Deloitte & Touche

Seeds of Change

The 2001 Tax Cut

Several individuals merit recognition for their contributions to *Seeds of Change: The 2001 Tax Cut*. The Tax Policy Services Group of Deloitte & Touche in Washington, D.C., prepared this publication under the direction of Clint Stretch, Director of Tax Policy, and Pat Hennessy, Managing Partner, Washington National Tax. Bart Massey served as general coordinator for the publication.

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In looking back to all the time I have put in on this, and I think of my background as a farmer; you put the seed in the ground...and for the first period of time before it emerges above the ground, three-fourths of that growth that first month is below the ground. You don't see it unless you dig in there with your fingers and inspect it. And so Senator Baucus and I sowed that seed in January and that seed sprouted.

Senate Finance Committee Chairman Charles Grassley, R-Iowa, May 17, 2001, during Senate debate on Restoring Earnings to Lift Individuals and Empower Families Act of 2001

INTRODUCTION

Our ancestors, who lived in a closer and more immediately dependent relationship with nature, understood the cycles of plenty and of drought or famine in the world's affairs. Thus, great kings, troubled by dreams of famine consuming the rich harvest, called in their magicians and sages.

Today, we no longer depend on sorcerers and seers to interpret the dreams of our leaders as we plan for the future. Instead, we summon an army of economists, analysts, and central bankers to forecast and project. Yet, our leaders are no less troubled by their inability to know or control the future.

This is nowhere more true than in tax and budget policy. The Congressional Budget Office started projecting surpluses for this decade as early as September 1997, yet it has taken nearly four years, several substantial upward revisions of the forecast, and the election of a new president to bring about the tax cut that Congress adopted on May 26, 2001: The Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act).

The long journey to this year's tax cut reflects policymakers' difficulty in balancing several competing visions of the future and claims on the projected federal surplus. Many started the process expressing reservations about the surplus projections. To them, the budget drought represented by record deficits that hit in the 1980s was slow to end. In contrast, many others recognized the surpluses quickly and favored returning them to the taxpayers. Some saw the growing bounty, but wanted to repay the publicly held debt of the government and save for a future downturn. Still others saw an opportunity to invest in education, Medicare prescription drug coverage, and other initiatives.

Interestingly, we all tended to regard those who had different priorities as spendthrifts. Fear was expressed that tax revenues left in Washington would be squandered on new (wasteful) initiatives, that the opportunity to invest in the future would be squandered on tax cuts for the wealthy, or that the opportunity to pay down the public debt would be lost and our children's inheritance squandered.

President Bush campaigned on his vision of how to balance these competing concerns. From a projected $5.6 trillion surplus for the period 2002-2011, he asked Congress to preserve $2.6 trillion attributable to Social Security and to allocate $1.6 trillion of the remaining $3.0 trillion in projected surpluses for tax cuts and $0.6 trillion for other spending and increased interest costs. Bush's vision included a commitment to limit the growth of government spending to 4 percent for fiscal year 2002 and to the rate of inflation thereafter. The Act largely follows the president's tax recommendations, cutting taxes by $1.35 trillion through 2011. In so doing, it sows the seeds for dramatic changes in federal tax and budget policies for the foreseeable future.

These tax cuts are the largest since 1981. When their effect on the federal government's interest liabilities is considered, they commit over two-thirds of non-Social Security surpluses for the next 10 years. Little flexibility is left to Congress to exceed the spending limitations sought by the president or to address substantial new tax cut demands. Many such demands are already visible. Congress will have to find $50 billion to extend the research and experimentation (R&E) tax credit during this period, and several hundred billion dollars to ameliorate the problems with the individual alternative minimum tax discussed in Chapter 4 of this book. Moreover, congressional leaders are already working behind the scenes on $50 billion to $75 billion of small business tax cuts to ease the way for a minimum wage increase. For these tax cuts to materialize, the economy will need to generate sustained additional surpluses that are accompanied by spending discipline. The record of tax cuts and tax increases from 1981 to date appears in the Appendix. The record demonstrates that when deficits follow tax cuts, Congress can respond with repeated and substantial tax increases.

President Bush asked Congress to focus on a short list of essential tax reductions and to defer action on other tax changes until later in 2001 or next year. Congress responded by adopting a modified version of the president's core tax cut proposals, which include —

- Significant tax rate reductions;
- Lower taxes for married couples;

- A substantial increase in the child credit; and
- Repeal of the estate tax.

The individual income tax cuts are described in Chapter 1 and the estate tax relief in Chapter 2.

Congress did not adopt the president's request that it permanently extend the R&E tax credit, which expires in 2004, nor did it permit a deduction for charitable contributions by taxpayers who do not itemize their deductions.

In addition to adopting the largest of the president's tax cut proposals, Congress included a substantial number of new education incentives and a package of pension reforms that provides substantial increases in the limitations on contributions to IRAs, Roth IRAs, 401(k) plans, and other retirement savings vehicles. These changes are described in Chapter 3.

Many will be frustrated by the Act's long phase-in of tax cuts. The surpluses on which the current round of tax relief depends develop over time. Only about 30 percent of the projected non-Social Security surplus arises in the first five years of the budget-estimating period. As a result, Congress delayed significant portions of the tax cuts until later years. The chart following this introduction displays the phase-in of major provisions in the Act.

The Act also contains a provision terminating its tax cut provisions after December 31, 2010. This is an artifact of arcane federal budget rules; however, the provisions do have the effect of creating an enormous expiring provision issue to be addressed by later Congresses. We have drafted this book without regard to these sunset provisions because the current Congress clearly intends the changes made by the Act to be permanent.

The Act likely is not the last word on tax cuts by this Congress. As the tax cuts take effect, their impact on future spending and surpluses will begin to be felt and addressed. There remains a long agenda of unfinished tax business. The prospects for business tax relief and other actions are discussed in Chapter 5.

Overview of the Economic Growth and Tax Relief Reconciliation Act of 2001

Provision	Present Law	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Rates											
	39.6%	39.1%	38.6%		37.6%		**35% Fully Effective**				
	36.0%	35.5%	35.0%		34.0%		**33% Fully Effective**				
	31.0%	30.5%	30.0%		29.0%		**28% Fully Effective**				
	28.0%	27.5%	27.0%		26.0%		**25% Fully Effective**				
	15.0%	10% for First $6,000 of income for Singles and $12,000 for Married Couples Remaining portion of 15-Percent Bracket Unchanged							Raise Bracket Threshold to $7,000 and $14,000	**Index Thresholds for Inflation**	
Marriage Penalty Relief											
Standard Deduction		NO CHANGE				Gradually Increase Standard Deduction for Married Couples				**Twice Single Level Fully Effective**	
15-Percent Bracket		NO CHANGE				Gradually Increase 15-Percent Bracket for Married			**Twice Single Level Fully Effective**		
Child Credit	$500	$600				$700				$800	**$1,000 Fully Effective**
Personal Exemption Limitation Repeal		NO CHANGE					Phase-in Period				**Repeal**
IRA Limit	$2,000	NO CHANGE	$3,000			$4,000			$5,000	**Index $5,000 for Inflation**	
AMT Exemption	$33,750 Single $45,000 Married	$35,750 Single $49,000 Married				**$33,750 Single $45,000 Married**					
Estate Tax											
Top Rate	55%	NO CHANGE	50%	49%	48%	47%	46%	45%			**Repeal**
Exemption	$675,000	NO CHANGE	$1 million		$1.5 million		$2 million			$3.5 million	**Repeal**