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Obama's Tax Compromise and its Effects on Low-Income Taxpayers

By Nicholas Kasprak

Introduction

With both the Bush-era tax cuts and stimulus tax cuts set to expire at the end of this year, Congress has been vigorously debating the future of federal tax policy. There has been little agreement on which cuts to extend, whom to extend them for, and for how long. Most Democrats would like to see only the Bush-era tax cuts on income under $250,000 for families (and $200,000 for single filers) extended, some Democrats would like to see all of the Bush-era tax cuts expire, and Republicans would like to see all of them extended permanently. There is also the question of what to do with the temporary tax cuts enacted in 2009 as part of the stimulus bill, which included a refundable tax credit worth up to $800 for working families, as well as expansions of the child tax credit, the earned income credit, and the credit for college tuition.

Recently, President Obama and Senate Republicans agreed on a compromise plan, where all of the Bush tax cuts and nearly all of the stimulus bill tax cuts are extended for two years. The one stimulus cut that is not extended is the refundable $800 credit ($400 for single filers) known as Making Work Pay, but this is replaced by a cut in the employee portion of the Social Security payroll tax from 6.2% of wages to 4.2%.

Some argue that the compromise is too generous to wealthy taxpayers, or that it raises taxes on low-income workers – a claim which ignores the fact that, by the same standard, the bill passed by House Democrats raises taxes on them even more, since it lets the Making Work Pay credit expire and includes no cut in payroll taxes.

By contrast, the earlier plan that had been supported by most Republicans, the Tax Hike Prevention Act of 2010, extended all the Bush tax cuts but none of the stimulus cuts, and did not include any change to payroll taxes. The bill that recently passed through the House, supported by most Democrats, extended

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the Bush tax cuts for all but high-income earners. It extended some stimulus cuts but let others expire. Notably, it let the Making Work Pay credit expire, as well as the expansion of the credit for college tuition. The expansion of the earned income credit would have partially expired as well. This bill also does not include any cut in payroll taxes, which is an entirely new proposal found only in the compromise plan.

The compromise proposal has sparked considerable debate. While most Republicans and some Democratic senators support it, House Democrats are decidedly less enthusiastic, and President Obama has a great deal of work to do if he is to get the compromise through the House before the end of the year. Some argue that the compromise is too generous to wealthy taxpayers, or that it raises taxes on low-income workers – a claim which ignores the fact that, by the same standard, the bill passed by House Democrats raises taxes on them even more, since it lets the Making Work Pay credit expire and includes no cut in payroll taxes.

Comparison Baselines and Current Law

Those who make claims about whether a particular provision raises or lowers taxes must be careful in choosing and defining their baseline for comparison. One that is used commonly for official scoring is "current law," which can be confusing since one might reasonably assume it refers to a scenario in which the current tax structure is maintained in perpetuity, and your tax returns in future years look exactly like your 2010 tax return. However, because so many tax provisions are set to automatically expire at the end of this year, the "current law" scenario assumes that these will all expire. Essentially, "current law" is a scenario in which Congress ceases to pass any legislation at all, forever. It's reasonable to use for short-term estimates, but it's obviously not realistic in the long term.

A reasonable alternative when comparing tax proposals is to take the current 2010 income tax structure and extend it as is into 2011, using that as your baseline. But this is not as simple as it sounds: For one thing, most parameters in the tax code, such as bracket thresholds, are indexed to inflation, and rise automatically every year without requiring any act of Congress. It's also not realistic: Even in a normal year, many tax provisions, such as AMT exemption levels, require an act of Congress to be extended – these are known as "extenders." The Congressional Budget Office, when it compiles revenue estimates on major legislation, compares the effects against current law, but, recognizing the weakness of that baseline, also includes comparisons against what it calls the "Alternative Fiscal Scenario" in which common extenders provisions are continually renewed. However, constructing this scenario requires CBO to make political judgments about which provisions will and won't be extended, and is equally unrealistic in the long term, due to the uncertainty of such judgments.

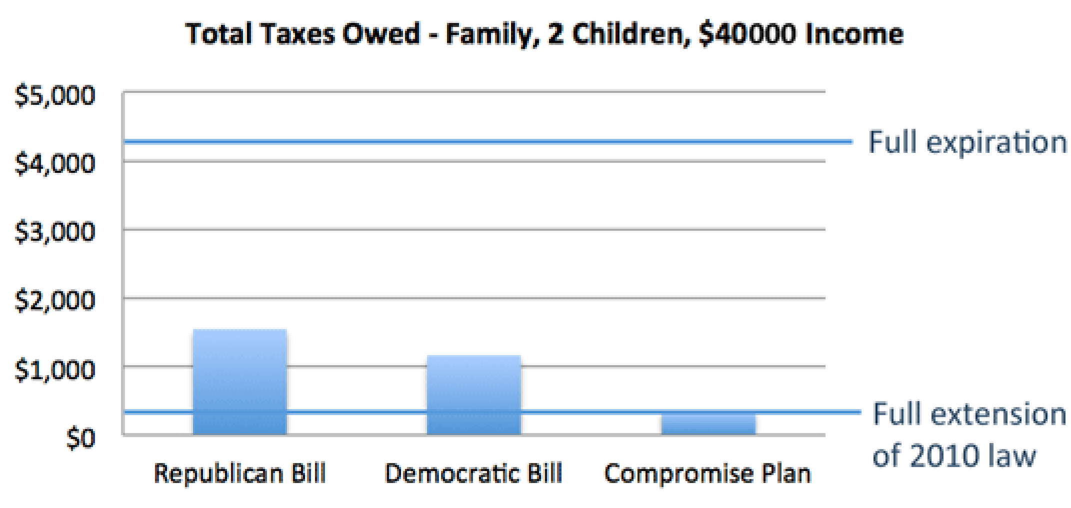
The Tax Compromise

So where does the claim that the tax compromise raises taxes on low-income workers come from? It's true only if your baseline for comparison is extending 2010 tax law as is into 2011, since 2010 law includes the Making Work Pay credit. However, nobody has proposed this, and it's not on the table. In fact, the compromise plan is by far the most generous to low-income people, because of the payroll tax cut. The table below shows how the various proposals being debated affect a sample of low-income taxpayers, compared against both the current law baseline in which all tax cuts expire, as well as against the scenario in which 2010 law is extended into 2011.

First, here's a scenario in which Making Work Pay is exactly equal to the payroll tax cut: The break even point is at $40,000 for married filers (and $20,000 for single filers.)

Table 1
Family, Two Children, $40,000 Income

	Full Expiration (Current Law)	2010 Law Extended to 2011 (Full Extension)	Tax Hike Prevention Act (Republican Bill)	Middle-Class Tax Relief Act (Democratic Bill)	Obama/ Republicans Compromise Plan
AGI	$40,000	$40,000	$40,000	$40,000	$40,000
Taxable Income	$15,550	$13,600	$13,600	$13,600	$13,600
Tax	$2,333	$1,360	$1,360	$1,360	$1,360
Credits	$1,203	$4,056	$2,873	$3,256	$3,256
Income Tax	$1,130	-$2,696	-$1,513	-$1,896	-$1,896
Payroll Tax	$3,060	$3,060	$3,060	$3,060	$2,260
Total Tax	$4,190	$364	$1,547	$1,164	$364
Increase/Decrease in taxes **compared to full expiration**			-$2643	-$3,026	-$3,826
Increase/Decrease in taxes **compared to full extension**			$1,183	$800	$0
Post-Tax Income	$35,810	$39,636	$38,453	$38,836	$39,636
% Change in Post-tax Income **compared to full expiration**			7.4%	8.5%	10.7%
% Change in Post-tax Income **compared to full extension**			-3.0%	-2.0%	0%

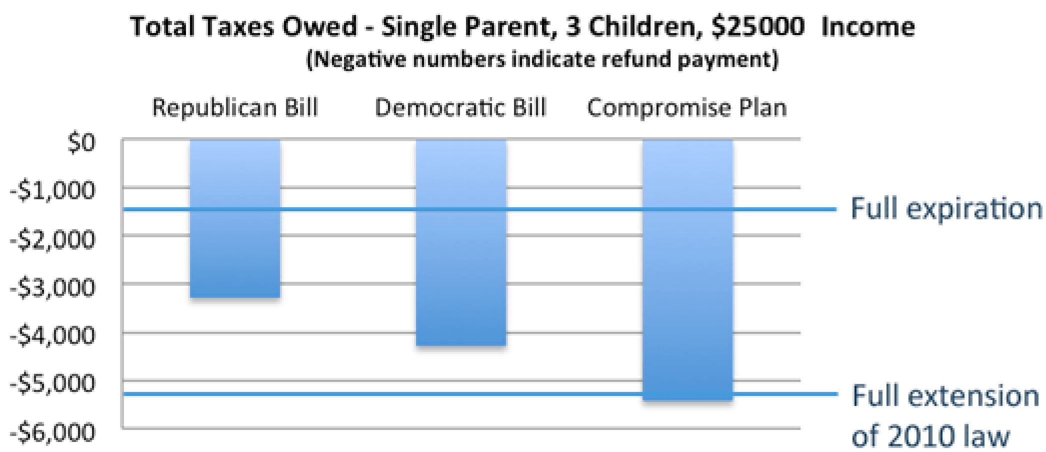


The compromise plan is much more generous than the bill passed by House Democrats because of the payroll tax cut. Compared with full expiration of all tax cuts (the scenario usually referred to as "current law" for reasons described above), it constitutes a 10.7% increase in after-tax income, and, because $40,000 in income is the point where Making Work Pay is exactly equal to the payroll tax cut, ends up being exactly the same as fully extending existing tax law into next year.

Next, here's a scenario in which the payroll tax cut ends up being even more generous than the Making Work Pay credit it replaces.

Table 2
Single Parent, Three Children, $25,000 Income

	Full Expiration (Current Law)	**2010 Law Extended to 2011 (Full Extension)**	**Tax Hike Prevention Act (Republican Bill)**	**Middle-Class Tax Relief Act (Democratic Bill)**	**Obama/ Republicans Compromise Plan**
AGI	$25,000	$25,000	$25,000	$25,000	$25,000
Taxable Income	$1,700	$1,700	$1,700	$1,700	$1,700
Tax	$255	$170	$170	$170	$170
Credits	$3,617	$7,401	$5,362	$6,362	$7,001
Income Tax	-$3,362	-$7,231	-$5,192	-$6,192	-$6,831
Payroll Tax	$1,913	$1,913	$1,913	$1,913	$1,413
Total Tax	-$1,449	-$5,318	-$3,279	-$4,279	-$5,418
Increase/Decrease in taxes **compared to full expiration**			-$1830	-$2830	-$3,969
Increase/Decrease in taxes **compared to full extension**			$2,039	$1,000	-$100
Post-Tax Income	$26,449	$30,318	$28,279	$29279	$30,418
% Change in Post-tax Income **compared to full expiration**			6.9%	10.7%	15.0%
% Change in Post-tax Income **compared to full extension**			-6.7%	-3.4%	0.3%

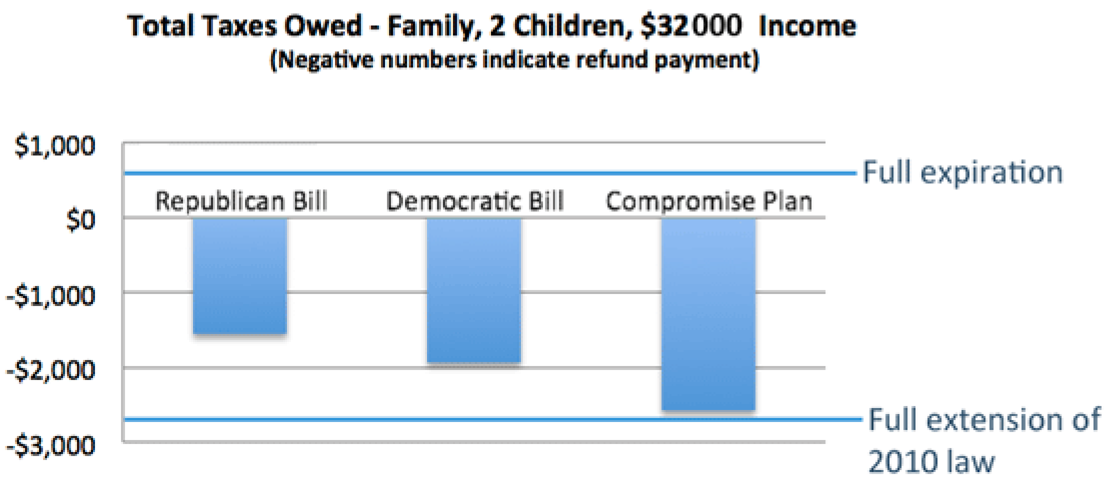


Again, the compromise plan is the most generous. This is because of the payroll tax cut, and additionally a slightly more generous earned income credit. The compromise plan extends a special category of EITC rates that apply to filers with three or more children, which is not included in the Democratic bill. It's even slightly more generous than full extension of all current tax cuts into next year, because for single filers making over $20,000, the payroll tax cut is worth more than the Making Work Pay credit.

Finally, here's the type of scenario that has led some to complain that the compromise raises taxes on low-income workers. We'll look at a single-income family, making $32,000, with two children.

Table 3
Family, Two Children, $32,000 Income

	Full Expiration (Current Law)	2010 Law Extended to 2011 (Full Extension)	Tax Hike Prevention Act (Republican Bill)	Middle-Class Tax Relief Act (Democratic Bill)	Obama/ Republicans Compromise Plan
AGI	$32,000	$32,000	$32,000	$32,000	$32,000
Taxable Income	$7,550	$5,600	$5,600	$5,600	$5,600
Tax	$1,133	$560	$560	$560	$560
Credits	$2,888	$5,741	$4,557	$4,941	$4,941
Income Tax	-$1,755	-$5,181	-$3,997	-$4,381	-$4,381
Payroll Tax	$2,448	$2,448	$2,448	$2,448	$1,808
Total Tax	$693	-$2,733	-$1,549	-$1,933	-$2,573
Increase/Decrease in taxes **compared to full expiration**			-$2242	-$2,626	-$3,266
Increase/Decrease in taxes **compared to full extension**			$1,184	$800	$160
Post-Tax Income	$31,307	$34,733	$33,549	$33,933	$34,573
% Change in Post-tax Income **compared to full expiration**			7.2%	8.4%	10.4%
% Change in Post-tax Income **compared to full extension**			-3.4%	-2.3%	-0.5%



The compromise plan is still clearly the most generous, but not quite so much as current 2010 tax law. The payroll tax cut is, in this case, not quite as valuable as the Making Work Pay credit, so this family sees a 0.5% drop in its after-tax income compared with 2010 law.   The people who complain that the compromise tax plan raises taxes on low-income earners ignore the fact that the Democratic bill that passed the House, by the same standard, raises taxes on the same groups even more – this same family sees a 2.3% drop in their after-tax income compared with 2010 law under the House bill.

Conclusion

The compromise between Senate Republicans and the President produces a much lower tax bill (or a higher tax refund) for low-income workers. Despite not being quite as generous as current 2010 tax law in very low-income cases, below $40,000 for married filers and $20,000 for single filers, it remains a better deal than the GOP or the Democratic bills proposed in Congress.

About these Numbers

These calculations are based on the Tax Foundation's projected 2011 tax bracket levels, which are calculated by the IRS according to inflation statistics from the Bureau of Labor Statistics (BLS). While the IRS has not officially released tax bracket levels for 2011 due to uncertainty about tax law changes, we use their formula to calculate bracket levels for many possible policy scenarios.

To plug in your own example to see how a hypothetical family of your choosing would fare under these alternative policy scenarios, visit the Tax Foundation's online tax calculator at www.mytaxburden.org.

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About the Tax Foundation

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