

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue top and bottom. The globe in the top bulb is dark blue, and the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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February 2, 2009

Congressional Research Service

Report RS20819

*President Bush's Tax Proposal: A Brief Overview*

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Updated June 21, 2001

**Abstract.** On February 8, 2001, President Bush sent to Congress the outlines of a proposal to cut taxes by an estimated \$1.6 trillion over 10 years. A conference committee version of the tax cuts (H.R. 1836) was approved by the House and Senate on May 26; it was signed into law on June 7 and became P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001.

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# CRS Report for Congress

Received through the CRS Web

## President Bush's 2001 Tax Proposal: A Brief Overview

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### Summary

On February 8, 2001, President Bush sent to Congress the outlines of a proposal to cut taxes by an estimated \$1.6 trillion over 10 years. Additional details of the plan were included in budget documents the Administration released on April 9. The plan is similar in its essentials to a proposal then-Governor Bush made during the presidential campaign. Its principal components are: a reduction in marginal individual income tax rates; an increased child tax credit; a tax cut for married couples; elimination of the estate and gift tax; a permanent research and experimentation tax credit; a charitable contribution deduction for non-itemizers; and several tax benefits for health care and education. Tax cuts similar to the President's have been considered by Congress over the past several years, but were not enacted, in part because of opposition by the Clinton Administration. In March 2001, specific tax cut legislation along the lines of the Bush program began to move through the House as a set of stand-alone bills, and by early May the House had passed bills containing much of the President's proposal. On May 23, the full Senate approved an omnibus bill including similar tax cuts. A conference committee version of the tax cuts (H.R. 1836) was approved by the House and Senate on May 26; it was signed into law on June 7 and became P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001. This report will not be updated. For a detailed comparison of the President's proposal and P.L. 107-16, see CRS Report RL30973, *Tax cuts: A Side-by-Side Comparison of the President's Proposal and House, Senate, and Conference Committee Bills*.

### The Proposal's Overall Size and Shape

The size and shape of the President's proposal can be inferred from the estimated impact it would have on federal revenues. Based on the revenue estimates, the centerpiece of President Bush's tax proposal is its reduction of marginal individual income tax rates. In the proposal's tenth year, by which time each of the proposal's provisions would be fully phased in, the reduction in tax rates would account for 43% of the plan's estimated revenue reduction. Other major elements of the plan are elimination of the estate and gift tax, which would account for 24% of the estimated revenue loss, and

expansion of the per-child tax credit, accounting for 11% of the revenue loss.<sup>1</sup> Thus, these three provisions would account for over three-quarters (77%) of the proposal's revenue loss when the plan is fully implemented.

The size of the tax cut can also be gauged by looking at its estimated revenue loss in several additional ways. For example, based on the Administration's revenue estimates and economic projections by the Congressional Budget Office, when the proposal is fully phased in it would reduce federal receipts by about 7.5% of projected revenue, an amount equal to 1.5% of gross domestic product (GDP). By comparison, as it was initially enacted the Economic Recovery Tax Act of 1981 (ERTA) — the large tax cut enacted at the beginning of the Reagan Administration — was expected to reduce tax revenue in its fifth full year by 25% of revenue that was otherwise expected to accrue and by 6% of projected GDP (see, however, the cautionary note below).<sup>2</sup> Looking at the 1990s, the net tax increase enacted by the Omnibus Budget Reconciliation Act of 1993 was anticipated to increase revenue by 4% of expected receipts by its fifth year (0.1% of GDP); the net tax cut enacted by the Taxpayer Relief Act of 1997 was expected to reduce revenue by 1% of receipts or 0.2% of GDP by its fifth year. The vetoed Taxpayer Refund and Relief Act of 1999 was expected to reduce revenue by 5% of anticipated revenues or 1% of GDP by the time it was fully phased in.

On the basis of these comparisons, the revenue effect of the President's proposal would be substantially smaller than that anticipated with ERTA's landmark tax cut, but substantially larger than the revenue impact of the significant tax legislation of the past decade. As a cautionary note, however, ERTA's tax cut was enacted in a somewhat different context than now exists: the tax system was not indexed, and inflation was pushing some taxpayers into higher tax brackets. Thus, ERTA's tax cut preempted what would have been inflation induced tax increases for many taxpayers.

## Principal Provisions

Again, the largest component of the tax cut plan is its **reduction in marginal tax rates** that the tax code applies to taxable income. Under current law, there are five tax rates that increase as taxable income increases; the current rates are: 15%; 28%; 31%; 36%; and 39.6%. The Bush plan would replace this structure with four tax rates. In general, the plan would separate the lowest bracket into two parts, with a 10% rate applying to the first \$12,000 for joint returns (\$6,000 for singles) and retaining a 15% rate for the rest of the bracket. The plan would consolidate the next four brackets into two,

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<sup>1</sup> The revenue estimates are the administration's, as reported in U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2002 Tax Relief Proposals* (Washington: April, 2001), 60 p. This document also contains a detailed description of the Administrations proposals and is posted on the Treasury Department's website at [<http://www.ustreas.gov/taxpolicy/library/bluebk01.pdf>]

<sup>2</sup> Parts of ERTA were repealed before they went into effect; the estimates here are for ERTA's initial provisions. Both the revenue estimates for ERTA and the projected revenue estimates (from the Feb., 1982, Congressional Budget Office baseline) are taken from U.S. Congressional Budget Office, *Projecting Federal Tax Revenues and the Effect of Changes in Tax Law* (Washington: Dec., 1998), p. 15. GDP figures are from U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal 2002-2011* (Washington: Jan., 2001).

with a single 25% rate replacing current law's 28% and 31% rates, and a single 33% rate applying to current law's 36% and 39.6% brackets. The chart below compares the proposed new structure with that of current law for married couples.<sup>3</sup> In using the table, note that the tax rates listed under the proposal are those that would be effective when the plan is fully phased in, which would not occur until 2006. However, the tax brackets shown in the table are those applicable to 2001. Because current law adjusts the rate brackets each year to reflect inflation, the actual dollar amount of the brackets will likely be different in 2006.

Note that the tax rates in the table are *marginal rates* — that is, they apply to increments of income a taxpayer earns within the corresponding income bracket. Increments of a taxpayer's income corresponding to lower brackets are taxed at lower marginal rates; increments corresponding to higher brackets are taxed at higher rates. For example, if single taxpayer earns \$70,000 of taxable income under current law, \$27,050 of his income would be taxed at 15%, \$38,500 (i.e., \$65,500 minus \$27,050) would be taxed at 28%, and \$4,450 would be taxed at 31%.

### Statutory Marginal Tax Rates Under Current Law and the President's Proposal

Singles			Married Couples		
Taxable Income Bracket (Tax Year 2001)	Current Law	Bush Proposal	Taxable Income Bracket (Tax Year 2001)	Current Law	Bush Proposal
\$0 — \$6,000	15%	10%	\$0 — \$12,000	15%	10%
\$6,000 — \$27,050	15%	15%	\$12,000 — \$45,200	15%	15%
\$27,050 — \$65,550	28%	25%	\$45,200 — \$109,250	28%	25%
\$65,550 — \$136,750	31%	25%	\$109,250 — \$166,500	31%	25%
\$136,750 — \$297,350	36%	33%	\$166,500 — \$297,350	36%	33%
\$297,350 —	39.6%	33%	\$297,350 —	39.6%	33%

The plan would further cut taxes for married couples by providing a “second-earner deduction”; that is, if both members of a married couple have incomes, the couple could deduct 10% of the lower-earner's income, up to a maximum of \$3,000. In doing so, the proposal would reinstate a provision similar to one that was enacted by ERTA in 1981, but that was repealed by the Tax Reform Act of 1986. The proposed deduction would reduce (and in some cases eliminate) current law's so-called “**marriage tax penalty**” that results in some couples paying more taxes than an unmarried couple with an identical cash income. (The deduction would also provide a tax cut to some couples that receive a marriage bonus under current law.)<sup>4</sup> Note that the new 10% bracket contains an

<sup>3</sup> Information on the content of the President's proposal is from an Administration press release on the tax plan reprinted in *BNA Daily Tax Report*, Feb. 9, 2001, p. L-1.

<sup>4</sup> For details on the tax consequences of marriage, see CRS Report RL30800, *The Federal Income Tax and the Treatment of Married Couples: Background and Analysis*, by Gregg A. Eesenwein.

element of tax relief for married couples: unlike other brackets, its width is twice that of singles.

The President's plan proposes to eliminate the **estate and gift tax**. Under current law, a graduated rate structure of 37% to 60% applies to estates after an exemption of \$675,000. (The exemption is scheduled to increase to \$1 million by 2006.)

The President's proposal would double the existing **per-child tax credit**, increasing it to \$1,000 from current law's \$500. At the same time, the plan would increase current law's phase-out threshold for the credit to \$200,000 for both married couples and singles from current law's \$110,000 (\$75,000 for singles). Additionally, the plan would make the credit applicable against the individual alternative minimum tax.

The plan would permit taxpayers who claim the standard deduction rather than itemized deductions to deduct **donations to charity**. The campaign version of the Bush proposal contains two added provisions: it would increase to 15% of taxable income current law's 10% limitation on corporate charitable-donation deductions; it would also permit charitable contributions to be made from individual retirement accounts (IRAs) without incurring the penalty for early withdrawal. The Administration's press release on the February 8 plan made no mention of these last two provisions, although it does state that along with the "above-the-line" deduction that President Bush "supports other proposals to increase charitable giving."<sup>5</sup>

The President's plan would make current law's **research and experimentation tax credit** permanent. Under current law the credit is equal to 20% of a firm's research spending above a base amount. The provision was first enacted in 1981, but has always been temporary, and has been scheduled to expire but extended on numerous occasions. Most recently, legislation in 1999 extended the credit through June, 2004. The plan also proposes to extend for one year a number of tax benefits due to expire in 2001. The most prominent of these are the work opportunity tax credit, the welfare-to-work tax credit, the exclusion for employer-provided education assistance, minimum tax relief for individuals, and the exception from subpart F for the active financing income of multinational firms.

The proposal would provide several **tax benefits for education**. The proposals included increasing the annual contribution limit for education individual retirement accounts to \$5,000 from \$500 and expanding the accounts to include expenses for primary and secondary education; an expansion of tax-exempt private-activity bonds to include school construction; and a \$400 tax deduction for teachers' school-supply and training expenses.

The President's plan also contains a number of **tax benefits related to health care**. One proposal would provide a refundable tax credit for the purchase of health insurance by persons under 65 who do not participate in public or employer-provided plans. The credit would equal 90% of health insurance premiums up to a maximum of \$1,000 per individual covered by a policy, up to a total of \$2,000. Other health proposals would provide an above-the-line deduction for long-term care insurance, permit up to \$500 in

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<sup>5</sup> BNA *Daily Tax Report*, Feb. 9, 2001, p. L-1.

unused benefits from flexible spending arrangements to be carried forward to the next year, and permanently extend and modify current law's medical savings accounts.

**Previous legislation** passed by the 106<sup>th</sup> Congress in 1999 and 2000 included provisions similar to many of the President's proposals. The legislation was vetoed, however, by President Clinton, who generally argued that the tax cuts were too costly and favored upper-income individuals. The Taxpayer Refund and Relief Act (TRRA; H.R. 2488) included a one percentage-point reduction in all tax rates and a tax cut for married couples as part of a broad range of tax cuts. In 2000, H.R. 8 would have repealed the estate and gift tax; H.R. 4810 would have cut taxes for married couples.

## Policy Issues

During the 2000 presidential campaign, then-Governor Bush advanced several arguments supporting his tax cut proposal. The arguments were based on both philosophical and economic grounds. Philosophically, Governor Bush stated his belief that high taxes are linked with large government. Economically, he argued that reduced taxes are linked with long-term economic growth because they stimulate work effort, saving, and entrepreneurship, a belief reflected in the plan's emphasis on cutting marginal tax rates.<sup>6</sup>

In December 2000, during the period between the election and his inauguration, President-elect Bush advanced an additional justification for a tax cut: to provide an economic stimulus to an economy that had begun to show signs of slowing down. In testimony before the Senate Budget Committee, Federal Reserve Chairman Greenspan offered qualified support for a tax cut, a support based on his negative view of extensive government holding of private liabilities that large surpluses would bring.<sup>7</sup> Many economists, however, are skeptical of the effectiveness of a tax cut as a short-run, counter-cyclical economic stimulus compared to monetary policy. There are several reasons. First, there are considerable time lags between the time the need for a stimulus is recognized and the time a tax cut has its stimulative effect. Thus, economic conditions may have changed by the time a tax cut's effects begin to take hold. Second, some economists believe that adjustments occur in private markets that counter and offset the effects of government taxing and spending policy.<sup>8</sup> And finally, the increasing openness of the U.S. economy means that international adjustments may well reduce the stimulative effect of fiscal policy.

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<sup>6</sup> These views are presented in the official Bush campaign website, as constituted on December 22, 2000 at [<http://www.georgewbush.com>].

<sup>7</sup> The testimony is posted on the Federal Reserve Board's website, at [<http://www.federalreserve.gov/boarddocs/testimony/2001/20010125/default.htm>].

<sup>8</sup> For a discussion of the tax cut as an economic stimulus, see CRS Report RL30839, *Income Tax Cuts, the Business Cycle, and Economic Growth: A Macroeconomic Analysis*, by Marc Labonte and Gail Makinen. For a recent economic analysis that emphasizes the role of time lags, see John B. Taylor, "Reassessing Discretionary Fiscal Policy," *Journal of Economic Perspectives*, vol. 14, Summer 2000, pp. 21-36. For a textbook discussion of time lags and the "new classical" view that markets offset government actions, see Joseph E. Stiglitz, *Economics of the Public Sector*, 2<sup>nd</sup> Ed. (New York: W.W. Norton, 1988), p. 679-83.

As well as short-run effects that may (or may not) impinge on the business cycle, tax cuts can affect long-run economic growth and economic efficiency, and Mr. Bush has argued for his plan partly on these grounds. The centerpiece of the tax cut — the reduction in marginal tax rates — is indeed likely to improve economic efficiency, on balance. According to economic theory, taxes are more economically efficient the less they distort economic decisions and behavior. And the lower are marginal tax rates, the less distorting taxes are, other factors remaining constant.

The plan's impact on long-run growth is less certain. It depends heavily on the tax-rate cut's impact on labor supply and saving. By itself, economic theory provides no clear answer on whether either labor supply or saving respond to tax cuts — in general, people may save or work less in response to a tax cut because their aftertax income has increased and they need to work (or save) less to purchase desired items, or they may save or work more because the aftertax return to saving (or working) has increased. It therefore falls to empirical evidence to indicate the impact of taxes; while results of studies vary, most suggest the impact of taxes on work and saving is small. Further, a tax cut that reduces the federal budget surplus would reduce government saving and, as a result, aggregate national saving, which may reduce economic growth.<sup>9</sup>

Another prominent issue in the current debate concerns the tax cut proposal's equity. The plan's critics (including many Democrats) have argued that the specific form of the President's tax cut is unfair, and favors high-income individuals.<sup>10</sup>

Another issue in the tax-cut debate has been its impact on the budget. President Bush has stated that his tax cut plan will not endanger the fiscal soundness of the Social Security and Medicare programs. Indeed, the anticipated revenue loss from the tax plan absorbs less than the expected off-budget surplus (i.e., the surplus in the Social Security trust fund). At the same time, however, critics have argued that the surpluses are uncertain, and even if they materialize the proposed tax cut would absorb much of the on-budget surplus, leading to cuts in government programs.<sup>11</sup> They further state that a tax cut that reduces the projected budget surpluses would likely advance the future point in time at which Social Security and Medicare payments to retiring "baby boomers" pull the federal budget back into deficit.

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<sup>9</sup> For discussions of the impact of taxes on labor supply and saving, respectively, see: James P. Zeliak, "Labor Supply and Taxes," and Douglas Berheim and John Karl Scholz, "Savings and Taxes" in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (Washington: The Urban Institute, 1999).

<sup>10</sup> For a discussion of the plan's equity issue, see CRS Report RL30779, *Across-the-Board Tax Cuts: Economic Issues*, by Jane G. Gravelle, and also Martin A. Sullivan, "'Dubya's', Tax Plan: Realistic, Yes; Progressive, No," *Tax Notes*, Dec. 20, 1999, p. 1491.

<sup>11</sup> William Gale, "All Tax Cuts Are Not Created Equal," *Los Angeles Times*, Jan. 29, 2001. This article is posted at the Brookings website, at [<http://www.brook.edu/views/op%2Ded/gale/20010129%5Fresponse.htm>].