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**PROPOSED TAX CUTS WOULD PROVIDE FEW BENEFITS FOR
TAXPAYERS IN KENTUCKY**

Proposed Tax Cuts Would Provide Few Benefits for Taxpayers in Kentucky

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EXECUTIVE SUMMARY

On January 7, 2003, President Bush proposed a \$725 billion dollar tax cut. The major element of the President's proposal is the elimination of taxes on income from corporate dividends. The plan also includes the acceleration of future tax cuts, as well as new tax reductions for businesses.

On May 1, 2003, Republicans in the House of Representatives unveiled a modification of the President's proposal. This proposal contained many of the elements that were in the President's plan. However, instead of eliminating taxes on dividends, the proposal would reduce tax rates on both capital gains and dividends.

This report analyzes the impact of the proposal by House Republicans on taxpayers in Kentucky. It finds:

- **The elimination of taxes on capital gains and dividends would provide no benefits to most taxpayers in Kentucky.** Over 90% of taxpayers in the state have incomes of less than \$100,000. These taxpayers would receive an average tax savings of only \$41 from the capital gains and dividend tax cut. In fact, 80% of the taxpayers in the state would receive no benefit at all from the reduction of taxes on capital gains, and 81% would receive no benefit at all from the reduction of taxes on dividends.
- **The full tax cut package is heavily skewed towards wealthy taxpayers.** In Kentucky, only 2% of taxpayers have incomes above \$200,000. Under the proposed plan, this top 2% of taxpayers would receive an average tax cut of over \$11,500, receiving in the aggregate 24% of the total tax savings realized in the state. In contrast, 53% of taxpayers in the state have incomes below \$40,000. These taxpayers would receive an average tax cut of only \$140, receiving in the aggregate just 9% of the total tax savings realized in the state.

BACKGROUND

Tax Proposals in the House of Representatives

On January 7, 2003, President Bush unveiled a new tax cut proposal. This proposal has an estimated cost over the next ten years of \$725 billion.¹

The largest tax cut in the plan would eliminate taxes on dividends paid by corporations. Under this proposal, which would cost \$395 billion, taxpayers would pay no taxes on dividends paid by corporations if the corporations paid federal taxes on the profits used to pay out these dividends. If corporations chose to reinvest profits rather than paying dividends, shareholders would instead receive favorable capital gains treatment on these “deemed dividends.”

The second part of President Bush’s proposal, which would cost an estimated \$330 billion, would accelerate tax cuts scheduled to go into effect between 2006 and 2010. These tax cuts include reductions in individual income tax rates, the expansion of the 10% tax bracket, and the increase in the child tax credit. The tax cut proposal would also provide additional tax benefits for small businesses and would provide temporary relief from the alternative minimum tax for some taxpayers.

The fate of the President’s tax cut proposal in Congress remains unclear. Budget legislation approved by the House in March 2003 contained \$550 billion for tax cuts, less than the President’s request, while Senate budget legislation contained \$350 billion. Despite these reductions, Administration officials have indicated that they will continue to seek the passage of the entire \$725 billion tax cut package.²

¹ Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President’s Fiscal Year 2004 Budget Proposal* (Mar. 4, 2003).

² Recently, Administration officials have indicated that the Administration may use approaches such as phasing in the dividend tax cut in order to fit all parts of the tax cut package into the budget legislation. *White House Eases Stand on Dividend Taxes*, Washington Post (Apr. 22, 2003).

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On May 1, 2003, House Republicans unveiled their modification of President Bush's tax proposal, which is likely to be debated in the House on May 9.³ For the years 2003 to 2005, the proposal is nearly identical to the part of President Bush's plan that accelerates future tax rate cuts. But instead of calling for the elimination of taxes on dividends, the House Republican proposal would instead reduce tax rates on both capital gains and dividends to 15%.⁴ This capital gains and dividends proposal costs \$296 billion over ten years. To keep the total cost of the package to \$550 billion over this time period, the Republican proposal would allow a number of popular tax benefits, including the increased child tax credit, marriage penalty relief, an expansion of the 10% tax bracket, and expanded tax benefits for small businesses, to expire after 2005.⁵

OBJECTIVE AND METHODOLOGY

To conduct this analysis, the report utilizes two sets of data. First, in order to determine income distributions for taxpayers in Kentucky, the report uses data from the 2000 Census on household income in 1999.⁶ This data, adjusted to reflect estimated changes in income between 1999 and 2003, is analyzed to determine the percentage of households in the state that fall within a given income

³ Congress Daily, *Thomas Touts Tax Cut Plan as 'Superior' to Senate Alternatives* (May 2, 2003).

⁴ Currently, dividends are taxed as ordinary income, while capital gains are taxed at a 20% rate. For taxpayers in the 10% and 15% tax bracket, the House Republican proposal would tax dividends and capital gains at rate of 5%.

⁵ *House G.O.P. Tax Cuts Outdo Bush Plan in Favoring Wealthy*, New York Times (May 3, 2003). Analysts have estimated that if the provisions in the tax proposal that are scheduled to expire in 2005 are instead extended, they would increase the total ten year cost of the bill by \$510 billion, from \$550 billion to \$1.06 trillion. Center on Budget and Policy Priorities, *Tax Policy Center and CBPP Analyses Show that Thomas Tax Plan Would Be More Tilted Toward the Very Wealthy — and More Expensive — Than the Bush Plan* (May 3, 2003).

⁶ U.S. Census Bureau, *Census 2000 Summary File 3 Data: Household Income in 1999* (2003).

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level.⁷ Second, the report combines the Census data with data on the average savings that would accrue to each income group under the House Republican tax plan,⁸ as well as IRS data that indicates the likelihood that an individual in a given income group in Kentucky will pay taxes on capital gains or dividends.⁹ The combined data is used to estimate the per-household tax breaks that would be received in 2003 by residents of Kentucky under the House Republican tax cut proposal.

⁷ Because a household for Census purposes can have more than one taxpaying unit — for example, two single taxpayers who file separate tax returns — the Census data on average household income could overestimate the average income level in the state. To the extent this occurs, the actual tax cuts received by taxpayers in Kentucky would be smaller than estimated in this report.

⁸ Urban-Brookings Tax Policy Center, *Chairman Thomas' Economic Growth and Jobs Plan: Distribution of Income Tax Changes by AGI Class, 2003* (May 2003). Urban-Brookings Tax Policy Center, *Tax Dividends and Long-Term Capital Gains at 15 Percent: Distribution of Income Tax Changes by AGI Class, 2003* (Jan. 2003). Estimates of the distribution of income are based on the U.S. Census Bureau definition of money income, while the breakdown of estimated tax savings for each income group is based upon IRS Adjusted Gross Income (AGI). Although there are some differences between these two measures (for example, AGI includes deductions for items such as IRAs, interest on student loans, and self-employment taxes), these differences are minor. The analysis also assumes that taxpayers in Kentucky within a given income group would receive the same average tax cut as the national average for all taxpayers within that income group. While there may be some differences between the Kentucky taxpayer and the average taxpayer (for example, Kentucky taxpayers in a given income level might be more or less likely to have dividend income, or might be more or less likely to be married and have children), these differences are likely to be relatively small and would be unlikely to impact the overall findings of this analysis.

⁹ Internal Revenue Service, *Tax Year 2001: Selected Income and Items for Individual Tax Returns, Forms 1040, 1040A, and 1040EZ, by Size of Adjusted Gross Income, Texas* (2003).

FINDINGS

Impact of Capital Gains and Dividend Tax Cut Proposal on Taxpayers in Kentucky

The central part of the House Republican tax cut proposal is a plan to reduce taxes on capital gains and stock dividends. These provisions would provide no benefit to most taxpayers in Kentucky.

Census data shows that 91% of households in Kentucky have incomes below \$100,000. In 2003, these taxpayers would receive an estimated average tax cut of only \$41 under the capital gains and dividend proposal.

Most taxpayers in Kentucky would actually receive no tax relief under the capital gains and dividend tax cut proposal. Four of every five taxpayers in the state (80%) report no capital gains income on their tax returns. These taxpayers would receive no tax savings at all from the reduction of taxes on capital gains. Similarly, four of every five taxpayers in the state (81%) would receive no tax savings at all from the reduction of taxes on dividends.

The capital gains and dividend tax cut proposal would provide significant benefits to the very wealthiest taxpayers in Kentucky, however. The households in the state with incomes above \$200,000 annually would receive an estimated average tax cut of almost \$3,900 in 2003 under the capital gains and dividend proposal.

Distribution of Tax Cut Benefits in Kentucky

The President's proposed tax cut plan includes a number of other tax breaks in addition to the capital gains and dividend proposal. For example, the plan would accelerate many of the income tax cuts enacted in 2001 and scheduled to go into effect in future years. Until 2005, the plan proposed by House Republicans contains similar provisions. The White House estimates that the average

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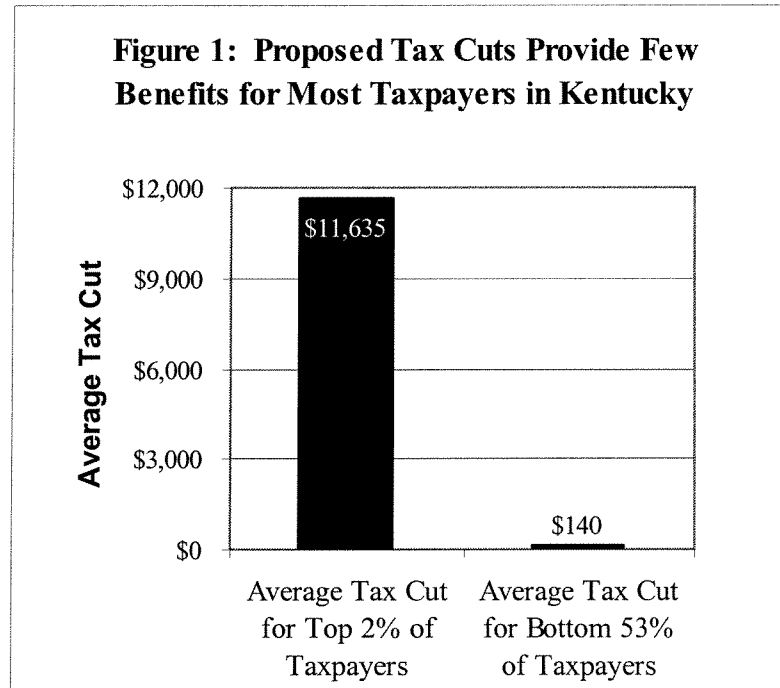
American household would receive a tax break of \$1,083 under these provisions.¹⁰ These average figures are misleading, however. The benefits of the tax plan are heavily skewed toward the wealthy. In Kentucky, a household with the estimated median income of \$37,500 would receive an estimated average tax cut of only \$360 in 2003 — 67% smaller than the White House estimate of average tax relief.

In aggregate, the 2003 tax savings for taxpayers in Kentucky are estimated to be approximately \$1.3 billion. The distribution of these benefits overwhelmingly favors the wealthy. Approximately 2% of the households in the state (26,000 households) have incomes over \$200,000. These households will receive an estimated \$300 million in tax savings, an average of over \$11,600 per household. This is equal to 24% of the total tax savings. The 9% of households with the highest incomes will receive 49% of the total tax savings

In contrast, 53% of the households in the state (860,000 households) have incomes below \$40,000. These taxpayers will receive an estimated total tax cut of \$120 million in 2003, just \$140 per household. This is just 9% of the total tax benefits. Figure 1.

¹⁰ The White House, *Taking Action to Strengthen America's Economy* (Jan. 2003) (online at www.whitehouse.gov/infocus/economy). The tax savings estimates by the White House include the tax savings due to the dividend tax cut and to the acceleration of income tax cuts. The distribution of tax savings from the House Republicans proposed tax cuts are similar to the provisions in the President's proposal, although they are weighted even more heavily towards upper income taxpayers. See *House G.O.P. Tax Cuts Outdo Bush Plan in Favoring Wealthy*, *supra* note 5.

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CONCLUSION

This report analyzes the impact of proposed tax cuts on taxpayers in Kentucky. It finds that most taxpayers in the state would receive no tax savings from the proposal to eliminate taxes on capital gains and dividends. It also finds that the House Republican tax cut proposal is heavily tilted towards the most well-off taxpayers, with the 2% of taxpayers with the highest incomes in the state receiving 24% of the total benefits.