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WHEN A TAX CUT IS NOT A TAX CUT

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The increasingly heated rhetoric surrounding the campaign for the White House includes claims and counterclaims by both candidates regarding their proposed tax cuts. Claims made by Senator Obama to cut taxes for 95 percent of all Americans are of particular interest because they expand the usual meaning of a tax cut beyond a reduction in the rate of taxation or a reduction in the amount paid in taxes due to a tax credit, tax rebate, or deductions from taxable income. For investors and employers, the conventional meaning of a tax cut is a reduction in capital gains tax or a change in depreciation allowances which allows employers to expense capital items in their budgets over a shorter period of time, thereby rolling back their profits and cutting their profits tax.

The U.S. income tax system is based on marginal tax rates which are higher in higher income brackets. For example, if the rate on the first $5,000 of taxable income is 10 percent, rich and poor alike regardless of very large differences in their total incomes pay $500. If the rate climbs to 15 percent for all income between $5,001 and $10,000, everyone with $10,000 of taxable income pays a total tax of $1250 ($500 on the first $5000 plus $750 on the second $5000). In this case, a tax cut means cutting the rates applied to the various income brackets. At the present time Obama openly asserts that he would raise the top rate from 35 percent to 39.6 percent, returning it to the rate imposed during all eight years of the Clinton administration.

Tax cuts impact the federal budget on the *revenue* side. The extent and direction of that impact depends on how one understands macro-economic affairs. Though they disagree as to whether tax cuts should target aggregate supply or aggregate demand, supply-side and Keynesian economists agree that tax cuts stimulate economic activity. Neo-classical economists, especially those with libertarian leanings, embrace tax cuts because they reduce the overall role of government in economic affairs. Monetarists argue that tax cuts are a clumsy way of intervening in economic affairs and that macro-economic policy should be left in the hands of the Federal Reserve which can adjust the money supply and the rate of interest to changing economic conditions much more effectively. It follows that major proposals to cut taxes are likely to be seen quite differently by economists with different views on how to think about and talk about macro-economic affairs.

The stated goal of the Obama tax proposal is to reduce taxes on the middle class. However, according to Harvard economist Greg Mankiw, when account is taken of Obama's higher Social Security tax rates plus the phase out of personal exemptions and certain itemized deductions marginal tax rates actually increase for many middle-class taxpayers. Research conducted by the American Enterprise Institute and cited approvingly by Mankiw indicates that marginal rates for taxpayers with adjusted gross incomes (AGI) of

approximately $28,000 to $85,000 and for those between $100,000 and $120,000 would in fact increase. For those with incomes between $85,000 and $100,000 marginal rates would not change. With this type of research much depends on the assumptions that drive the analysis. In this instance, it is a four-person family with two children and two earners.

Based on data from the IRS, the Tax Foundation reported that the average tax rate for taxpayers in the bottom half of the income distribution dropped from 5 percent of AGI in 1987 to 3 percent in 2006. Under the present system, approximately 41 percent of all Americans pay no income tax at all. Therefore, any additional tax credit, tax rebate, or deductions will not reduce their taxes. It follows that taxes can be reduced for no more than 59 percent of all Americans not the 95 percent that Obama claims, unless tax cut is stretched to include unearned income transfers, commonly referred to as *refundable* tax credits.

With a refundable tax credit, taxpayers receive tax refunds even if they have paid no taxes whatsoever. For example, if a taxpayer has a tax liability of $1,850 and a refundable tax credit of $2,360, that person pays no taxes and could receive a tax refund of the difference -- $510. The earned income tax credit which targets low wage-earners already is refundable. Obama has proposed introducing several new refundable tax credits for child and dependent care, college education, and mortgage interest. McCain has proposed a new refundable tax credit for health care.

Some sophisticates call a refundable tax credit a "negative tax." Others call it a handout. Whatever it's called, money is transferred from the rich to the poor on the basis of the rich's greater ability to pay and the poor's greater need for assistance. Clearly, Obama's tax cut proposal contains a hefty amount of income redistribution. To illustrate, filers with family income of approximately $603,000 to $2.87 million, according to an Urban Institute-Brookings Institution project, would pay on average an additional $116,000 in taxes. For taxpayers with incomes above $2.87 million, Obama proposes raising their taxes by $702,000. Further, regardless of size or profitability employers would see their costs increase due to a hike in their contributions to Social Security for workers with earnings above $200,000-250,000. Everyone else would see their taxes decrease. McCain, on the other hand, does not impose a higher Social Security tax and proposes a cut in taxes for everyone though not as much for low-income earners as would Obama. Low-income earners get more from Obama's proposals because they are loaded with more new refundable tax credits. Take away those credits and the relief offered by Obama to many middle-class taxpayers, as Mankiw points out, morphs into higher marginal tax rates.

Keynesian economists support income redistribution because the poor are more likely than the rich to spend a greater share of any money they get thereby boosting consumer spending and the U.S. economy. Supply-siders oppose redistribution because it results in reduced after-tax incomes for the rich, a negative impact on capital outlays for the businesses they own and a disincentive for them to work harder and smarter, produce more goods and services, and employ more labor. Libertarians oppose it because it involves more government meddling in private economic decision-making. Monetarists object to it because income redistribution is much less effective in achieving price stability and economic growth than is Federal Reserve management of the supply of money and the rate of interest.

Income transfers in the form of refundable tax credits impact the federal budget on the *expenditure* side. If the higher marginal tax rates on the rich do not yield sufficient revenue to cover those transfers, other federal taxes must be increased or any budget shortfall must be addressed by borrowing funds through the sale of securities issued by the U.S. Treasury, thereby adding to the public debt.

To paraphrase Gertrude Stein's "a rose is a rose is a rose is a rose," a tax cut is a tax cut is a tax cut … unless it's a handout, a tax increase in disguise, or both.

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