

# Issue Brief for Congress

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## Major Tax Issues in the 107<sup>th</sup> Congress

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## Major Tax Issues in the 107<sup>th</sup> Congress

### SUMMARY

Tax cuts were one of the principal issues Congress addressed during 2001 and the first half of 2002. The debate during early 2001 centered on whether part of the budget surpluses that were projected at the time should be returned to taxpayers as a tax cut, and whether the particular cuts that were actively considered favored upper-income individuals. In May, Congress passed a \$1.35 trillion 10-year tax cut, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA; P.L. 107-16). The Act contained:

- ! reduced individual income tax rates,
- ! phase-out of the estate tax;
- ! tax cuts for married couples;
- ! a larger per-child tax credit;
- ! education tax benefits; and
- ! tax cuts for Individual Retirement Accounts and pensions.

Most of the Act's tax cuts are scheduled to be "phased in" over periods of up to 10 years. The Act also contains language terminating ("sunsetting") all of its cuts after 2010.

Several developments altered the tax-policy debate in late 2001, including a recession and a change in budget projections, showing budget deficits rather than surpluses anticipated for the next several years. The attacks of September 2001 also changed the context of the tax and budget debate. In this setting, at the end of 2001 policymakers began debating additional tax cuts, with supporters arguing the need for an economic stimulus and skeptics questioning their possible budgetary and distributional impact.

In October, the House approved H.R. 3090, a bill containing tax cuts for both individuals and businesses. In the Senate, the

Finance Committee approved a smaller tax cut measure. The Finance bill was not taken up by the full Senate, and H.R. 3090 was not approved by the full Senate. In December, the House approved H.R. 3529, a scaled-down version of its earlier bill. The Senate did not approve the bill before the end of the year.

Congress returned to consideration of tax cuts in February, 2002, when the House approved H.R. 622, containing much the same tax cuts it approved in December. The Senate did not approve the measure. Instead, the House and Senate in March approved a scaled-back stimulus package as an amended version of H.R. 3090. The bill contained a temporary 3-year expensing benefit for business, more favorable treatment of business losses, tax incentives to develop areas damaged by terrorism, and extension of a set of temporary tax benefits. President Bush signed the bill on March 9 (P.L. 107-147).

Debate on tax policy continued in Congress throughout 2002, including, for example, the question of whether the tax cuts enacted in 2001 should be made permanent and not allowed to expire after 2010. Also, several international tax issues drew congressional attention in 2002, including the U.S.-European dispute over the U.S. extraterritorial tax (ETI) benefit for exporters – a provision that European nations have complained violates World Trade Organization (WTO) strictures against export subsidies. Another international tax issue was whether legislation should be adopted to curb corporate "inversions," where the parent of a U.S. corporate group reorganizes in a tax haven in order to save U.S. tax. However, Congress adjourned for the year without passing additional substantial tax legislation.

## MOST RECENT DEVELOPMENTS

*During the first part of 2001, the focus of tax policymakers in Congress was on President Bush's proposal for an omnibus tax cut. A bill containing provisions similar to the President's proposal passed both houses of Congress on in May; it became P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001. In late 2001, the House passed several additional tax cut bills, but the legislation was not approved by the Senate. Instead, in March 2002, Congress passed a scaled-down version of tax cuts initially approved by the House as H.R. 3090; the Act became P.L. 107-147. During the spring of 2002, the House passed several bills aimed at repealing the sunset provisions of the 2001 tax cut, but the bills were not approved by the Senate. Congress adjourned for the year without passing additional major tax legislation.*

## BACKGROUND AND ANALYSIS

### The Economic Context

#### The State of the Economy<sup>1</sup>

At times in the past, tax cuts have been employed as a fiscal stimulus — that is, as a means of boosting economic activity so as to revive a sluggish economy. For example, the tax cut enacted by the Revenue Act of 1964 is thought by many to have boosted economic growth and reduced unemployment. By the outset of 2001, however, the U.S. economy had recorded over nine consecutive years of continuous expansion. Tax policy has therefore not been called upon in recent years as a tool to address an economic downturn. Moreover, economists have increasingly come to regard fiscal policy as a less effective tool than monetary policy for addressing economic cycles because of time lags and adjustments in the international economy.

However, in late 2000, the economy began to show signs of weakness, and fiscal stimulus was one of the arguments the Bush Administration advanced in support of the large tax cut that was enacted in June 2001. Although the Congressional Budget Office reported in August that economic growth had reached a standstill, shrinking budget surpluses led the Administration to cast doubt on the possibility of further stimulative tax cuts.

The terrorist attacks of September 11 led policymakers to revisit the idea of a tax cut for economic stimulus, and in November, the National Bureau of Economic Research determined the economy had been in recession since March. The idea of tax cuts for fiscal stimulus was debated during the closing months of 2001 and the first months of 2002. In October 2001, the House approved H.R. 3090, a bill cutting both business and individual taxes. However, the Senate did not Act on the measure, and the House approved a smaller tax cut in December and again in February 2002. In March, the House and Senate approved a scaled-back version of the tax cut; it became P.L. 107-147.

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<sup>1</sup> Authored by David Brumbaugh, Specialist in Public Finance, Government and Finance Division.

The economy contracted in each of the first three quarters of 2001 but resumed positive growth in the fourth quarter of 2001 and has continued to grow since then. Nonetheless, some observers believe a number of factors continue to exert a drag on economic growth – including revelations of corporate malfeasance, poor stock market performance, and greater geopolitical risks. As a consequence, the merits of a tax cut for economic stimulus continued to be debated at the end of 2002.

For further information, see the section below entitled: “Tax Cuts to Stimulate the Economy.” See also CRS Report RL30839, *Income Tax Cuts, the Business Cycle, and Economic Growth: A Macroeconomic Analysis*; CRS Report RL30329, *Current Economic Conditions and Selected Forecasts*; and CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*.

## **The Federal Budget**

After decades of continuous deficits, the federal budget moved into a state of surplus in fiscal years 1998 through 2001 – a development that was the result of both deliberate deficit-reducing policies and a long period of economic growth that helped boost tax receipts. At the outset of the 107<sup>th</sup> Congress in January 2001, the budget outlook was bright despite mounting evidence of an economic slowdown. The Congressional Budget Office (CBO) predicted large and growing budget surpluses for the next 10 years.

As the 107<sup>th</sup> Congress progressed, however, the budget picture changed markedly. The budget situation worsened with almost each successive budget report. In August 2001, CBO reduced its surplus projections as a result of the tax cut enacted in June of that year and as a result of economic weakness. In January 2002, CBO reduced its projected 10-year surpluses further and predicted that the federal budget would move into deficit in fiscal years 2002 and 2003 before returning to surplus. And in August, CBO again revised its projections downwards, predicting deficits in fiscal years 2002 - 2005, and reducing estimates of surpluses in the out years. The changed projections were the result of enacted legislation, changed economic conditions, and technical changes.

## **The Federal Tax Burden<sup>2</sup>**

In recent years, some have pointed to the relatively high aggregate level of federal taxes compared to the economy as evidence of the desirability of a tax cut. As a percentage of GDP, federal taxes were at their highest level since the end of World War II in FY2000, at 20.8%, before falling to 19.6% in FY2001. This level is not a dramatic departure from the past; since the mid 1950s, federal taxes as a percentage of GDP have remained within a range of between 17% and just below 20% of GDP. Growth in the economy combined with, to a lesser extent, federal legislation to reduce the budget deficit (tax increases in 1990 and 1993) have produced the increase in federal revenues as a percentage of GDP over the last several years.

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<sup>2</sup> Authored by Gregg A. Esenwein, Specialist in Public Finance, Government and Finance Division.

Although there have been some fluctuations in the distribution of the federal tax burden over the last 20 years, the fluctuations have been concentrated at the ends of the income spectrum. During the 1980s the federal tax burden increased for lower-income families and decreased for upper income families. This trend was reversed in the 1990s with tax reductions at the lower end of the income spectrum and tax increases at the upper end of the income spectrum. Families in the middle income brackets, however, experienced very little change in their federal tax burdens over this period, despite legislated tax cuts. Some of the benefits of the tax changes contained in the tax cut enacted with the 1997 Taxpayer Relief Act did not necessarily accrue to middle-income families. The \$500 child tax credit likely reduced federal taxes for middle income families, but only those families with qualifying children. The benefits of reductions in the tax on capital gains, expanded IRAs, and other savings and investment incentives tended to accrue to families at the upper end of the income spectrum.

For further information, see CRS Report RS20059, *The Federal Tax Burden*, and CRS Report RS20087, *The Level of Taxes in the United States, 1940-2000*.

## Possible Tax Issues in 2003

A glimpse of possible tax issues in the 108<sup>th</sup> Congress is provided by a number of issues Congress addressed in 2002 but did not resolve. Among the most prominent of these is the scheduled expiration at the end of 2010 of the tax cuts enacted by the 2001 tax cut bill (EGTRRA). In order to comply with Senate procedural rules for budget legislation (the “Byrd rule”) EGTRRA contained language providing that all its tax cuts no longer apply after 2010. The House passed a number of bills in 2002 that would have made EGTRRA’s tax cuts permanent; experts suggest that it appears likely that the 108<sup>th</sup> will return to the question of whether to rescind the scheduled expiration of some or all of the tax cuts.

Congress may also consider a tax cut designed to stimulate the economy, and President Bush has indicated that he will likely propose an economic stimulus package that includes a tax cut. However, the precise nature of the tax cuts that will be considered is not clear. The shape of the stimulus bills that were passed by the House in the 107<sup>th</sup> Congress but that were not enacted may suggest some of the measures that will be considered. Some of the more prominent of these provisions were an acceleration of the scheduled phase-in of individual income tax reductions enacted with EGTRRA and reduction or repeal of the corporate alternative minimum tax.

Possible congressional tax topics may also be among the tax proposals advanced by participants in President Bush’s economic forum of August 2002. Among the proposals were a suggestion to increase the limitation on capital loss deductions, a proposal to reduce or eliminate the double taxation of dividends by adopting a form of “tax integration,” and a call for increased contribution limits for tax-favored retirement plans such as 401(k)s.

Congress may also consider a number of time-sensitive tax issues. In the near term is the dispute between the United States and the European Union (EU) over the U.S. tax code’s extraterritorial income (ETI) tax benefit for exporting, which the EU has complained violates international agreements prohibiting export subsidies. World Trade Organization (WTO) panels have repeatedly ruled against ETI and have granted the EU the authority to impose

retaliatory tariffs on U.S. products. However, EU officials have stated they will not impose tariffs as long as the United States is seen to be making progress on bringing its tax laws into compliance. Another time-sensitive issue is that of the alternative minimum tax (AMT) for individuals. The AMT rules provide an exemption amount that is not indexed for inflation. Unless it is modified by legislation, this feature of the tax, along with the recent enactment of tax cuts under the regular income tax, may press increasing numbers of taxpayers into AMT status in coming years.

## **Tax Cut and Economic Stimulus Proposals**

### **The House Bill of October 2001**

Following the terrorist attacks of September 11, 2001, policymakers in the Administration and Congress began deliberating the advisability of an economic stimulus package that would include tax cuts. On October 12, the House Committee on Ways and Means approved H.R. 3090, the Economic Security and Recovery Act of 2001. The full House approved the measure on October 24. In broad terms, the bill proposed to reduce taxes by an estimated \$99.5 billion in its first year (FY2002) and by an estimated \$159.4 billion over 10 years. Measured against the Congressional Budget Office (CBO) projections, the bill would reduce revenue by 4.7% in FY2002. Substantial parts of the bill, however, cut taxes by shifting the timing of tax collections from the present towards the future, thus reducing the bill's 10-year cost to 0.6% of expected revenue.

In contrast to the tax cut Congress passed in June, a substantial part of H.R. 3090 consisted of business tax cuts. The principal business provisions were:

- ! an "expensing" allowance for business equipment that would permit firms to deduct 30% of the cost of new investment in the year it is placed in service. The provision would expire after 2003;
- ! an increase for two years in the amount of equipment that can be entirely expensed from current law's \$24,000. (Under current law, the limit is scheduled to increase to \$25,000 for 2003 and thereafter.)
- ! repeal of the corporate alternative minimum tax (AMT). Under current law, firms pay either their regular tax or AMT, whichever is greater. The bill would also make AMT credits refundable. (AMT credits are a mechanism for reconciling timing differences between the regular tax and AMT);
- ! extension of the net operating loss (NOL) carryback period to 5 years from current law's 2-year period. The provision would expire after 3 years. (Net operating loss carrybacks allow firms to deduct losses in the current year from taxable income (if any) earned in past years, and can therefore produce a tax refund); and
- ! permanent extension of the foreign "active financing" exception to subpart F, thereby allowing U.S. firms' active financing income to benefit from the deferral tax benefit available to other foreign active business income.

The principal tax cuts for individuals were:

- ! a tax rebate for individuals who did not receive the maximum \$300 or \$600 rate reduction tax-credit check under the June, 2001 tax cut bill (not including dependents). The rebate would equal the difference between \$300 (for singles) or \$600 (for couples) and the tax-credit check already received;
- ! acceleration of the reduction of prior law's 28% tax rate. The 2001 tax cut bill reduced the 28% rate to 25% gradually, over the period 2001–2006. The proposal would implement the full reduction in 2002; and
- ! reduction of the capital gains tax rate from current law's 10% and 20% to 8% and 18%. (Under current law, property must be held for at least 5 years to qualify for the 8% and 18% rates. The bill made the rates available to all capital gains property held for one year or longer.)

In addition to these tax cuts, the bill extended for 2 years a set of temporary tax benefits scheduled to expire in 2001, including: the provision allowing nonrefundable personal credits to offset an individual's AMT; the work opportunity tax credit; the welfare to work tax credit; the tax credit for certain electricity production; percentage depletion for marginal oil and gas wells; authority to issue qualified zone academy bonds; the increased cover-over of excise tax to Puerto Rico and the U.S. Virgin Islands; and several other temporary provisions.

The House-passed bill contained a provision distributing \$9 billion to State unemployment compensation accounts.

## **The Senate Finance Committee Bill**

On November 8, the Senate Finance Committee approved a tax cut bill as an amended version of H.R. 3090. The Committee tax-cut proposal was smaller than the House version of H.R. 3090: it would have reduced taxes by an estimated \$66.4 billion in its first year, approximately two-thirds the size of the estimated revenue reduction in the House bill's first year.

One large item in the Committee bill was a tax rebate for persons who either received no rate-reduction tax credit check under the June, 2001 tax act or who received a reduced credit. The amount of the credit would generally be the maximum amount allowed for their filing status – \$600 for joint returns, \$500 for heads of households, \$300 for singles – minus the tax credit check already received under the June act.

The bill contained a number of business investment provisions, although they were smaller in size than those in the House bill. The Committee proposal permitted firms to "expense" (deduct immediately) 10% of the cost of new equipment rather than 30%, as in the House bill. The Finance Committee plan also increased the amount of equipment permitted to be entirely expensed to \$35,000. This provision was the same as that of the House bill but would only apply for one year rather than 2, as in the House bill. And as in the House bill, the Committee proposal extended the net operating loss carryback period to 5 years, although the Finance Committee proposal expired after one year rather than the House bill's 3 years. The Finance Committee plan did not repeal the corporate AMT as the House bill would.



Other components of the Finance Committee proposal included a one-year extension of various temporary tax benefits scheduled to expire under current law at the end of 2001. Prominent examples are the use of personal tax credits to offset the individual AMT, the work opportunity tax credit (WOTC), the welfare-to-work tax credit, and the foreign “active financing” exception to subpart F. The bill also contained several tax benefits aimed at New York City and economically distressed areas, including extension of the work opportunity tax credit to certain employees in New York and authorization of tax-exempt private-activity bonds for rebuilding the damage incurred in the September 11 attack.

Several of the largest items in the Finance Committee bill were not tax provisions. These included a 75% subsidy of health insurance premiums for displaced workers that would extend through 2002. A second non-tax proposal was the extension for 13 weeks of unemployment benefits.

## **H.R. 3529**

On December 20, the House passed a modified version of the economic stimulus package it had passed earlier as H.R. 3090. H.R. 3529 contained the same combination of tax cuts for individuals and businesses as H.R. 3090, but with a few changes: it left out the first proposal’s repeal of the corporate alternative minimum tax (AMT), although it reduced the AMT significantly by removing the AMT’s depreciation adjustment. H.R. 3529 also dropped several of H.R. 3090’s capital gains cuts and extended the active financing exception to Subpart F for 5 years rather than making it permanent. The bill’s reduction in tax revenues was estimated at \$89.8 billion in its first year and \$156.8 billion over 10 years. Although the modified package thus contained a tax cut that somewhat smaller than that of H.R. 3090, it also contained a 13-week extension of unemployment benefits and a tax credit for the purchase of health insurance by unemployed workers.

## **H.R. 622 in the Senate**

On January 23, 2002, Senator Daschle introduced a stimulus package containing several tax cuts. The proposal was made as an amendment (S.Amdt. 2698) to H.R. 622, a House-passed bill relating to adoption. Although revenue estimates are not available for the proposal, its tax cuts appear to be more modest in scope than those in either the October House bill or H.R. 3529. The tax cuts proposed in the amendment included an expensing allowance (i.e., first year deduction) for 30% of business equipment investment that would expire after one year and a tax payment to individuals who either received no payment under the 2001 Economic Growth and Tax Relief Reconciliation Act tax cut or who received less than the maximum allowable payment. The amendment also contained two non-tax proposals: a 13-week extension of unemployment benefits and an increase in Medicaid payments to the states. The tax proposals were not adopted by the Senate.

## **H.R. 622 in the House**

On February 14, the House passed its third economic stimulus package since the Fall of 2001 as a modified version of H.R. 622. The bill’s tax provisions are essentially those of H.R. 3529 and are similar to the stimulus elements of President Bush’s budget proposal. Like H.R. 3529, the bill also contains an extension of unemployment benefits. On the same

day, the Senate passed an amended version of H.R. 3090, containing no tax provisions and only an extension of unemployment benefits.

### **The March 2002 Stimulus Package (H.R. 3090; P.L. 107-147)**

On March 7, the House approved a scaled-back version of H.R. 3090, the Job Creation and Worker Assistance Act of 2002. The Senate approved the measure on March 8, and the President signed the bill on March 9. The bill is estimated to reduce revenue by \$51 billion in FY2002 and by \$94 billion over its first 5 years. Its principal elements are an expensing benefit for business investment that expires after 3 years; more favorable treatment of business losses (as measured by the tax code; so called “net operating losses”); a package of tax incentives designed to stimulate development in areas subject to terrorist attacks; extension of a set of temporary tax benefits; and a 13-week extension of unemployment benefits.

### **Legislation in 2001: The Economic Growth and Tax Relief Reconciliation Act (H.R. 1836; P.L. 107-16)<sup>3</sup>**

On February 8, 2001, President Bush sent the outlines of a tax plan to Congress that was the same in its essentials to the tax proposal he advanced during the presidential campaign. The plan was included, with several additions, in the budget the President announced on April 9. According to Administration estimates, the tax cuts would reduce revenue by \$1.6 trillion over 10 years. In the House, tax cuts similar to the President’s proposals were passed in March, April, and early May as components of several different bills: H.R. 3, H.R. 6, H.R. 8, and H.R. 10. The Senate passed a somewhat different tax cut plan on May 23 as an amended version of H.R. 1836. On May 26, the House and Senate both approved a conference agreement on the bill, entitled the Economic Growth and Tax Relief Reconciliation Act of 2001. Although the congressional bill contained some differences from the President’s plan, the President signed the measure on June 7; it became P.L. 107-16.

Timing is an important element of P.L. 107-16 in several ways. First, many of the Act’s most important provisions are “phased in”; that is, they become fully effective only gradually, over a number of years. Second, several of the Act’s provisions are retroactive, applying to tax year 2001, part of which has already occurred. Finally, the Act’s tax cuts generally “sunset” or expire after 2010. The provision was included because of Senate procedural rules on budget reconciliation. In April 2002 and again in June, the House passed legislation that would make the bill’s provisions permanent.

Following the budget resolution Congress passed in early May (H.Con.Res. 83), P.L. 107-16 as enacted was expected to reduce taxes by an estimated \$1.35 trillion over the period 2001-2011. As with the President’s plan, the Act’s centerpiece is a **reduction in the individual income tax rates** that apply to taxable income. Prior to the Act, the tax code’s rates were 15%, 28%, 31%, 36%, and 39.6%; the Act reduces these to 10%, 15%, 25%, 31%, and 35%. These reductions are generally somewhat smaller than those called for by the

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<sup>3</sup> Authored by David Brumbaugh, Specialist in Public Finance, Government and Finance Division.

President or as proposed in the House-passed tax cut contained in H.R. 3. Nonetheless, by the time they are fully effective, the rate cuts will account for about one-fourth of the annual reduction in tax revenue expected to result from the Act. In addition, the Act eliminates the overall limit on itemized deductions and phases out the tax code's restriction on personal exemptions.

The rate reductions are phased in and will not be fully effective until 2006. At the same time, the Act's application of a 10% rate to the lowest part of the lowest bracket is retroactive to January 1, 2001 — a provision designed to provide an economic stimulus. Beginning in July, the Treasury Department issued checks based on the rate reduction. (Since the retroactive rate reduction is to the lowest bracket, individuals paying taxes at all marginal rates receive its benefit.)

The Act increases the tax code's **per-child tax credit** from current law's \$500 to a new level of \$1,000, phased in over the period 2001-2010. Also, under current law, the child tax credit is refundable only for families with three or more children. The Act extends refundability to smaller families, subject to certain limitations. The Act also provides that the refundable child credit will not be reduced by a taxpayer's alternative minimum tax (AMT), and that the credit will offset both a taxpayer's AMT and regular tax.

P.L. 107-16 provides **tax reductions for married couples**. Under current law, certain structural features of the income tax result in a married couple paying either more or less in tax than they would as two singles. Because of these features, couples are said to receive either a "marriage penalty" or a "marriage bonus." A couple is likely to incur a marriage penalty if each spouse has an income and the incomes are similar in size; couples are likely to receive a marriage bonus if their incomes are markedly different. Features of the tax code that lead to marriage penalties and bonuses include a standard deduction for couples that is larger than for a single filer but that is not twice that of singles, and tax brackets for couples that are wider than for single filers but not twice as wide. In addition, provisions such as the earned income tax credit (EITC) that "phase out" above certain income levels can result in a marriage penalty.

The Act changes the standard deduction, the income bracket to which the 15% tax rate applies, and the EITC. The new law increases the standard deduction for married couples to twice that of a single filer over the period 2005-2009. The Act widens the 15% tax-rate bracket for married couples so that it is twice as wide as the 15% bracket for a single filer. Again, this provision is phased in over five years, becoming fully effective in 2009. For the EITC, the Act gradually increases by \$3,000 over 2002-2007 the beginning and ending income levels of the credit's phase-out range. The measure also makes several other simplifying changes in the EITC rules.

The Act **phases out the federal estate tax** over the period 2002-2010. The phase-out consists of a gradual reduction in estate tax rates over the phase-out period, as well as an increase in the effective exemption delivered by the estate and gift tax unified credit. The effective exemption is increased to \$1 million in 2002 and to \$3.5 million by 2009. The federal credit for state death taxes is gradually repealed by the Act. The gift tax is retained at the top income tax rate of 35% that is applicable under the Act.

An additional provision of the enacted measure is its treatment of the basis of bequeathed assets. Generally, when a taxpayer sells an asset, he is taxed on the sales proceeds but is permitted to deduct his “basis” in the asset from the sales proceeds. Frequently, an asset’s basis is its purchase price. Bequeathed assets, however, are permitted a “step up” in basis — their basis becomes their fair market value at the time of the decedent’s death. As a result, if and when a beneficiary sells an inherited asset, he is not taxed on any appreciation that occurred during the lifetime of the decedent. The Act replaces current law’s step-up in basis with a more limited regime. In general, a beneficiary’s basis in an inherited asset is the basis that existed in the hands of the decedent — the asset’s basis is “carried over.” However, the new law also permits estates’ executors to increase the carried over basis of transferred assets by a total of \$1.3 million, plus an additional \$3 million in the case of assets transferred to surviving spouses.

P.L. 107-16 contains a number of **tax benefits for education**. The Act increases the annual contribution limit for education individual retirement accounts (IRAs) from current law’s \$500 to \$2,000. It also expands the range of qualified education expenses that can be funded by tax-free withdrawals to include elementary and secondary school expenses. The new law applies more generous rules to tax-favored tuition savings plans: it permits qualified private institutions to offer tuition plans, and applies tax-free treatment to distributions from qualified plans. The tax exclusion for employer-provided education assistance is permanently extended under the bill for both undergraduate and graduate courses. In the case of student loan interest, the Act repeals the 60-month limitation on the deductibility of interest and increases the income phase-out ranges. The measure also allows an “above the line” deduction (i.e., a deduction that can be claimed without itemizing deductions) for qualified education expenses, but restricts the deduction to 2002-2005. For tax-exempt bonds, the Act increases the arbitrage exception applicable to bonds financing school construction. It also expands the range of private activities for which tax-exempt bonds can be issued to include elementary and secondary public schools owned by qualified private corporations.

P.L. 107-16 contains a variety of **tax cuts for IRAs and pensions**. For both Roth and traditional IRAs, the Act gradually increases the annual contribution limitation to \$5,000 and indexes the limit for inflation thereafter. For pensions, the Act contains provisions designed to expand coverage by increasing contribution and benefit limits for qualified plans and by increasing elective deferral limits. The new law also contains provisions designed to enhance pension benefits for women, to increase plan portability, to strengthen pension security and enforcement, and to reduce regulatory burdens.

The Act provides a temporary reduction in the individual **alternative minimum tax** by increasing its exemption by \$2,000 in the case of single returns and \$4,000 for joint returns for the years 2001 through 2004. The exemptions under prior law were \$33,750 and \$45,000, respectively.

Other provisions of the Act include:

- ! more generous rules for the **adoption tax credit**, including an increase in the expense limit to \$10,000 for both non-special needs and special needs adoptions;
- ! provision of a 25% tax credit for **employer-provided child care**; and

- ! an increase in the **dependent care tax credit** rate to 35%, along with an increase in eligible expenses to \$3,000 for one child and \$6,000 for two or more children. The Act also increases the income threshold at which the credit's rate is reduced to \$15,000 from \$10,000.

For further information, see CRS Report RL30973, *Tax Cuts: Description, Analysis, and Background*.

## A Closer Look at Selected Issues

### Tax Cuts to Stimulate the Economy<sup>4</sup>

As noted above, President Bush supported a tax cut in early 2001 because the economy was beginning to show signs of slowing down. Since then, additional tax cuts have been proposed by some as a means to stimulate the sluggish economy; the modest tax cut enacted in March 2002 was partly designed as a fiscal stimulus. Regardless of the implications of tax levels and structure for equity, fairness, intergenerational debt burden, and the role and size of government, any tax reduction will affect the macroeconomy.

Tax cuts have distinct short run and long run effects. Often, they are at odds with each other. In the short run, tax cuts that are funded through a reduced surplus increase aggregate demand and influence the business cycle if they are spent. If the economy is in recession, then the tax cuts are likely to raise growth in the short run. If the economy is operating at full capacity, the boost in aggregate demand will quickly be dissipated through higher interest rates, inflation, and a larger trade deficit. If a tax cut is meant to prevent a recession by providing a short-term stimulus, its efficacy should be judged by how much spending (or dissaving) it generates.

The efficacy of a tax cut that is meant to boost long-run growth should be judged by how much additional work, net saving, and investment it generates. Empirical estimates as to how much of a behavioral response can be expected when taxes are cut are inconclusive. These effects are likely to be negligible in the short run if the economy is in a recession. If the tax cuts are funded through a reduced surplus (i.e., less government saving), this will have a negative effect on national saving, reducing long-run growth. The extent that national saving falls is determined by how much new private saving offsets the fall in government saving.

Since saving is the opposite of spending, it is difficult to craft a tax cut that can boost growth in both the short run and long run. If tax cuts to individuals (e.g., payroll or income tax reductions) are spent to end a recession, then long-run growth will suffer because of the reduction in national saving. Tax cuts aimed towards higher saving (e.g., a reduction in the capital gains tax) are unlikely to prevent a recession because they will generate little additional short-run spending. Reductions in business taxes (e.g., reduction in corporate tax rates, an investment tax credit) could boost both short-run spending and long-run growth

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<sup>4</sup> Authored by Marc Labonte, Economist, and Gail Makinen, Specialist in Economic Policy, Government and Finance Division.

through higher investment. There is uncertainty, however, as to how great a short-run investment response could be expected in a recession and whether the tax cut would generate enough private saving to offset the decline in public saving.

Theory suggests, and arguably the past two decades demonstrate, that monetary policy is a more effective tool for ironing out the ebb and flow of the business cycle because of exchange rate effects and because it can be implemented more quickly. Most historical recessions have ended without the use of fiscal policy. At present, political inhibitions concerning a sustained return to budget deficits may prevent a tax cut from being large enough to boost aggregate demand significantly. Moreover, with the expansionary policies already in place, questions have been raised about the need for further tax cuts to stimulate aggregate demand.

For further information, see CRS Report RL30839, *Tax Cuts, the Business Cycle, and Economic Growth: A Macroeconomic Analysis*; CRS Report RL30329, *Current Economic Conditions and Selected Forecasts*; CRS Report RL31134, *Using Business Tax Cuts to Stimulate the Economy*, and CRS Report RS21014, *Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts*.

## Capital Gains<sup>5</sup>

Since the enactment of the individual income tax in 1913, the appropriate taxation of capital gains income has been a perennial topic of debate in Congress. Capital gains income is often discussed as if it were somehow different from other forms of income. Yet, for purposes of income taxation, capital gains income is essentially no different from any other form of income from capital, such as interest or dividend income. A capital gain or loss is the result of a sale or exchange of a capital asset. If the asset is sold for a higher price than its acquisition price, then the transaction produces a capital gain. If an asset is sold for a lower price than its acquisition price, then the transaction produces a capital loss.

Current law's treatment of capital gains differs from what would occur under a theoretically pure income tax. A tax consistent with a theoretically appropriate measure of income would be assessed on real (inflation-adjusted) income when that income accrues to the taxpayer. Conversely, real losses would be deducted as they accrue to the taxpayer. In addition, economic theory indicates that any untaxed real appreciation in the value of capital assets given as gifts or bequests should be subject to tax at the time of transfer. Under the current income tax, however, nominal (non-inflation adjusted) capital gains income is taxed when it is realized (sold or exchanged) by the taxpayer. Capital losses (within certain limits) are also deducted on a nominal basis when they are realized by the taxpayer.

Under current law, capital assets are separated into four categories. Assets that have been held for 12 months or less are considered short-term assets. Assets that have been held longer than 12 months are considered long-term assets. Collectibles (art work, antiques, coins, stamps, etc.) are the third category of assets and the fourth category of capital gains assets includes the portion of gain attributable to previously taken depreciation deductions on section 1250 property (depreciable real estate). Short-term capital gains are taxed at

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<sup>5</sup> Authored by Gregg Esenwein, Specialist in Public Finance, Government and Finance Division.

regular income tax rates. Long-term capital gains are taxed at a maximum tax rate of 20%. The tax rate is 10% for long-term gains that would have been taxed at a 15% regular tax rate. Collectibles held longer than 12 months are taxed at 28%. The un-recaptured section 1250 gain attributable to depreciation deductions is taxed at a maximum tax rate of 25%.

Effective for taxable years beginning in 2001, assets that have been held for at least 5 years and would have been taxed at a 10% tax rate will be taxed at an 8% tax rate. For assets that are held more than 5 years and whose holding period begins after December 31, 2000, the maximum tax rate will be 18% rather than 20%. Net capital losses are deductible against up to \$3,000 of ordinary income, that is, non-capital gain income. Any portion of the net loss in excess of the \$3,000 limit can be carried forward and used to offset gains in succeeding tax years. Excess net losses can be carried forward indefinitely and without limit on the amount of losses that can be carried forward.

Under current law, taxpayers are allowed to exclude from taxable income up to \$500,000 (\$250,000 in the case of single returns) of the gain from the sale of their principal residences. To qualify the taxpayer must have owned and occupied the residence for at least two of the previous 5 years prior to the date of sale.

For further information, see CRS Report 98-473, *Individual Capital Gains Income: Legislative History*; CRS Report 96-769, *Capital Gains Taxes: An Overview*; and CRS Report RL30040, *Capital Gains Taxes, Innovation and Growth*.

## **Tax Treatment of Saving <sup>6</sup>**

The appropriate tax treatment of saving has been one of the most prominent tax policy debates in recent decades. It incorporates such topics as individual retirement accounts (IRAs), capital gains taxes, investment incentives, and corporate income taxes, to name a few. The issue of savings has links to both economic performance and equity, which has helped make it controversial. An increased saving rate generally increases the country's capital stock, which in turn makes possible higher economic growth and a higher standard of living in the future. If tax incentives can boost saving, targeted tax cuts may thus be able to boost economic growth. On the other hand, income from investments is a higher proportion of income at higher income levels; tax benefits for saving — for example, IRAs and special rates for capital gains — thus reduce the progressivity of the tax system.

Economics suggests that the efficacy of tax incentives for saving depends heavily on how responsive individuals' savings rates are to changes in the rate of return to saving, after taxes. If individuals respond to tax incentives by increasing their saving, tax benefits may be an effective tool for increasing economic growth. On the other hand, if saving is unresponsive to targeted tax cuts, their efficacy for that purpose is questionable. Economic theory provides no clear answer on this issue and instead identifies two countervailing effects of tax incentives for saving. One effect (known as the substitution effect) leads individuals to save more because the after-tax rate of return has increased; a second effect (the income effect) works in the opposite direction, because a tax cut enables an individual to reach a given savings target with a lower savings rate.

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The ambiguity of economic theory in this area places an added burden of proof on empirical evidence, and there have indeed been a plentitude of statistical studies. But taken as a group, these studies too produce no clear answer; some find a positive and significant relationship between tax incentives and saving — that is, they find that targeted tax cuts increase saving. Other studies find no relationship, and still others find a negative relationship. Thus, the impact of taxes on saving is unproved. However, even if individuals were to respond positively to savings incentives, that does not necessarily mean incentives are good economic policy. First, what matters for economic growth is not simply private saving but national saving — that is, the private saving rate minus any government dissaving by means of a budget deficit. Thus, the effect of tax cuts for saving in reducing government tax revenue may at least partly offset any positive effect they may have on private saving. Second, even though increased saving produces higher standards of living in the future, from an economic perspective a tax-induced distortion that increases saving may not actually increase economic welfare. Absent market failures, economic theory suggests a tax is more efficient the less it changes behavior. And if saving is unresponsive to tax changes, it may be less damaging to economic welfare than alternative sources of tax revenue. Economic theory and evidence on the efficacy of savings incentives are ambiguous and conflicting.

Tax benefits for saving in the current tax code are numerous. Among the most prominent are Individual Retirement Account (IRAs), 401(k) retirement savings plans and other qualified employer-sponsored retirement plans, life insurance policies and annuities, qualified state tuition programs, and medical savings accounts (MSAs). In addition, the favorable tax treatment of owner-occupied housing can be thought of as a saving incentive, as can the reduced tax rates for capital gains under the individual income tax.

For further information, see CRS Report RL30255. *Individual Retirement Accounts (IRAs): Issues, Proposed Expansion and Universal Savings Accounts (USAs)*.

## **Fundamental Tax Reform Proposals (Including Flat Tax Plans)<sup>7</sup>**

The idea of replacing our current income tax system with a “flat-rate tax” was the focus of renewed congressional interest over the last several years. Although often referred to as “flat-rate taxes,” many of the recent proposals (introduced in the 105<sup>th</sup>, 106<sup>th</sup>, or 107<sup>th</sup> Congresses) go much further than merely adopting a flat-rate tax structure. Some involve significant income tax base-broadening while others entail changing the tax base from income to consumption. Most of the recent tax reform proposals (the Armey, Shelby, English, Specter, Tauzin, Linder, Souder, and Largent/Hutchinson plans) would change the tax base from income to consumption. Others are not consumption tax proposals. Representative Gephardt would keep income as the tax base but broaden the base and lower the tax rates. Representative Crane’s proposal would levy a tax on the earned income of each individual as a replacement for the current individual income tax, corporate income tax, and estate and gift taxes. Representative Snowbarger’s proposal would permit each taxpayer to choose between the current individual income tax return and an alternative individual tax return with a flat rate. Senator Dorgan’s proposal would allow most taxpayers to choose between the current individual tax system and his “shortcut” tax plan under which taxes withheld would equal the employee’s tax liability.

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The flat tax controversy focused on shifting from the present system, which is predominantly an income tax system, to a consumption tax system as a way to raise the savings rate, improve economic efficiency, and simplify the tax system. There is, however, no conclusive empirical evidence that a consumption tax will or will not increase the personal savings rate and consequently the level of national savings. Highly stylized life-cycle models show that a consumption tax would cause a substantial increase in the savings rate, but these models are controversial because of their idealized assumptions. To raise the same amount of tax revenue, a consumption-based tax would require higher marginal tax rates than would an income tax (since consumption is smaller than income). Distortions caused by these higher marginal rates could offset (or even exceed) other advantages of the consumption tax. Hence, whether an income tax system or a consumption tax system is more efficient is unknown.

Proponents of some flat tax proposals argue that integration of the current corporate and individual income taxes as well as simple returns would result from a consumption tax. The current income tax system is complex. The federal tax code and the federal tax regulations are lengthy and continue to expand. However, in tax year 1999, approximately 70% of individual taxpayers took the standard deduction, which made complexity less relevant. In comparison to the current income tax, a flat rate would do little to reduce complexity for most taxpayers who currently just look up their tax liability in a table, although it might reduce complexity for a significant minority. Finally, some argue that it is “unfair” to compare the current income tax system with an uncomplicated, “pure” consumption tax that could become complicated by the time it is enacted.

It has been argued that some flat tax proposals would reduce the balance-of-trade deficit since imports would be taxed but the tax would be rebatable on exports. Economic theory, however, suggests that border tax adjustments have no effect on the balance-of-trade because the balance-of-trade is a function of international capital flows; border tax adjustments would be offset by exchange rate adjustments.

The United States is the only developed country without a broad-based consumption tax at the national level. Other developed nations have adopted broad-based consumption taxes, but as adjuncts rather than as replacements for their income based taxes.

For further information, see CRS Issue Brief IB95060, *Flat Tax Proposals: An Overview*.