Individual Income Taxes After 2010: Post–Permanence–ism

Abstract - *This paper consists of three parts. First, I review the legislative history related to the enactment of two major tax cut proposals during George W. Bush's presidency, the first in 2001 and the second in 2003. Second, I present results from a simple tax calculator that calculates the expected change in tax liabilities from 2010 to 2011 under current law for taxpayers of different filing status and at different income levels. The paper concludes by exploring some alternative approaches to address the looming tax increase and describes possible lessons from the legislative tax history of 2001–2006.*

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INTRODUCTION

Tax policy changes during the last six years have been significant. A dozen tax bills with gross revenue changes in excess of $1 billion have been enacted into law and the total estimated reduction in tax receipts is approximately $2.1 trillion as measured on a rolling, ten–year basis from year of enactment. The cumulative total reduction in taxes for fiscal year 2007 is $223 billion or approximately nine percent of total receipts. On a dollar–weighted basis, the majority of these changes constitute what this paper will define as the Bush Tax Cuts: the 2001 and 2003 tax proposals by President Bush. The key elements of the President's 2001 tax relief proposal were to reduce marginal tax rates on ordinary income, provide "marriage penalty" relief, increase the child tax credit and repeal the estate and gift tax; and the 2003 proposal was to end the double taxation of corporate income and accelerate the phase–in of the 2001 bill. Neither legislative proposal was enacted as proposed nor were the Bush Tax Cuts accomplished in just two acts; in total, there were five bills that collectively created current law with regard to these policies.

With a few exceptions discussed later, the Bush Tax Cuts are set to expire at midnight on December 31, 2010. Under current law, these policy changes then revert to their pre–2001 constructions. The Bush Administration has maintained a position of advocating that all of the Bush Tax Cuts be made permanent (e.g., Ritterpusch (2007)).

However, while the outcome of the 2008 Presidential election is uncertain, one thing is known: George W. Bush will not be in the White House in 2010 to advocate to preserve his tax policies. Whoever is President will have proposed a budget with his or her own tax ideas and a politically unimaginative policy stance such as the status quo seems unlikely. Furthermore, budget constraints and likely Congressional resistance are further restraints on the likelihood of making the Bush Tax Cuts permanent. While a straightforward extension of 2010 law (i.e., complete permanency) is nearly impossible in the author's view, a total lack of legislative action is equally improbable, given the historical frequency of tax code changes and broad applicability of the pending tax increase. Therefore, among the set of policy options for the individual tax code post–2010, perhaps the only two elements excludable from the set are total extension of present law and a reversion to pre–2001 law.

The purpose of this paper is to look for lessons to be learned from studying the legislative process by which these policies were enacted and to measure the magnitude and distribution of the pending tax increase. Taken together, these observations may suggest potential parameters for the types of changes Congress could consider as 2010 approaches.

The paper contains three parts. First, a review of the legislative process by which the Bush Tax Cuts became law highlights the multi–step nature of the process and the typical differences between the House and Senate approaches to tax legislation. It also serves as a good case study of the differences between what was proposed by the President and enacted into law. Next, results are presented from a simplified tax calculator designed to highlight the effects of the pending expiration of these tax policies on typical taxpayers across a spectrum of incomes. Finally, under the assumption that permanence is not a realistic option, the paper discusses the range of options that could be considered, including trade–offs between political and economic issues, and presents tax–calculator results for one reform option, a broad–base low rate structure.

A HISTORY OF THE BUSH TAX CUTS

While over a dozen tax cuts were enacted between 2001 and 2006 for relief totaling $2.1 trillion, this paper will define the Bush Tax Cuts as consisting of portions from five tax bills and two major tax policy initiatives. Those two initiatives were President Bush's keystone tax proposals made in 2001 and in 2003. Table 1 lists the five tax bills that created the structure now in place.

TABLE 1
FIVE BILLS OF THE BUSH TAX CUT

Year	Tax Bill	Provisions of the Bush Tax Cut
2001	Economic Growth and Tax Relief Reconciliation Act (EGTRRA)	10% bracket, lower marginal rates, marriage penalty relief, increased child tax credit, estate tax repeal, increased IRA and pensions contributions.
2003	Jobs and Growth Tax Relief Reconciliation Act (JGTRRA)	5%/15% dividend and cap gains tax rate dropping to 0%/15% in 2008; Accelerated phase–in of reduced marginal tax rates from 2001 bill.
2004	Working Families Tax Relief Act	"Filled the valley" by extending the temporarily accelerated provisions from the 2003 tax bill, namely 10% tax rate bracket, child tax credit and marriage penalty relief.
2006	Tax Increase Prevention Reconciliation Act (TIPRA)	Extension of capital gains and dividend rate structure through 2010, AMT patch for 2006.
2006	Pension Protection Act (PPA)	Made permanent Title X of the 2001 tax cut, which includes higher contribution limits for IRAs and 401(k)s.

Generally, the Bush Tax Cuts are set to expire at the end of 2010. The exception to this statement is that a series of important changes to savings and pension policy from 2001 were made permanent in the Pension Protection Act of 2006.[1] Notably, while these provisions were a significant part of the 2001 tax cut, they were not originally proposed by the President and the support for these provisions, unlike other parts of the package, was overwhelmingly bipartisan.

2001 Tax Cut

From a political perspective, the Bush tax cut proposals began on the campaign trail in 2000. From a legislative perspective, the initial official proposal was President Bush's first budget proposal. In February 2001, the White House submitted to Congress the President's Fiscal Year 2002 Budget Proposal, which contained roughly 30 tax proposals. Here I identify a subset of those proposals as being the elements of the 2001 Bush Tax Cut: the ten percent bracket, the reduction of other ordinary tax rates, the marriage penalty relief, the doubling of the child tax credit to $1000, and the repeal of the estate tax.[2] The other roughly two dozen provisions cover a range of issues and vary in size from less than $1 billion to $70 billion (the healthcare tax credit proposal) and also include other major policy initiatives of the President such as proposals to encourage charitable giving. In total, these five provisions accounted for 85 percent of the cost of the entire tax proposal made by President Bush in his first budget.

The President's budget proposed these policies to take effect January 1, 2002, but the idea of accelerating these provisions and making some retroactive to January 1, 2001 soon began to circulate in Congress. In fact, on February 5, 2001, three days *before* the Administration officially submitted the President's Budget, President Bush indicated support for this idea (Office of the Press Secretary, 2001).

House of Representatives

Congressional action on the President's proposal began in the House of Representatives as a series of bills that addressed the President's proposal in pieces.[3] H.R. 3, Economic Growth and Tax Relief Act, containing the ten percent bracket and reduction in other tax rates as proposed by the President, was reported by the Committee on Ways and Means on March 1, 2001 and passed the House on March 8 by a vote of 230–198, with ten Democrats voting "yea" along with all Republicans. Marriage penalty relief and the child tax credit increase was reported by Ways and Means on March 22, 2001 and passed on the House floor on March 29 by a vote of 282–144, with 64 Democrats joining all Republicans in voting "yea." Estate tax repeal was reported by the Committee on March 29 and passed the House on April 4, 2001 by a vote of 274–154, with 58 Democrats joining all Republicans. Retirement savings legislation raising contribution limits for IRAs from $2,000 to $5,000,

[1] A small provision from the 2001 tax cut was made permanent in 2002 relating to tax treatment of Holocaust restitution payments in H.R. 4832, (P.L. 107–358). Until the Pension Protection Act, this was the only temporary provision that had been made permanent from the 2001 or 2003 tax proposals. Some provisions enacted in TIPRA on a temporary basis were made permanent by the Tax Relief and Health Care Act of 2007, but none qualifies as a provision in The Bush Tax Cut, as defined here.

[2] The President's Budget included a few additional provisions in his Tax Relief Package including permanent R&E extension and a series of charitable provisions. Other White House documents, such as President's Agenda for Tax Relief (http://www.whitehouse.gov/news/reports/taxplan.html), do not include the minor charitable provisions. R&E permanence was never seriously promoted and action on charitable reforms was not addressed in Congress until after enactment of the tax cut package.

[3] The Ways and Means Committee Chairman during the Bush Tax Cuts, Congressman Bill Thomas (R–CA), referred to this approach as "canoes verses battleship."

raising contribution limits on 401(k) plans and making other pension law reforms (generally known as Portman–Cardin; notably not in the President's Budget) was marked up in the Committee on April 25, 2001 and passed the House on May 2 in an overwhelming bipartisan vote: 407–24.[4,5]

In the eight weeks between March 1 and May 2, the U.S. House of Representatives voted 96 times. Eleven votes were on final passage of legislative bills under regular order and four of those eleven were tax bills. Put differently, there was a clear focus on working methodically through the Committee and on the floor to allow Members to cast separate, individual votes on all the aspects of the 2001 Bush tax cut.[6] From this vote data, it is simple to observe that tax credits and increased tax deductions for low– and middle–income taxpayers are more politically popular than across–the–board reductions in marginal rates. However, there has been bipartisan support for estate tax repeal, a policy that is more distributionally skewed than the rate cut proposal. Finally, reducing the tax on savings through expanded tax–deferred retirement savings was overwhelmingly bipartisan and may suggest that tax reform proposals designed around tax–free savings vehicles may be more feasible than other approaches.

Senate

On May 15, 2001, the Senate Finance Committee marked up a comprehensive version of the President's proposal that contained the ten percent bracket, $1,000 child tax credit, reduced marginal rates, marriage penalty relief, expansion of pensions and IRAs, a temporary AMT relief provision and a few dozen other smaller provisions. This bill had a revenue loss of $1.347 trillion over ten years, reflecting the Senate's budget resolution.

On May 16, the House passed H.R. 1836, which contained only the House version of the marginal rate provisions. The vote was nearly identical to that of H.R. 3: 230–197, with 13 Democrats and all Republicans voting "yea."

On May 23, the Senate amended H.R. 1836 with the Finance Committee's bill and passed it by a vote of 62–38, with 12 Democrats and 50 Republicans voting "yea." The Senate then requested a conference with the House. Two days later, a conference report was signed.[7] The House vote was 240–154, with 28 Democrats voting "yea." The Senate vote was 58–33, with two Senators voting present. Two Republicans voted "nay" and 12 Democrats voted "yea."

The final product sent to the President's desk contained most elements of the original Bush proposal with the most notable exception of the lack of charitable reform provisions and no R&E provision. Its design had been altered in an attempt to create economic stimulus to a slowing economy through the use of $36 billion in rebate checks that were

[4] Of the 24 Democrats voting "nay" on the this bill, five were Members of the Ways and Means Committee, including then–ranking–Member Charles Rangel (D–NY). The bill had 314 cosponsors.

[5] H.R. 622, "Hope for Children Act," contained the President's proposal to increase the adoption tax credit. It was marked up by the Ways and Means Committee on May 9 and, ultimately, was included in the 2001 Tax Cut. However, it was not part of the President's Agenda for Tax Relief.

[6] In addition to the individual components of the 2001 tax package and the separate votes described in the text, there were additional votes on alternative proposals offered by the minority. Due to space constraints, those alternatives and their vote outcomes are not discussed here.

[7] On May 24, 2001 Senator Jim Jeffords left the Republican Party and became an independent and caucused with Democrats. The timing of the tax bill and the timing of his announced switch were closely coordinated. During the announcement of his intention to switch, he stated, "I will make this change and will caucus with the Democrats for organizational purposes once the conference report on the tax bill is sent to the president. I gave my word to the President that I would not intercept or try to intervene in the signing of that bill" (see press conference by Senator James Jeffords (2001)).

sent from July to September of 2001 to 85 million taxpayers. The top marginal tax rate was reduced five percentage points while the President's proposal called for a seven–point cut. However, additional tax relief to high–income tax payers was provided through the elimination of Pease (a provision to limit the value of itemized deductions by phasing out the deduction above a particular income threshold) and PEPs (the phaseout of the personal exemption for high–income taxpayers). The number of brackets increased from five to six, while the President's proposal would have reduced the number to four. The phase–in of the child tax credit was much longer in the enacted version as opposed to the proposal, and Congress crafted a transition towards estate tax repeal that focused primarily on raising the exemption amount with a slow and modest reduction in the top estate rate through 2009, followed by brief repeal for 2010.

Generally however, the provisions in the 2001 tax bill were sunset at the end of the budget window, on December 31, 2010. This was required to avoid a budget point of order in the Senate because these cuts were being enacted under a 50–vote budget resolution structure—known as the budget reconciliation process—that did not allow for permanent tax cuts.[8]

Following enactment of the 2001 tax bill, Congress made attempts to make the bill permanent. In February 2002, the House considered a resolution, "[e]xpressing the sense of the House of Representatives that the scheduled tax relief provided for by the Economic Growth and Tax Relief Reconciliation Act of 2001 passed by a bipartisan majority in Congress should not be suspended or repealed" (H. Con. Res. 312, 2002). The resolution was considered under expedited procedure and required a two–thirds majority to pass, but received just 235 yeas and 181 nays.

In June 2002, the House passed a bill to make permanent the estate and gift tax repeal and in September of 2002 passed a resolution urging the Senate to consider the bill. Also in June 2002, the House voted to make the adoption tax credit permanent, passed a bill to make permanent the marriage penalty relief provisions, and voted to make permanent a provision relating to Holocaust restitution payments (this ultimately became law in December 2002). In June 2002, the House passed a bill to make the pension provisions permanent and in September passed a resolution urging the Senate to consider this legislation. This ultimately became law in 2006. And, in July 2002, the House passed a bill to make permanent education–related provisions from 2001. The Senate voted on permanent estate and gift tax repeal in June 2002. The vote failed by six votes. The Senate, under Democrat leadership in 2002, did not consider other permanency bills.

2003 Tax Cut

The second part of the Bush Tax Cut proposal was made in February 2003. The President's Jobs and Growth Plan had principally two broad components: accelerating the phase–in of the individual tax relief enacted in 2001 and eliminating the double taxation of corporate earnings through a proposal for corporate tax integration. Based on a Treasury Department proposal a decade earlier (U.S. Department of the Treasury, 1992), the proposed corporate tax integration policy was marketed more simply as "ending the double taxation of dividends." This proposal was elegant with regard to its efficiency, yet

[8] The specific budget rule point of order that constrained this legislation to be enacted on a temporary basis is known as the Byrd Rule. See Viswanathan (2007) for a lengthy discussion on the sunsetting of tax policy changes.

complex in the sense that it created newly required accounting for tracking the taxes paid on the corporate level to determine what tax—if any—would need to be paid by the individual. In addition, the President's proposal included a temporary AMT relief provision and a large increase in Section 179, small business expensing, from $25,000 to $100,000. The total cost for this package was $725 billion, and the corporate tax integration proposal cost $396 billion (U.S. Congress, 2003b).

The Congressional strategy was a bit different in 2003 as compared to 2001. Like in 2001, the President's proposal was laid out in February and, similarly, the House was first to act.[9] The Ways and Means Committee Chairman introduced H.R. 2, Jobs and Growth Tax Act of 2003, which was exactly the President's proposal on February 27, 2003. However, Congressional action was slower and did not begin until May 6 when the House Ways and Means Committee moved a package costing $550 billion, as constrained by the House Budget Resolution that year. Most provisions related to accelerating the phase–in of the 2001 tax bill were enacted on a temporary basis (2003 through 2005, generally) and then resorted back to the scheduled phase–in. Unlike most provisions from 2001, the acceleration of lower marginal rates was fully phased in without any "snap back." The President's corporate tax integration proposal was replaced with a 15 percent tax rate on dividend and capital gains tax income. In effect, this was roughly a 50 percent cut in the dividend tax rate and a 25 percent cut in the statutory capital gain tax rate.[10] These two provisions cost $277 billion, slightly more than half of the total package. The dividend and capital gains provisions were scheduled to sunset in 2012. A few motivating factors for the different approach towards corporate tax integration include: the lower revenue cost, the ability to scale the cost to match a given budget constraint, and simplicity. The House passed this bill by a vote of 222 to 203. Unlike in 2001, three Republicans voted against this package.

The Senate took a different approach, and the Finance Committee passed a bill containing the President's proposals for accelerating the 2001 tax cut along with the President's small business expensing provision and AMT provision. The Senate dividend tax relief focused on allowing all taxpayers to receive $500 tax free and lowering the tax rate on dividend income above $500 by ten percent for 2004 through 2007 and 20 percent for 2008 through 2012. This provision cost $81 billion. For a much smaller revenue cost, the Senate bill focused less on the marginal effective change in the tax on dividends and more towards providing tax relief for lower–income taxpayers. In addition, the Senate proposal did not include any change with regard to capital–gains taxation.

The Senate bill also included more than $80 billion in revenue raisers. These provisions included the codification of economic substance doctrine ($13.7 billion), the repeal of Section 911 (exemption for income earned by Americans living abroad, $35 billion) and the extension of customs user fees ($18 billion) (U.S. Congress, 2003a). Therefore, the rhetorical argument could be made that the reduc-

[9] The U.S. Constitution gives a unique power regarding tax policy to the House of Representatives and not to the Senate. Article I, Section 7 notes, "All bills for raising revenue shall originate in the House of Representatives; but the Senate may propose or concur with amendments as on other Bills." However, while the Senate cannot send the House a tax bill that they originate, they can begin action in the Committee. Therefore, this constitutional law does not explain why the House went first in advancing these policy changes. However, the rules of the Senate make it difficult and often very time consuming to consider any controversial legislation. Therefore, considering multiple tax bills in the Senate, as was done in the House, would be extremely difficult.

[10] Because capital gains taxes are deferred, the consequence of the cut in the capital gains tax rate is diminished.

tion in dividend taxes did not increase the deficit. In total, the Senate bill contained dozens of small, targeted provisions. The total net cost of the Senate's tax bill was $350 billion due to the constraint set forth in the Senate Budget Resolution. The Senate package passed with 51 votes; three Democrats voted for the bill and three Republicans voted against it.

Much as in 2001, following the passage of the bill in the Senate, Congress moved quickly towards completing a conference report and sending legislation to the President. In general, the final legislation was modeled closely on the House–passed bill, with the significant exception that the total budget cost conformed to the Senate's $350 billion constraint.[11] Instead of fully phasing in the Bush tax cuts as had been proposed by the President, only the phase–in of the marginal rates was fully eliminated. For the child tax credit, marriage penalty relief, and expansion of the ten percent bracket, these provisions were put in full effect for 2004 and 2005, but then returned to the underlying phase–ins from the 2001 legislation.[12] For dividends and capital gains, the House structure was adopted with two modifications. First, a zero tax on capital gains and dividends was added for low– and moderate–income taxpayers for 2008. Second, the provision's expiration date was moved forward from December 31, 2012 to December 31, 2008 to reduce cost.

The final legislation may appear to be a "triumph" of the House of Representatives over the Senate; a result of successful negotiating tactics but important procedural differences between the House and Senate are noteworthy and any conference report must receive a majority vote in both chambers. The Senate's version of the 2003 tax bill that was brought into the conference between chambers had been open to amendment when it was considered on the Senate floor. House tax bills are never open to amendment when considered on the House floor. The open amendment process in the Senate results in the need for legislation to be more tolerable to more Members. As a result, the Senate often brings bills into conference that are very different from how those bills appear when the conference concludes, but the procedural difference between an amendable and unamendable legislative vehicle can explain much of the difference. The conference report passed the House by a vote of 231–200, with seven Democrats voting "yea" and one Republican voting "nay." The conference report passed the Senate by a vote of 51–50, with the Vice President casting the tie–breaking vote.

2004 Tax Cut

The 2003 tax bill created what was commonly referred to as a "valley" in the level of tax relief for individuals as some 2001 provisions were temporarily accelerated. For example (and as discussed above), the $1,000 child tax credit for 2004 would be reduced back to $600 in 2006. Congress worked to pass legislation in 2004 to eliminate phase–ins for the Bush tax cuts. This legislation, Working Families Tax Relief Act, eliminated the remaining phase–ins that were temporarily adjusted in 2003. Two tax relief provisions that were not accelerated in 2003 or 2004 were the elimination of the personal exemption phaseout (PEP) and the phaseout for itemized deductions (Pease). Those provisions take effect over a three–year period, 2006–2009. The Working Families Tax Relief Act also

[11] While the total legislative package cost $350 billion, the tax portion of the bill was $330 billion and the bill contained $20 billion in aid to the States.

[12] House and Shapiro (2004) construct a dynamic general equilibrium model that demonstrates that phasing the reduction in marginal tax rates in 2001 produced a negative economic effect, while the immediate cut in marginal rates in 2003 provided a significant immediate boost in production and investment.

contained the perennial "extenders package" of tax provisions that regularly expire and are regularly extended. This bill also included a patch to the individual alternative minimum tax (AMT) ($23 billion). The total revenue loss from this legislation was $146 billion and provisions related to the Bush Tax Cut were $109 billion.

2005/2006

Starting in 2005, Congress began work to extend the 2003 dividend and capital gains tax cuts from 2008 to 2010. Two factors motivated this effort. The first was a concern that financial markets would increasingly discount the dividend and capital gains policy from 2003 as those policies neared expiration. While the Bush Administration argued that these policies should be made permanent to reduce legislative uncertainty, Congress was (like in earlier years) constrained under the budget process to a temporary bill, since achieving 60 votes in the Senate was not possible. Since the original dividend cut was enacted for a five–year period there was a desire to maintain this policy for a minimum of five years.

The second motivation was a belief that advancing the expiration of the dividend and capital gains tax cut to December 31, 2010 aligned these policies with the other components of the Bush Tax Cut and raised the probability of more fundamental tax reform at that point. There was a hope that since permanence was not politically feasible and many further reforms were still needed in the tax code, creating a large "naturally occurring" tax cliff from 2010 to 2011 might create sufficient legislative pressures for fundamental change. Because the cost of extending the Bush Tax Cuts in 2010 will be large—approximately $300 billion—including the cost of extending the estate tax repeal; the fiscal outlook will have deteriorated further; and both social–policy–oriented tax relief towards lower– and middle–income families along with growth–oriented reductions in marginal tax rates will all be set to expire, pressure for base–broadening and reductions in tax subsidies may be achieved.

On November 15, 2005, the Committee on Ways and Means considered H.R. 4297, which provided for an extension of the capital gains and dividends tax cut through 2010 and also extended other expiring provisions, generally for one year. The bill passed the House on December 8, 2005. In the Senate, legislation was introduced on November 16, 2005 and passed on the floor on November 18, 2005. The Senate bill did not contain an extension of dividends and capital gains at all, and instead consisted of AMT relief and traditional expiring provisions along with charitable giving reforms and a series of other provisions.

Final action was delayed until 2006, however, and the conference report was signed and voted on in May 2006. The final bill contained an extension of the capital gains and dividends tax rate through 2010 ($51 billion) and also included a one–year AMT patch ($34 billion). The traditional expiring provisions (R&D tax credit, etc.) that had been included in the House and Senate bill were not included in the final bill due to revenue constraint imposed by the budget resolution dictating that the entire cost not exceed $70 billion. In addition, the bill contained $22 billion in revenue raisers. As a matter of Senate budget rules (Byrd Rule), revenue raisers were required to ensure that the bill had no revenue loss beyond the five–year budget window.

The final component of the Bush Tax Cuts was contained in the Pension Protection Act of 2006. In that bill, the pension and IRA provisions from the 2001 tax cut were made permanent. The ten–year cost was $36 billion, almost all of the cost occurring in the second half of the ten–year budget window. Specifically, the pension bill made permanent the Saver's Credit and the provisions in Title X of the

2001 tax cut. Those include the increased IRA contribution limits and catch–up contribution provision, the increases in contributions for 401(k)s, and a variety of modifications to vesting, distribution rules, portability and rollovers.

AMT Tax Relief

AMT relief has been enacted six times since 2001 to prevent a rapid expansion of the number of AMT filers. Because the Bush Tax Cuts lowered ordinary tax liabilities significantly, they also increased the projected number of taxpayers on the AMT (Burman, Gale, Leiserson, and Rohaly, 2007). President Bush has repeatedly included in his budget a provision to provide temporary relief from the AMT and these policies have been consistently enacted by Congress every year. However, this paper is not focused on the AMT, but rather on the changes to the ordinary income tax structure. Therefore, neither the tax relief provided to abate the effect of the AMT nor the pending increases in the AMT burden caused by the Bush Tax Cuts are discussed.

Tax Calculator

To demonstrate the impact of the expiration of the Bush Tax Cuts in 2010, I have constructed two simple tax calculators: the Bush Tax Cut Calculator (BTC), representing 2010 tax law, and the After Bush Tax Cut Calculator (ABTC), representing 2011 tax law. The following is a description of the provisions in each tax model.

In general, the models are designed to capture the major provisions most likely to effect a change in a taxpayer's liability at a given income level. Those include tax rate structure, marriage penalty provision, EITC, Pease and PEP, dividend and capital gains tax treatment, and child tax credit. The Bush Tax Cut Calculator is based on 2010 law and the After Bush Tax Cut Calculator is based on 2011 law. Results are presented in 2007 dollars. The calculator is run across a range of incomes from $0 to $500,000, and for three types of taxpayers: single, married and married with two children. To capture the effect of the change in tax treatment of dividends and capital gains, the calculators assigns a proportion of the taxpayers' income to wages, to dividends and to capital gains. These proportions are based on Statistics of Income (SOI) data on 2004 tax returns (U.S. Department of the Treasury, 2006). Regarding the itemizing deduction versus the standard deduction, taxpayers are assumed to have deductible expenses equal to 15 percent of their income. The calculator tests whether that amount is more or less than the standard deduction and assumes the larger of the two. The calculator does not address estate tax repeal as the exercise relates to income tax returns and does not address the pension provisions enacted in 2001 because they have been made permanent. Furthermore, the calculator is based on ordinary tax liability, not the alternative minimum tax (AMT). However, if no change to the AMT occurs between 2007 and 2010, a large majority of taxpayers earning between $100,000 and $1 million would be affected.

Figures 1A and 1B present estimates of total income tax liability (or refundable credit) for three types of taxpayers at five income points for 2010 and for 2011. In all cases, the 2010 tax liability is lower. For married filers with children earning $20,000, the tax refund is larger in 2010.

Figure 2 presents the *change* in tax liabilities for a single, married and married–with–two–children taxpayer under both the Bush Tax Cut assumptions and the After Bush Tax Cut assumptions at all income points up to $250,000. The most dramatic changes are for low– and middle–income families with children due to the large increase in the child tax credit and the marriage penalty relief in the Bush Tax Cuts. In all cases, tax liabilities are

TABLE 2
RESULTS OF THE BUSH TAX CUT CALCULATOR AND AFTER BUSH TAX CUT CALCULATOR

Provisions	Bush Tax Cut	After Bush Tax Cut
Marginal Tax Rates	10, 15, 25, 28, 33, and 35	15, 28, 31, 36, and 39.6
Dividends and Capital Gains	0% for taxpayers in 10 or 15% bracket; 15% for all others	Dividends taxed as ordinary income; Capital gains taxed at 10% for those in 15% bracket and 20% for all others
Standard Deduction for Married	200% of single ($10,700)	167% of single ($8,935)
15% Tax Bracket Width for Married	200% of single (max is $63,700)	167% of single (max is $53,190)
Child Tax Credit	$1,000 ($935 in 2007 dollars), phaseout at $55,000/$110,000 (single/ married)	$500 ($455 in 2007 dollars); same phaseout
Earned Income Tax Credit	$3,000 ($2970 in 2007 dollars) increase in phaseout range for married couples	No increase for married filers relative to single filers
Personal Exemption Phaseout (PEP)	Repealed	Phased out $156,400—$278,000 (single) and $234,600—$357,100 (married)
Itemized Deduction Phaseout (Pease)	Repealed	Phased out beginning at $156,400

Figure 1A. Tax Liability 2010

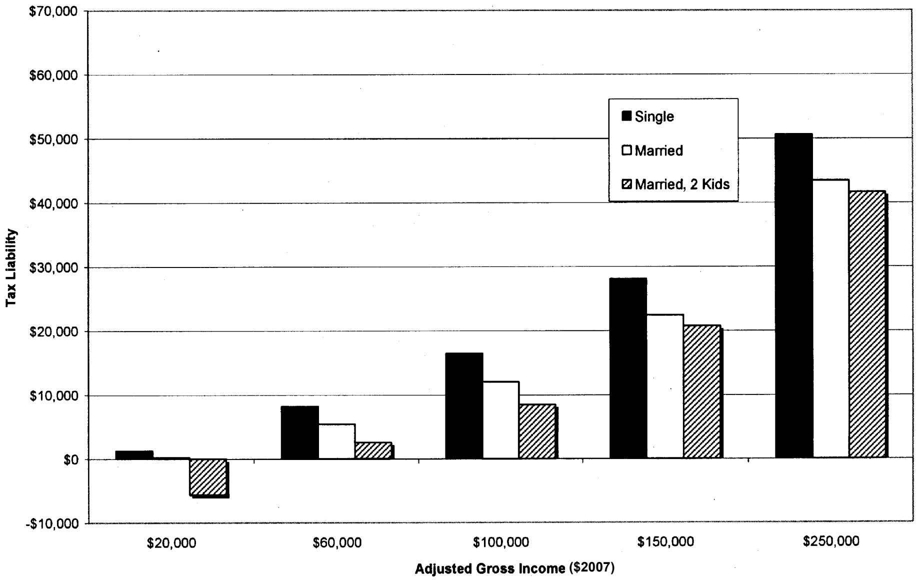


Figure 1B. Tax Liability 2011

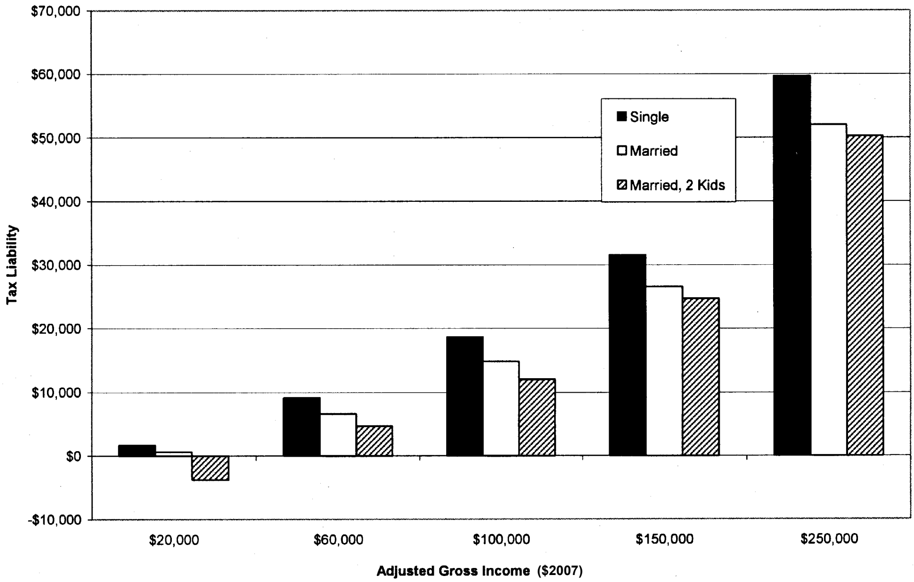


Figure 2A. Differences in Bush and Expired Bush Tax Cuts Liability

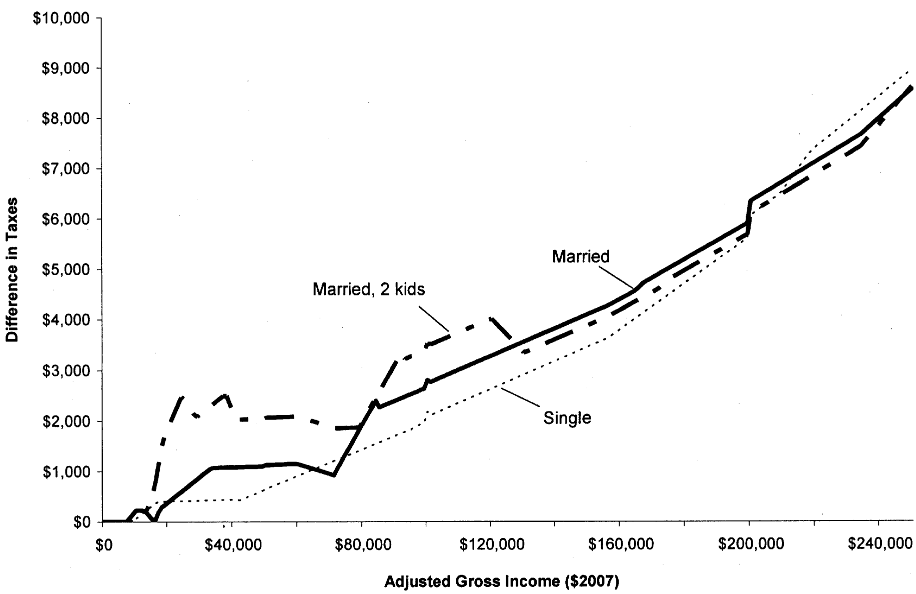
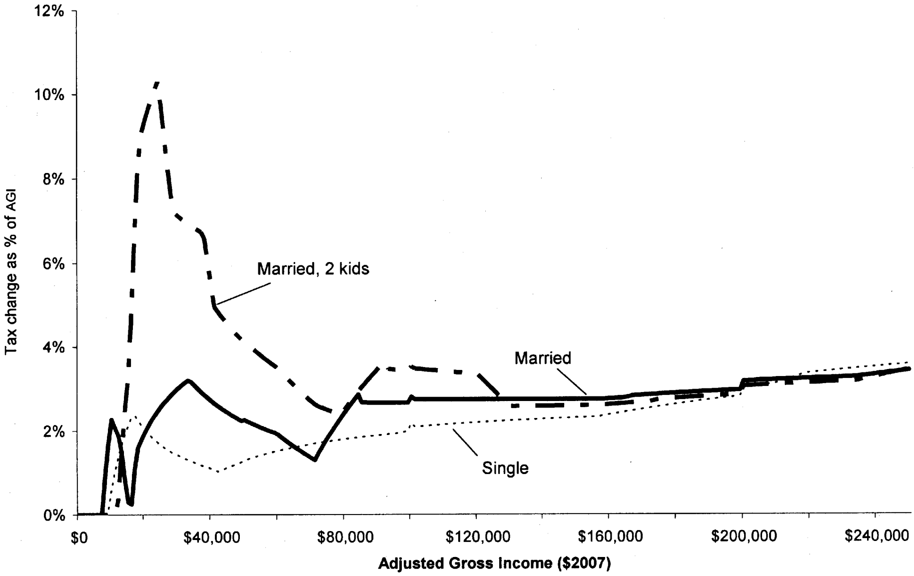


Figure 2B. Differences in Bush and Expired Bush Tax Cuts Liability, % of AGI



lower under the Bush Tax Cuts for these typical taxpayers.

Figure 3A and 3B present a similar set of information as Figure 2, but focus on the five income points in Figure 1: $20,000, $60,000, $100,000, $150,000 and $250,000, and show changes in tax liabilities in absolute terms and as a share of income. Here, in a clearer picture than in Figure 2, the reader can observe that among low– and middle–income taxpayers, tax breaks were proportionately larger for taxpayers with children. In addition, tax breaks were larger for higher–income taxpayers in dollar terms. As a share of income, the tax increase is only modestly larger for higher–income taxpayers with one exception. Low–income taxpayers with children face a large nine–percent tax increase under current law.

Figure 4 focuses only on taxpayers earning $60,000 and disaggregates the difference in tax liabilities caused by rate reduction, marriage penalty and increased child tax credit. For the single filer earning $60,000, $443 of the tax savings is due to the lower marginal rate structure, $391 is due to the creation of the ten percent tax bracket, and $80 is due to the lower tax on dividends and capital gains. For married couples, the benefit of the ten percent tax bracket is double that for single filers, $783, and the increased standard deduction saves $250. For the married couple with two children, the savings is an additional $956, reflecting (in 2007 dollars) the change in the child tax credit. The married filers do not benefit from a lower marginal tax rate at this income point. Both before and after, their marginal rate is 15 percent. For this analysis, the stacking order in calculating the benefit for each provision is as follows: standard deduction benefit, capital gains and dividends, ten percent bracket, other marginal rate reductions, and child tax credit.

POST–PERMANENCE–ISM

While the rhetorical drumbeat of long–range tax policy from President Bush and most Congressional Republicans has been

Figure 3A. Tax Increase in 2011—Current Law

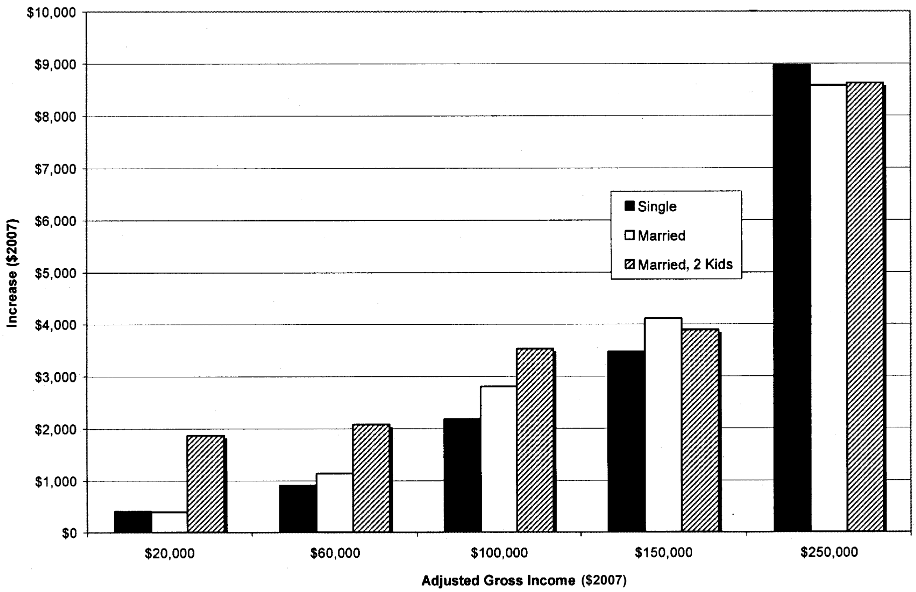


Figure 3B. Tax Increase in 2011—Current Law, Share of AGI

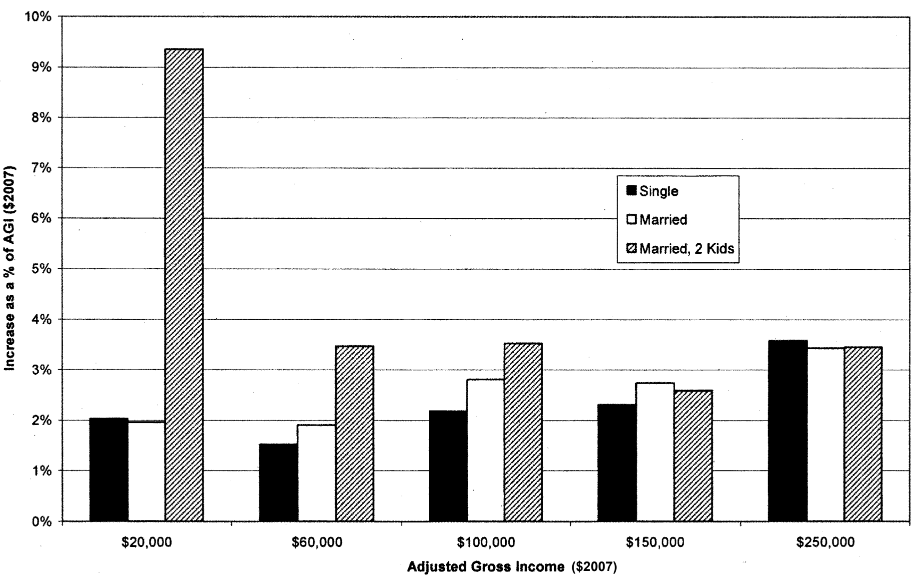
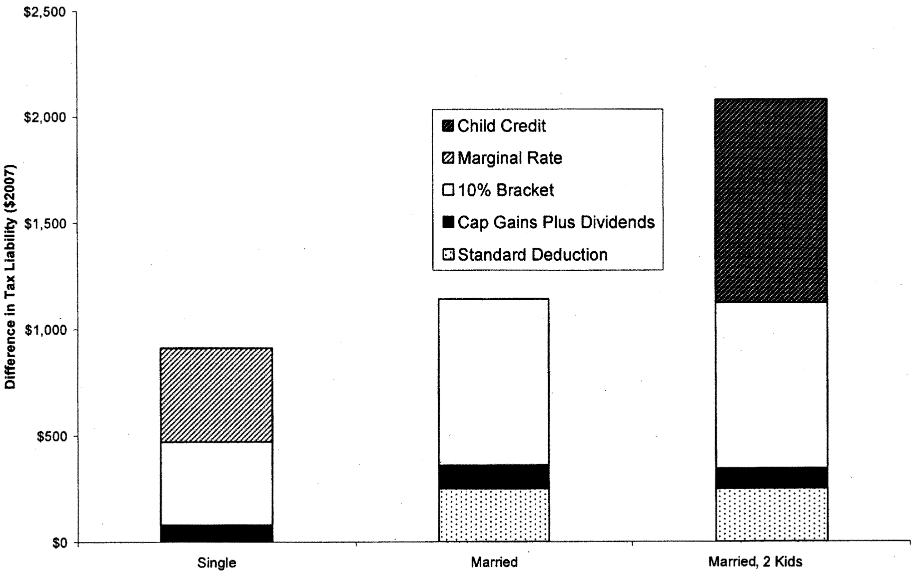


Figure 4. Expired Bush Cut Tax Increase for AGI of $60,000



making the Bush Tax Cuts permanent, the political reality is that such an objective is likely unattainable. First and most simply, as the expiration of the Bush Tax Cuts nears, President Bush will no longer be President, and the next President will likely be advocating his or her own tax policy ideas.[13] Second, Democrats, with majorities in the House and Senate, were generally strong opponents of the Bush Tax Cuts and at a best appear interested in extending only some provisions. Third, the cost of extending the Bush Tax Cuts will become seriously large. According to the Congressional Budget Office, the cost of extending the Bush Tax Cuts is over $300 billion per year, not including the challenge posed by AMT.[14] This amounts to approximately eight percent of on–budget, current–law–projected revenues.[15]

On the other hand, it seems unlikely that Congress will sit idly by in 2010 while taxpayers face a total tax increase of $300 billion a year and most individual taxpayers face hikes of $1,000 or more. Every taxpayer would face a tax hike, and millions of households that paid no tax in 2010 would be added to the tax rolls.

Therefore, it is reasonable to assume that some legislative action will occur. Balancing the desire of lawmakers not to increase tax liabilities on large majorities of the voting population against the budget cost of keeping even portions of the Bush Tax Cuts in place will be a significant challenge. Even extending the child tax credit, a ten percent bracket and marriage penalty relief (the provisions that benefit lower– and middle–income tax payers) is costly. For example, extending the $1,000

[13] As an example, when asked by BusinessWeek if he supports extending the 2001 and 2003 tax cuts, Rudy Giuliani recently answered, "I support continuing the level of taxation where it is, certainly not letting it increase," and avoided directly endorsing any of the Bush Tax Cut provisions (Bartiromo, 2007).

[14] This includes the outlay cost of the increased EITC and the child tax credit.

[15] The current law baseline projection assumes no fix for the AMT. Indexing the AMT for inflation would reduce revenues by about $60 billion a year.

child tax credit costs roughly $35 billion a year after 2011. Extending the lower rate on dividends and capital gains costs an additional $35 billion annually. The reduced marginal rate structure costs $130 billion a year, and extending estate and gift tax repeal costs roughly $80 billion annually (U.S. Congress, 2007).

This looming tax increase coinciding with growing budgetary pressures may provide impetus for reforms that include significant offsetting tax increases to accompany any effort to preserve elements of the Bush Tax Cut. Or, a more fundamental rewrite of the tax code may be considered.

An Illustrative Radical Reform Option: Low Rates and a Broad Based Income Tax Reform

A wide range of options for reform could be imagined: extending the Bush Tax Cuts largely as they are but offsetting the cost with revenue raising reforms; scrapping the tax code and moving to a cleaner income tax or replacing the current code with a consumption tax; allowing marginal rates to increase and making permanent existing credits and deductions; etc.

To explore the impact of an income tax reform that includes radical base broadening and lower rates, I ran a tax calculator with parameters that approximate a reform simulated by the Joint Tax Committee that would eliminate most credits and deductions in the individual income tax system and lower marginal tax rates by 23.5 percent (U.S. Congress, 2006). Dividend and capital gains tax rates would remain at 15 percent and the AMT would be repealed. Gone from the tax calculator model presented above would be the child tax credit, personal exemptions, and any individual deductions (the mortgage interest deduction, the state and local sales tax deduction, and the charitable deduction). Deductions for retirement savings would be preserved. Pease and PEPs do not exist in the reform proposal. The standard deduction and EITC (as expanded in 2001) would remain.

This broader base would allow the revenue–neutral financing of the following rate structure: 7.55, 11.55, 19.1, 21.4, 25.2, and 26.8. The tax brackets are the same as the Bush Tax Cut structure.

There are a few caveats. First, the Joint Committee on Taxation (JCT) analysis is revenue–neutral over the budget window 2007–2016. However, the first four years of that period are Bush Tax Cut years and the final six years (2011–2016) are after the Bush Tax Cuts expire. Therefore, what is revenue–neutral over the budget window is not budget–neutral in the long run. A long–run, revenue–neutral proposal would have modestly higher rates.[16] However, the broad effects of this policy are generally the same. Second, the JCT proposal would likely result in shifts in the form of compensation that result in a change in taxable income. Such effects may be incorporated in the JCT calculations but are not included in the tax calculator in this paper. Third, lower marginal tax rates could affect the supply of labor and workers could change the number of hours they work. The tax calculator makes no adjustment for these factors.

Figures 5A and 5B present the difference in tax liabilities between extending the Bush Tax Cuts in 2011 and adopting the lower–rate, broader–base structure. The elimination of the child tax credit and personal exemptions has a dramatic effect on lower–income joint filers with

[16] Extension of the Bush Tax Cuts would reduce individual income tax revenues by approximately nine percent per year relative to allowing their expiration. Given that the first four years in the budget window of the JCT analysis contain the Bush Tax Cuts, a rate cut based on long–run neutrality would be roughly five percent, or about one percentage point higher.

Figure 5A. Tax Change in 2011 Under Base–Broadening, Rate–Reducing Reform

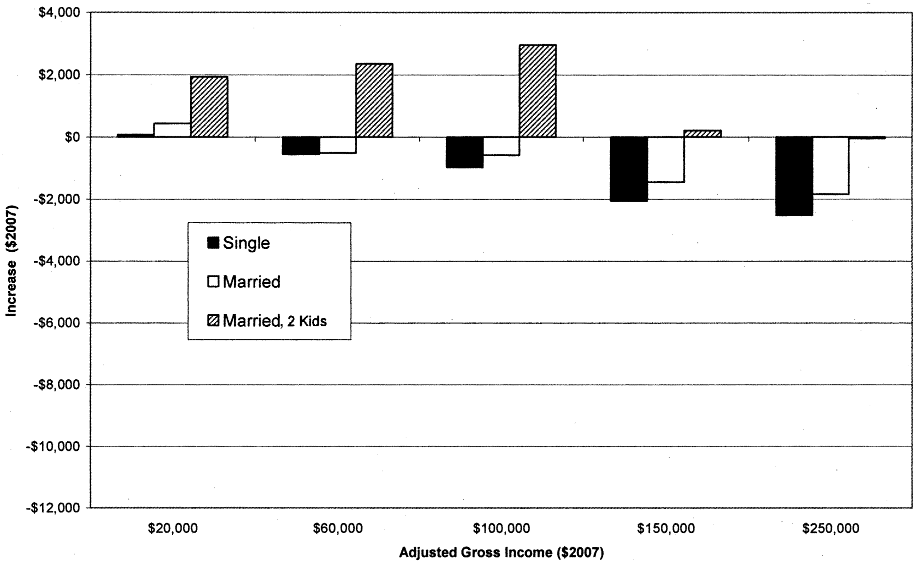
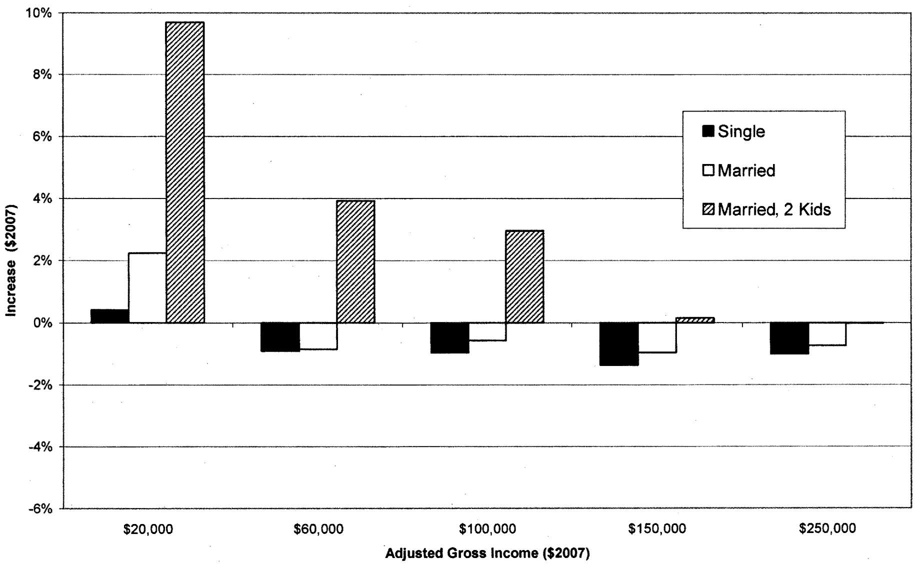


Figure 5B. Tax Change in 2011 Under Base–Broadening, Rate–Reducing Reform, % of AGI



children. While taxes are lower on high income taxpayers without children, the difference is very small as a share of income. Average tax rates are only one percent higher for single taxpayers earning $250,000 and unchanged for joint filers with two children.

Figures 5C and 5D show the change in tax liability between allowing the tax cuts to expire in 2011 or adopting the broad–based, low–rate structure. As expected, the results are notably different than in 5A and 5B because the starting point is a narrower base and higher rate structure. There is virtually no change in tax liability for most low–income taxpayers and a modest tax cut as incomes rise. This proposal is based on a proportional reduction in ordinary income tax rates, and fine tuning to the rates could produce other desired distributional impacts to those presented in Figures 5A–5D, but a key observation is that the simple income tax reform proposal discussed above does not have a radically different distributional consequence relative to the Bush Tax Cuts and is relatively distributionally neutral with regard to current law in 2011.

Macroeconomic Effects

The JCT performed a macroeconomic analysis of this proposal using four economic models and assuming various financing assumptions to offset the long–run cost. In general, long–run GDP effects range from 0.2 to 3.5 percent relative to allowing the Bush Tax Cuts to expire.

A separate macroeconomic analysis presented by the Treasury Department of the estimated effect of making the Bush Tax Cuts permanent found that long–run GDP effects (assuming the cuts are financed by reducing government spending) are 0.7 percent. Conveniently, this result can be compared to one of the estimates in the JCT analysis because both organizations used an overlapping generations model (OLG) owned by Tax Policy Advisers LLC. The long–run GDP effect from the OLG model of the JCT simulation is 2.6 percent. This fairly close apples–to–apples comparison of extending the Bush Tax Cut without any revenue offsets (0.7

Figure 5C. Change from Current Law in 2011 Under Base–Broadening Reform

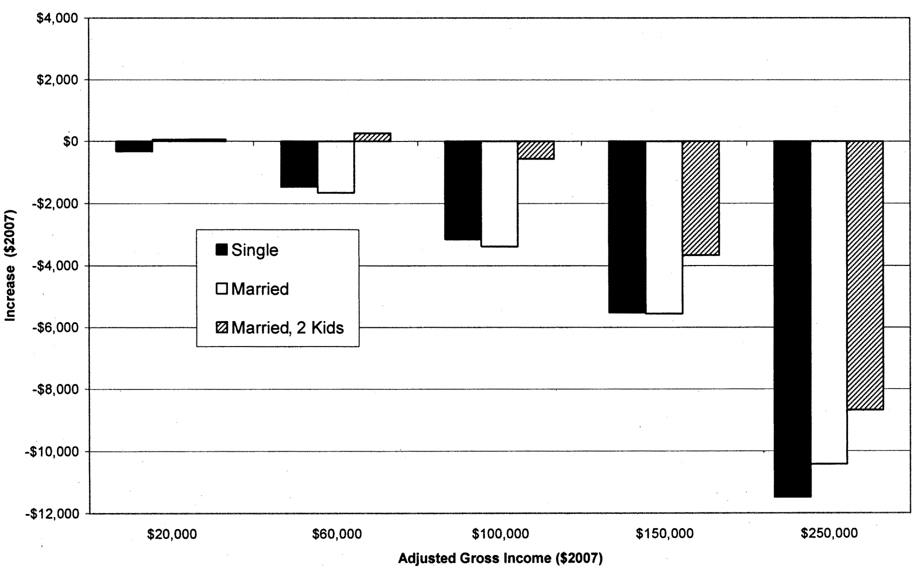
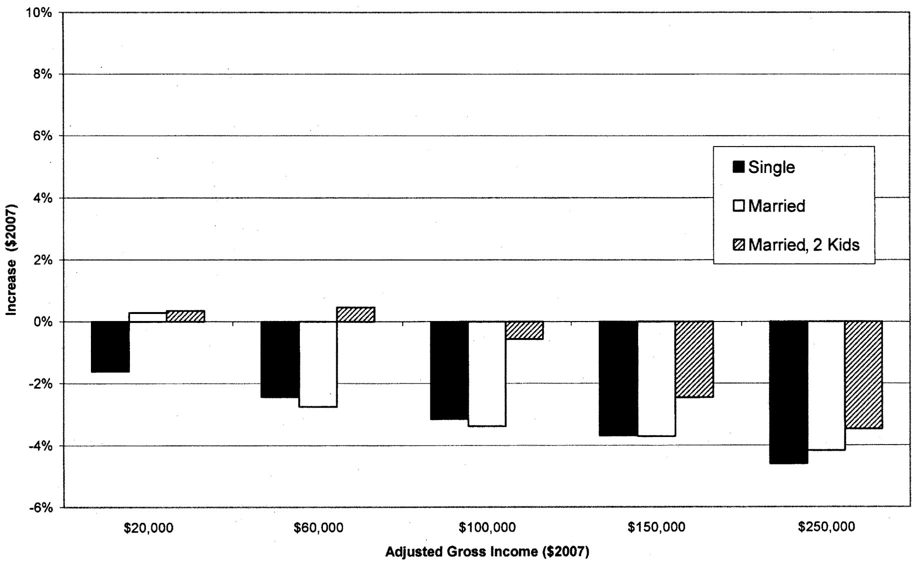


Figure 5D. Change from Current Law in 2011 Under Base–Broadening Reform, % of AGI



percentage point increase in real GDP relative to current law for extending the Bush Tax Cuts) and the revenue–neutral, broad–base, low–rate proposal analyzed by the JCT (2.6 percentage point increase in real GDP, relative to current law beyond 2010) suggest that, in terms of economic growth, there is even more benefit to be realized by broadening the tax base and further lowering rates than by continuing with the tax rate structure of the Bush Tax Cut. Both options would likely yield more growth than allowing current law to expire.

Option Two: A Hodge–Podge Approach

While there are numerous options for broadening the individual income tax base due to the plethora of special credits and deductions that exist in the Code, here I will briefly summarize four compromise options that would raise significant sums: 1) limiting the mortgage interest deduction; 2) repealing the exclusion for employer–provided health insurance and providing a "health standard deduction of $15,000; 3) capping the deduction for the state and local sales tax; and 4) limiting the benefit of all itemized deductions to 15 percent. These incremental steps could offset other tax cuts, such as keeping parts of the Bush Tax Cuts.

The Congressional Budget Office (CBO) in a biannual publication called *Budget Options* describes a proposal to transform the current deduction for home mortgage deductions (currently limited to mortgages of less than $1 million) into a flat rate credit of 15 percent for mortgages up to $400,000 (U.S. Congressional Budget Office, 2007). Such a proposal would have no impact on taxpayers who own their home with no mortgage or on those who rent. However, other taxpayers would face an increase in taxes if their marginal tax rate was above 15 percent and/or if their mortgage was larger than $400,000. This proposal would also be a tax cut for those taxpayers with mortgage interest expenses not large enough to justify itemizing their deductions. Such a reform would generate $41 billion in

TABLE 3
REVENUE EFFECT OF BASE–BROADENING PROVISIONS AND EXTENSION OF BUSH TAX CUTS

Provisions	Revenue Effect in 2011 ($b)	Revenue Effect in 2012 ($b)	Average Revenue Effect 2011–2017
Revenue Raisers			
Health insurance deduction reform	–3.7	11.7	50.5
Mortgage deduction reform	37.8	41.0	55.2
State and local tax deduction limitation	34.7	62.2	68.7
15% limitation on itemized deductions	$90.3	127.2	151.0
Bush Tax Cut Provisions			
Marriage penalty relief	–4.2	–8.9	–7.4
Lower rate on dividends and capital gains	17.0	–21.2	–30.7
$1,000 child tax credit	–6.8	–34.1	–30.9
Repeal of estate tax	–36.0	–59.8	–70.4
Reduction in individual income tax rates	–81.6	–121.7	–121.7

2012: enough to extend the lower tax on dividends and capital gains or enough to extend the $1,000 child tax credit.

The second proposal for partially broadening the tax base would be to provide a cap on state and local sales tax deductions. CBO proposes limiting the deductions up to two percent of gross income. Such an approach would generate about $35 billion in 2011 and $62 billion in 2012 according to CBO.

Third, in the President's most recent budget, he proposed a new standard deduction for health insurance combined with a repeal of the exclusion for employer–provided health insurance. The JCT estimates such a policy would raise $333 billion over ten years, with the out–year amount rising rapidly. Such a policy could almost offset the cost of estate repeal and could certainly offset the cost of the recently proposed estate tax compromise proposals.

Finally, CBO (2007) and Batchelder, Goldberg, and Orszag (2006) explore the possibility of limiting all itemized deductions to 15 percent. This option is a full–scale version of the limitation of home mortgage deductions applied to all itemized deductions or could be viewed as a compromise to the more radical broad–base, low–rate reform discussed above. Such a change would amount to a tax increase for roughly 40 percent of all taxpayers by broadening the tax base significantly. Those affected would be taxpayers who currently itemize their deductions and face a tax rate greater than 15 percent. Such a change would raise $90 billion in 2011. All four of these revenue estimates are based on the assumption that the Bush Tax Cuts expire as in current law.

While a package combining a subset of the base–broadening options discussed above could be constructed as an offset for a significant portion of the Bush Tax Cuts, cost would likely remain an issue. The positive macroeconomic effects of such a package would be larger than a simple extension of the Bush Tax Cuts but not as large as for the broader–base, lower–rate approach discussed above.

Table 3 above provides a summary of the revenue impact of the base–broadening proposals mentioned above as well as the cost of extending aspects of the Bush Tax Cuts. All estimates originate from the JCT.

CONCLUSION

With just three years left before the Bush Tax Cuts are scheduled to expire, a switch in control in Congress, and an upcoming Presidential election, the difficulty of dealing with the forthcoming fiscal shock in 2011 is a challenging problem. In addition to the tax issues laid out in this paper, the individual Alternative Minimum Tax poses a huge tax and budgetary challenge, and the change in the tax structure from 2010 to 2011 is even greater with regard to the estate tax as that tax goes from reduced to eliminated to reinstated. Two thousand and eleven is also the year for which the Social Security and Medicare Trustees project that the outflow from the HI Trust Fund will exceed the income and interest on the Trust Fund.

Neither allowing the Bush Tax Cuts to expire nor preserving them in their entirety is likely. Broadening the tax base to offset the revenue loss incurred by extending the Bush Tax Cuts could further improve economic efficiency, but enacting any tax increase is a political challenge. Increased budgetary pressures may provide political defenses for such a move, however. As shown, reforms that radically broaden the tax base and reduce tax rates can be designed to be roughly distributionally neutral and would result in a measurable increase in real GDP.

Finally, given the newly adopted budget rules in Congress (namely, pay–as–you–go rules), here is one budget–related observation. Budget constraints matter in the legislative process, but are often illogical. While Congress was constrained to pass tax cuts not a penny more that $1.347 trillion in 2001, they were able to cut taxes an additional 50 percent over the next five years. The ultimate design of the 2003 tax cut was significantly affected by a budget constraint, but was structured in such a way as to utilize phase–ins and sunsets to encourage an additional tax cut in 2004. How Congress deals with the budgetary impact of the expiration of the Bush Tax Cuts in 2010 remains to be seen.

Acknowledgments

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APPENDIX

TABLE A1
2001 TAX CUT: AS PROPOSED AND AS ENACTED

Provision	Description, as Proposed	Cost (10 Years), as Proposed[1]	Description, as Enacted in 2001	Cost (10 Years), as Enacted[2]
New 10% tax bracket	Create new 10% tax bracket for the first $6,000 (single)/$12,000 (married) portion of the existing 15% bracket. Rate would be phased in from 2002 through 2006.	$317 billion	New rate not phased in. $6,000/$12,000 bracket in 2002 increasing to $7,000/$14,000 in 2003. $500/$1000 credit for 2001.	$421 billion
Reduction of income tax rates	28%, 31%, 36% and 39.6% rates reduced to 25% and 33%, phased in over 5 years. Total number of brackets cut from 5 to 4.	$560 billion	All rates above 15% reduced, but top rate down only to 35%. Other rates cut to 33%, 28%, and 25%. Phase–in repeal of Pease and PEPs, thereby reducing effective marginal tax rate for certain high–income taxpayers.	$454 billion
Child tax credit	Increase from $500 to $1,000, phased in over 5 years. Also raises and broadens the phaseout range.	$211 billion	Phased in over 10 years, partially refundable.	$172 billion
Marriage penalty relief	Above the line deduction for two–earner couples of 10% of lesser–couple earnings, phased up to $30,000 over 5 years.	$103 billion	Standard deduction set to double the single deduction, phased in over five years. 15% bracket enlarged to double the single filers bracket width, phased in over 4 years. Increase EITC phaseout for joint filers.	$63 billion
Repeal of estate and gift tax	Reduce tax rates by 5 percentage points in 2002, 10, 15, 20, 30 and 40 percentage points in 2008 and full repeal in 2009. Carry–over basis.	$306 billion	Reduce tax rates gradually to 45% through 2010 and increase exemption amount from $1 million to $3.5 million in 2009. Phaseout state credit.	$133 billion
Expansion of charitable deduction for non–temizers	Allows above–the–line charitable deductions up to the amount of the standard deduction for non–itemizers, phased in through 2006.	$84 billion	Never enacted.	N/A

[1]Throughout, this paper uses revenue estimates from the Joint Committee on Taxation, as those numbers are binding for budgetary purposes in Congress (see U.S. Congress, 2001b).
[2]U.S. Congress, 2001a.

TABLE A2
2001 TAX CUT: AS PROPOSED AND AS ENACTED

Provision	Description, as Proposed	Cost (10 Years), as Proposed[1]	Description, as Enacted in 2003	Cost (10 Years), as Enacted[2]
Accelerate 10% bracket	Accelerate the phase in of the 10% bracket	$44 billion	Fully phase in relief for 2003 and 2004, then reverts to current law phase in in 2005	$12 billion
Accelerate individual tax rates	Accelerate the phase in scheduled to occur through 2008 to 2003	$74 billion	Enacted as proposed	$74 billion
Accelerate marriage penalty relief	Accelerate the phase in scheduled to occur through 2008 to 2003	$55 billion	Fully phase in relief for 2003 and 2004, then reverts to current law phase in	$35 billion
Accelerate child credit increase	Accelerate the phase in scheduled to occur through 2008 to 2003. Pay the increased amount by rebate check.	$90 billion	$1000 in 2003 and 2004, then reverts to current law phase in	$32 billion
Eliminate double tax of dividends	Integrate the corporate and individual tax to ensure there is never double taxation but always one level of tax.	$396 billion	Cut top dividend and capital gains tax rates to 15%. Lower income tax brackets have this income taxed at 5% falling to 0% in 2008.	$148 billion
Increase Section 179 expensing	Raise the maximum amount a small business can expense from $25,000 to $75,000. Raise phase out to $325,000.	$29 billion	Raised the cap to $100,000 and the phase–out to $400,000. Sunset after 2005	$1 billion[3]
Increase AMT exemption in 2003–2005	Increase AMT exemption by $4000 (singles),$8000 (married) through 2005.	$37 billion	Increase AMT amount by $4500 (single) and $9000 (couples) for 2003 and 2004	$18 billion
50% Accelerated Depreciation	Not Proposed	N/A	Increase the 30% bonus depreciation previously enacted in 2002 to 50% and extend through 12/31/2004	$9 billion[4]

[1]U.S. Congress, 2003d.
[2]U.S. Congress, 2003c.
[3]This provision, like accelerated depreciation, affects the timing of tax payments. Revenues were reduced by $9 billion between 2003 and 2006.
[4]The nature of this provision is that it affects the timing of taxes paid. Accelerated depreciation will increase revenue loss in the early years and increase revenue gain in the later years. This provision reduced revenue by $55 billion between 2003–2005 and raised revenue after that.