married couples by $1,550, producing a tax savings of $232.50 in both 2003 and 2004, for a total benefit of $465.

Table 4 details the calculations behind this estimate. The standard deduction is what taxpayers subtract from their adjusted gross income to arrive at their taxable income. The standard deduction therefore provides a tax benefit equal to the amount of the deduction multiplied by the taxpayer's marginal tax rate. Two calculations were necessary to estimate the effect of the increased standard deduction. First, the tax benefit of the standard deduction was calculated using the "old" standard deduction, as it would have been without marriage penalty relief.[9] Second, the tax benefit of the "new" standard deduction was calculated by multiplying the actual standard deduction under current law by the marginal tax rate of 15 percent.[10] The tax savings from marriage penalty relief is simply the difference between the two sets of numbers.

Additional Tax Relief

The goal of this paper is to arrive at estimates of tax savings that are applicable to taxpaying families with a wide range of incomes. Taxpayers in different economic and tax situations could realize significantly more tax relief. Legislation enacted since 2001 provided dozens of additional opportunities for tax reduction. The following list briefly describes some broadly applicable tax reductions for individuals that are not included in the calculations above.[11]

- <u>Lower individual income tax rates</u>: The following rate reductions are implemented by 2003: the 28 percent rate falls to 25 percent; the 31 percent rate falls to 28 percent; the 36 percent rate falls to 33 percent; and the 39.6 percent rate falls to 35 percent.
- <u>Reduced alternative minimum tax (AMT):</u> The alternative minimum tax exemption amount is raised by $9,000 to $58,000 for married taxpayers and by $4,500 to $40,250 for unmarried taxpayers.

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[8] These acts also lowered the marriage penalty by increasing the 15 percent tax bracket for married-filing-jointly returns to equal twice the 15 percent bracket for single individuals (up from the pre-EGTRRA ratio of 1.67). The effect of this expanded 15 percent bracket is not included in the present analysis.

[9] The IRS published its cost-of-living adjustment for 2003 prior to enactment of the 2003 tax act, thus providing the baseline for the "old" standard deduction in 2003. For 2004, the "old" 2003 standard deduction was adjusted using the actual 2004 increase in the standard deduction ($200). Internal Revenue Service, "Rev. Proc. 2002-70, page 845: Cost of Living Adjustments for 2003," *Internal Revenue Bulletin*, Bulletin No. 2002-46, 11/18/2002; and *supra* note 4.

[10] The new 10 percent rate was not used here because the calculations should reflect the marginal tax rate, which under the pre-2001 tax regime would be 15 percent. The marginal tax rate could actually be higher (under the old tax regime, the 28 percent marginal rate for married couples in 2003 would have begun on taxable income above $47,450), but the lower 15 percent rate is used in the present analysis for conservatism.

[11] For additional detail, see the following National Association of Tax Professionals reports, all available online at http://www.natptax.com/tax_act_summaries.html: "Economic Growth and Tax Relief Reconciliation Act of 2001" (7/11/2003); "Jobs and Growth Tax Relief Reconciliation Act of 2001" (2003); and "Medicare Prescription Drug, Improvement, and Modernization Act of 2003" (2003).

- Additional marriage penalty relief: The 15 percent tax bracket for married couples is expanded, with the threshold increasing to equal twice the threshold for single filers for 2003 and 2004, and to 1.8 times the single threshold after 2004.
- Earned Income Tax Credit (EITC): The beginning and ending of the EITC phase-out range are both increased by $3,000 by 2008.
- Estate and Gift Taxes: The estate and generation-skipping taxes are gradually repealed by 2010 by increasing the effective exemption amount and lowering tax rates. Gift tax rates are set equal to the top individual income tax rate.
- Expanded IRAs: Contribution limits for Individual Retirement Accounts (IRAs) are increased from $2,000 per year to $5,000 by 2008.
- Lowered capital gains tax: The previous capital gains tax rates of 10 percent and 20 percent are lowered to 5 percent (down to zero by 2008) and 15 percent, respectively.
- Lowered dividends tax: The tax rate on shareholder dividends is lowered from the top applicable individual income tax rate to rates of 5 percent (down to zero by 2008) and 15 percent.
- Health Savings Accounts (HSAs): Starting in 2004, taxpayers can make annual tax-deductible contributions of up to $2,600 for individuals and $5,150 for families to Health Savings Accounts. Taxpayers aged 55 to 64 can make additional contributions. HSAs can be used to pay for over-the-counter drugs, long-term care insurance and premiums for certain health insurance plans.
- Education IRAs: Contribution limits for education IRAs are raised from $500 to $2,000 annually.
- State tuition programs (Section 529s): The definition of state tuition programs (also known as Section 529s) is expanded, and distributions for qualified education expenses are made tax-deductible.
- Student loan interest deduction: The eligibility of the student loan interest deduction is expanded to include single taxpayers with incomes up to $65,000 (an increase of $15,000) and married taxpayers with incomes up to $130,000 (an increase of $30,000).
- Adoption tax credit: The tax credit for adoption expenses is increased to $10,000, up from $5,000 ($6,000 for special needs children).

Methodology

As noted above, the calculations presented in this paper are for a married couple filing a joint tax return and claiming two dependent children and the standard deduction. The analysis assumes that the return does not claim any other deductions or credits, even though this family might be eligible for other tax relief, such as the Earned Income Tax Credit or reduced individual income tax rates. The tax benefits of the marriage penalty relief would be smaller to the degree that the family claims itemized deductions.[12] The calculations above do not take into account the potential impact, if any, of the alternative minimum tax or the Earned Income Tax Credit.

This analysis utilizes income tax parameters specified in law or published by the IRS. Each year the IRS releases its estimate of cost-of-living adjustments in the standard deduction

[12] However, even itemizers could benefit from the expansion of the threshold for the 15 percent tax bracket. See *supra* note 8.

and tax brackets for the upcoming year. In November 2002, the IRS announced that the annual cost-of-living adjustment would raise the standard deduction for married couples filing jointly to $7,950 in 2003. Subsequent to that announcement, JGTRRA became law and legislated that the standard deduction be raised to $9,500. The IRS announced in December 2003 that the standard deduction for 2004 would increase to $9,700. The figure of $8,150 used in Table 4 is an estimate, derived by adding to the pre-JGTRRA 2003 standard deduction the same cost-of-living adjustment as the actual adjustment for 2004 ($200).

The data presented here are all in nominal dollars (i.e., there are no adjustments for the effects of inflation). The manner in which the tax relief is provided complicates adjustment for inflation, as different taxpayers will receive their tax savings at different times. For example, the tax savings from the new 10 percent tax bracket in 2001 was provided via a rate reduction tax credit. Although the tax benefit was for the 2001 tax year (and thus affected taxes due in April 2002), the benefit was provided through an advanced refund check received by most families in calendar year 2001. Similarly, JGTRRA increased the child tax credit for 2003 and 2004. However, in order to accelerate the economic impact of the tax relief, most eligible families actually received a check for the advanced credit during the 2002 calendar year.

Table 5. Inflation-Adjusted Tax Savings

Tax Savings	2001	2002	2003	2004	2005	2001-05
New 10% Tax Bracket	$600	$0	$600	$700	$715	**$2,615**
Child Tax Credit	$0	$200	$1,000	$200	$1,000	**$2,400**
Marriage Penalty Relief	$0	$0	$0	$233	$233	**$465**
Total (nominal)	**$600**	**$200**	**$1,600**	**$1,133**	**$1,948**	**$5,480**
CPI growth projection			2.3%	1.6%	1.7%	
CPI-U	0.947	0.962	0.984	1.000	1.017	
Total (2004$)	**$633**	**$208**	**$1,626**	**$1,133**	**$1,915**	**$5,514**

Source: Joint Economic Committee calculations.

Table 5 presents the data from Table 1 by the approximate year in which the tax benefits are actually received. With the exceptions of the advanced rate reduction credit in 2001 and the advanced child tax credit refund in 2003, tax benefits are assumed to fall one year after the applicable tax year. In other words, a reduction in 2003 taxes is assumed to materialize in 2004 (when the taxes are actually due to the IRS). Changes in withholding rates could affect the timing, but are not taken into account in Table 5. The calculations in Table 5 use the Consumer Price Index (CPI-U) as the measure of inflation. For 2004 and 2005, the rate of inflation is the projected annual rate as estimated by the Congressional Budget Office.[13] Overall, when the tax benefits are adjusted to 2004 dollars, the net effect is tax savings of $5,514, an amount very similar to the unadjusted amount of $5,480.

[13] Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005-2014* (January 2004).

Conclusion

Tax legislation enacted since 2001 has provided families with a broad array of tax relief. Over the four-year period 2001 to 2004, the effect of just three of these provisions is tax savings of $5,480 for a family of four making $36,400 or more. This estimate is not based on any specific income level, but indicates the benefit amount available to most families with income of more than $36,400 in 2004. The tax benefits, however, begin accruing at income of $10,750 in 2004, thus benefiting many families who currently pay little or no income taxes. The estimate of $5,480 should be considered conservative, since it does not include potential savings from the dozens of additional tax relief provisions available to many families.

This analysis focuses on the direct, measurable benefits of certain reductions in the individual income tax. However, in addition to boosting disposable family income, a central goal of the tax reductions of the last three years has been to stimulate economic growth through increased savings and investment. As the economic expansion continues to increase in strength, workers and consumers receive additional benefits. The savings estimates presented here do not take into account the indirect benefits that result from the economic growth stimulated by the tax reductions.

Most of the tax reductions enacted since 2001 expire after 2010. Families all along the income spectrum face the prospect of considerably higher tax burdens unless action is taken to avoid the expiration of these tax reductions. Likewise, repeal of this tax relief would represent a sizeable tax increase for middle-income families. Making the tax relief permanent would not only provide greater certainty to taxpayers, but would also ensure that families do not experience sudden and significantly higher tax bills.

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