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Comparing Popular Tax Deductions to the Bush Tax Cuts

Hallowed Deductions Give Little to the Middle; Bush Tax Cuts Help More

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The debate over what to do with the Alternative Minimum Tax has led to some silly public statements about who benefits from special provisions of the income tax code. Lawmakers find it easy to demand repeal or reduction of the AMT, but in announcing support for tax hikes or spending cuts to make up the uncollected revenue, as now required, their rhetoric has been deceptive, to say the least.¹

So far the favorite revenue target is to repeal the Bush tax cuts, which so many have accused of benefiting only "the rich," or to enact something similar. The idea of repealing the deduction for state-local taxes is also getting some attention. Comparing those two ideas in Table 1, we see that the tax savings would flow to almost exactly the same people.

There are many ways of quantifying tax policy changes, and throughout the debate over the Bush tax cuts, opponents preferred "shares." This presentation answers the question: What share of the tax savings went to the top 20, 10, or 1 percent of taxpayers? Because the Bush tax cuts were mainly across-the-board cuts in tax rates, high-income taxpayers who paid the most to begin with received the largest shares of tax savings. This presentation dovetailed nicely with "class warfare" rhetoric that Bush favored high-income people.

People who favored the Bush tax cuts preferred to present the change in tax rates for each income group. This presentation answers the question: For each income group, what percentage of current tax payments will be saved under the Bush tax cuts? Because annual tax savings between \$1,000 and \$5,000 are large for low- and middle-income taxpayers, this presentation showed the tax cuts' broad appeal.

In this piece, we use the first method, presenting the tax savings of various tax laws as "shares," but we apply it not only to the Bush tax cuts but to popular tax preferences that are vociferously defended by many of the same politicians who denounce the Bush tax cuts.

Table 1. Tax Savings from State-Local Tax Deduction Compared to Bush Tax Cuts

Tax Returns Divided Into Ten Groups by Income (a)		Share of Tax Savings from State-Local Tax Deduction	Share of Tax Savings from All Bush Tax Cuts
Bottom 10%	(≤ \$5,888)	0.0%	0.1%
Second 10%	(> \$5,888)	0.0%	0.4%
Third 10%	(> \$12,251)	0.2%	1.3%
Fourth 10%	(> \$18,940)	0.6%	2.5%
Fifth 10%	(> \$26,483)	1.4%	3.7%
Sixth 10%	(> \$35,386)	3.3%	5.4%
Seventh 10%	(> \$45,945)	7.1%	7.4%
Eighth 10%	(> \$60,219)	13.0%	9.2%
Ninth 10%	(> \$80,228)	20.0%	13.5%
Top 10%	(> \$118,376)	54.4%	56.6%
(a) Adjusted gross income			
Note: All numbers for Tax Year 2007. Baseline is current law.			
Source: Tax Foundation Microsimulation model and IRS Public Use File			

Actually, the Bush tax cuts are more generous to all of the lower- and middle-income groups. The eighth and ninth highest-earning groups get more savings from the state-local deduction, and the top group gets slightly more from the Bush tax cuts.²

The two most commonly abused phrases in this debate are "rich" and "middle-class." In one breath politicians want to call people making between \$75,000 and \$250,000 "middle-class" and in the next breath "rich." Unfortunately, this rhetoric makes principled tax reform much more difficult.

To give just one example from each party, Senate Finance Committee member Charles Schumer (D-NY) said repealing the deduction for state-local taxes paid "would devastate people at all levels of income, from working families of modest means to the upper-middle class."³ On the other side of the aisle and in the other house of Congress, House Ways and Means Committee member Jerry Weller (R-IL) called the state and local tax deduction one of "the most important middle class tax breaks in the tax code today," adding, "Any of these types of proposals [to repeal it] are dead on arrival in Congress."⁴

Can people in the top 10 percent of the income spectrum really be "middle-class"? In the minds of these lawmakers, it's evidently possible when discussing the tax savings of the state-local tax deduction, but those high-earners quickly become "rich" in commentary on the Bush tax cuts. Again from Senator Schumer: "Unfortunately, recent tax cuts were designed to provide the most benefits to the people who don't need them, but didn't provide much relief to middle class families."⁵

Any economist will tell you that a good tax reform policy is one that lowers rates while broadening the income base, thereby removing many deductions and credits. By this standard,

repealing the state-local deduction is a far sounder proposition than enacting surtaxes or repealing the Bush tax cuts.

Unfortunately, many powerful lobbies on Capitol Hill like it the other way and ask lawmakers to raise tax rates on some to pay for gifts to others in the form of exemptions, deductions and credits. Usually the motivation is power politics: grabbing money from the public till for the groups that favor one party or the other.

The Most Popular Tax Preferences -- for the Middle Class?

We turn now to three other large tax preferences. In Table 2, we compare the distribution of tax savings that flow from three fixtures in the tax code, tax preferences that have been in the code for decades. One is fairly obscure because the tax savings flow to a fairly small group of tax returns at the top of the income spectrum: the tax exemption for municipal bond interest. One is probably the most famous deduction from a lobbying perspective because some of the nation's most powerful economic interests mobilize every time it is threatened: the deduction for interest paid, most of which is mortgage interest. And the third is undoubtedly the tax deduction most strongly supported by individual taxpayers, the deduction for charitable gifts. For comparison, we add in the two from Table 1—the deduction for state-local taxes paid, and the entirety of the Bush tax cuts.

Table 2. Share of Tax Savings from Other Popular Tax Preferences Compared to Bush Tax Cuts and State-Local Tax Deduction

Tax Returns Divided Into Ten Groups by Income (a)		Share of Tax Savings from Popular Tax Preferences			Share of Tax Savings from State-Local Tax Deduction	Share of Tax Savings from all Bush Tax Cuts
		Municipal Bond Exemption	Interest Paid Deduction	Charitable Deduction		
Bottom 10%	(≤ \$5,888)	0.7%	0.0%	0.0%	0.0%	0.1%
Second 10%	(> \$5,888)	0.2%	0.0%	0.0%	0.0%	0.4%
Third 10%	(> \$12,251)	0.7%	0.1%	0.1%	0.2%	1.3%
Fourth 10%	(> \$18,940)	0.5%	0.5%	0.4%	0.6%	2.5%
Fifth 10%	(> \$26,483)	2.4%	1.4%	1.0%	1.4%	3.7%
Sixth 10%	(> \$35,386)	3.1%	3.0%	2.3%	3.3%	5.4%
Seventh 10%	(> \$45,945)	3.7%	6.0%	4.2%	7.1%	7.4%
Eighth 10%	(> \$60,219)	6.7%	12.1%	8.1%	13.0%	9.2%
Ninth 10%	(> \$80,228)	11.5%	24.5%	17.0%	20.0%	13.5%
Top 10%	(> \$118,376)	70.5%	52.4%	67.0%	54.4%	56.6%
(a) Adjusted gross income						
Note: All numbers for Tax Year 2007. Baseline is current law.						
Source: Tax Foundation Microsimulation model and IRS Public Use File						

Once again, we see that a greater share of the Bush tax cuts flows to lower- and middle-income people than is the case with any of these three other tax preferences. The savings from each of

them is similar, though, flowing to mostly the same people at the high end of the income spectrum, yet politicians routinely speak about them as if the middle class in America would suffer greatly if these tax preferences were cut back.

The tax returns in the top 20 percent (top two deciles) would pay 70.1 percent of the tax increase if the Bush tax cuts were repealed. However, they would pay over 74 percent of the tax increase if the state and local deduction were eliminated and 77 percent if the interest-paid deduction were eliminated. That means those deductions save more taxes for high-income tax returns than the Bush tax cuts.

As for the tax-free status of municipal bond interest, the savings flow even more lopsidedly to the highest-income taxpayers. As a result, if it were repealed, 83 percent of the tax hike would be shouldered by the top 20 percent of earners. The tax savings from the popular charitable deduction are similar: 84 percent of the tax savings are claimed by the top 20 percent of tax returns.

There are many reasons why upper-income taxpayers receive more tax relief from all of these tax preferences. First, lower-income taxpayers rarely itemize—they get more tax savings from claiming the standard deduction. Second, upper-income taxpayers tend to have higher state and local taxes and higher mortgage values. Third, these taxpayers tend to be in higher taxable income brackets, and thereby the value of the deductions in terms of tax savings is greater than for those in lower rate brackets.

Conclusion

It is a myth that middle-class Americans are the primary beneficiaries of our income tax code's biggest tax preferences. Instead, the truth is that most of the tax savings from the exemption of municipal bond interest and the three deductions for state-local taxes, charitable gifts and interest paid flow to people at the top end of the earnings spectrum.

Though all four of these tax preferences are popular among lawmakers, and the charitable deduction is unassailably popular among individual taxpayers, none of them is fundamental to sound tax policy, and they all cause tax rates to be higher.

Politicians can call taxpayers in the top ten percent "rich" and denounce the Bush tax cuts for flowing mostly to this group, but if they do, they must also acknowledge that the other popular tax preferences discussed here also flow to "the rich." On the other hand, if they call the people in the top ten percent "middle-class," then they can defend both the Bush tax cuts and these four other tax preferences as "benefiting the middle class." But they can't have it both ways.

Notes

1. Under the new so-called pay-go rules, every tax cut must be matched by spending cuts or tax hikes. To see the Tax Foundation's revenue-neutral proposal, see Gerald Prante, "A Progressive AMT Fix without Higher Tax Rates," *Tax Foundation Special Report*, No. 157, June 2007. See

also Patrick Fleenor, "Fixing the Alternative Minimum Tax," *Tax Foundation Special Report*, No. 155, June 2007.

2. Leonard Burman of the liberal-leaning Tax Policy Center has suggested that the state-local deduction could be repealed in favor of rate cuts: "You could also just roll back the top rates, and that would target the relief among the people who potentially could lose from repealing the state and local tax deduction. That would allow you to lower rates, the top rate from 35 percent to 33 percent." <http://www.aei.org/events/filter.economic,eventID.1488/transcript.asp>.

3. Press release,
http://www.senate.gov/~schumer/SchumerWebsite/pressroom/record_print.cfm?id=260212,
October 26, 2005.

4. Mary Dalrymple, "Bush Tax Reform Plan in Jeopardy," Associated Press, November 11, 2005.

5. Press release,
<http://www.senate.gov/~schumer/SchumerWebsite/pressroom/record.cfm?id=271185>, March
21, 2007.

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