

The 2001 Tax Bill

Almost a year and a half after it was proposed by then-candidate George W. Bush, a huge, back-loaded tax cut was passed by Congress in May. This issue of the CTJ newsletter provides an overview of the 2001 tax bill.

The Final Bush Tax Plan: An Overview of Round One

On June 7, President Bush signed into law a modified version of his tax cut proposal. If this plan takes full effect, it will undermine tax fairness, sharply increase income and wealth inequality, and bust the budget for years to come. Some 38 percent of the plan's tax cuts are targeted to the best-off 1.3 million of all taxpayers, while the 78 million individuals and families in the bottom three-fifths of the income scale will share less than 15 percent of the tax breaks. And despite pious claims about fiscal responsibility from feckless Senate "centrists," when fully in place, the final tax plan will cost 20 percent more than what Bush originally proposed.

But Bush's victory this year is only the first round in a long fight over the future of tax fairness and adequate public services. To keep the enormous tax cuts within the budget target, the plan is phased in fairly slowly, and its most regressive and expensive elements don't take effect until considerably later in this decade. So there will be plenty of opportunities for future Congresses and Presidents to reconsider the tax cuts enacted this year.

If the Congress to be elected in 2002 faces a budget crunch, it will be able to reconsider some of the tax cuts slated to take effect in 2004 and 2005. Among the most objectionable items taking effect in those years are a one-percentage-point cut in the top four tax rates, an increase in the estate tax exemption to \$1.5 million and a drop in the top estate tax rate to 47 percent.

Depending on who wins the national elections during the next presidential cycle, 2004 could usher in a whole new era for tax policy. Over the following four years, Congress and the president will have to decide whether to complete the Bush income-tax-rate reductions and whether to allow a further backdoor reduction in the highest rates by phasing out current law's disallowance of personal exemptions and a portion of itemized deductions at high income levels. Lawmakers may also reconsider the slated increase in the estate-tax exemption to \$3.5 million (\$7 million for couples) and the cut in the top estate-tax rate to 45 percent. Finally, the Congress and president elected in 2008 will face a big decision on the single most regressive item in the Bush tax plan: the scheduled repeal of the estate tax in 2010.

It's worth remembering that the ink was hardly dry on the 1981 Reagan tax cuts before Congress and even President Reagan began to have second thoughts. Bob Dole's big tax hike in 1982 took back about a third of the Reagan cuts, and further scale-backs followed regularly over the next dozen years. The process culminated in George H.W. Bush's tax boost in 1990 and Bill Clinton's tax increases on the rich in 1993, which laid the grounds for the current budget surpluses.

Don't be surprised if history repeats itself in the upcoming decade.

A Brief Overview of the 2000 Tax Bill

Income Tax Rate Reductions: The centerpiece of the 2001 tax bill is a reduction in each of the top federal income tax rates, and the creation of a new 10 percent tax rate for lower-income taxpayers. The original plan proposed by candidate Bush would have decreased the number of income tax brackets from five to four. The final tax bill actually *increases* the number of tax brackets from five to six. The following chart shows the brackets before and after the enacted plan at 2001 levels.

Taxable Income, Married Couples	2001 Law Before Tax Cut	Original Bush Plan	After Bush Tax Cut
\$0 to \$12,000	15%	10%	10%
\$12,000 to \$45,200		15%	15%
\$45,200 to \$109,250	28%	25%	25%
\$109,250 to \$166,500	31%		28%
\$166,500 to \$297,350	36%	33%	33%
Over \$297,350	39.6%		35%

Child Tax Credit Expansion: When it was enacted in the 1997 Tax Relief Act, the \$500 per-child credit was an important source of tax relief for families that qualified. Yet less than 60 percent of dependent children were eligible for even a partial credit in its first year: because the credit was mostly non-refundable (that is, it could only be used to offset federal income taxes), it was fully available only to relatively well-off taxpayers. The 2001 tax bill gradually increases the credit from \$500 to \$1000 per child under 17. Doubling the credit—as Bush proposed—will primarily benefit the relatively wealthy taxpayers who can take advantage of the full \$1,000 per child credit. Yet provisions added in the Senate version of the tax bill will make some lower-income taxpayers eligible for the credit as well. The final bill allows lower-income taxpayers a smaller *refundable* credit equal to 10 percent of the excess of their earned income over \$10,000.

Estate Tax Repeal: Repeal of the so-called “death tax” has been high on the Republican agenda for several years now—and was actually passed by Congress in 2000, only to be vetoed by President Clinton. This year’s tax bill gradually repeals the

estate tax by reducing the tax rates and increasing the exemptions each year from 2002 to 2010, when the tax is completely repealed.

“Back Door” Tax Rate Reductions: In addition to slashing the top marginal tax rates, the tax bill also repeals two provisions designed to phase out the value of tax breaks for the highest-income taxpayers: a disallowance of the personal exemption for married taxpayers earning over \$200,000 and a partial disallowance of itemized deductions for taxpayers earning over \$130,000. Because these provisions only affect the wealthiest taxpayers, this change is equivalent to an additional reduction in the top tax rate, and will further reduce the progressivity of the federal income tax.

Marriage penalty relief: Several features of the current tax system can, under certain circumstances, have the effect of requiring married couples at a given income level to pay more income tax than a similar unmarried couple. The 2001 tax bill includes several provisions designed to reduce the effect of this “marriage penalty.” However, none of the marriage penalty provisions begin to take effect until 2005.

- **Standard deduction.** The bill gradually increases the standard deduction for married joint filers, while keeping the standard deduction for single filers unchanged. In 2009, when the phase-in of this provision is complete, the standard deduction for married joint filers will be exactly twice the deduction allowable for single filers. This eliminates the “marriage penalty” inherent in the current standard deduction.
- **Rate brackets.** The tax bill eliminates the marriage penalty in the 15 percent bracket, by increasing the amount of income subject to the 15 percent rate for married joint filers while leaving the single filer income limit unchanged.
- **EITC phaseout expansion.** For married EITC recipients, the income levels at which EITC benefits begin to phase out is increased.

AMT Changes: The Alternative Minimum Tax (AMT) is designed to ensure that wealthy taxpayers cannot use various tax loopholes to reduce their total tax liability below a minimal level. The AMT is calculated as 26 percent (28 percent above \$175,000) of income, with a \$45,000 exemption for married couples. Because these exemptions have remained unchanged for more than a decade, and are not indexed for inflation—and because the regular income tax brackets *are* indexed each year for inflation—the AMT has grown to include a larger share of taxpayers each year. There is growing concern that the current exemptions will be insufficient to keep middle-class taxpayers from paying the AMT in the future. The 2001 tax bill affects the AMT in potentially contradictory ways. First, by reducing the regular income tax rates without cutting the AMT rate, the tax bill increases the likelihood that taxpayers at any income level will have to pay the AMT. Second, by temporarily increasing the AMT exemption from \$45,000 to \$49,000, the bill provides an additional cushion against AMT liability for upper-middle-income taxpayers. Since the AMT exemption hike is repealed after 2004, however, the net effect of the 2001 tax bill starting in 2005 is to throw significantly more taxpayers into AMT liability. In short, this tax bill, far from mitigating the AMT crisis, will actually make it much worse in the long run.

Other Provisions: The tax bill also extends existing tax breaks for dependent care (increasing the credit rate from 30 to 35 percent), education savings accounts (increasing the amount that can be contributed annually to these accounts from \$500 to \$2,000) and retirement savings incentives, and creates a new “college tuition deduction” that allows taxpayers earning under \$65,000 (\$130,000 for married taxpayers) to deduct up to \$2,000 for higher education expenses.

Top Five “Smoke and Mirrors” Provisions in the 2001 Tax Bill

During budget negotiations in May, Congressional leaders agreed to scale back the total cost of their tax cut from the \$1.6 trillion

ten-year cut initially proposed by the President to a more manageable \$1.35 trillion cut. In the weeks that followed, however, lawmakers found it increasingly difficult to fit their proposed cuts within their self-imposed \$1.35 trillion limit. As time ran down before Memorial Day, Congress resorted to an imaginative series of smoke-and-mirrors budgetary tricks to ensure that the official cost of the final plan would not exceed the \$1.35 trillion target. They succeeded—but managed to make a mockery of the budgetary process as well, cobbling together a set of tax cuts that appear only gradually—and then disappear in a puff of smoke. Here’s our salute to the five most egregious maneuvers used by Congress to reduce the apparent cost of the final tax plan.

1: Gradual Phase-ins

The Real Cost of the "\$1.35 Trillion" Plan	
Official "10-year" estimate:	\$1.35 trillion
<i>Add: last 9 months of FY 2011</i>	\$0.138 trillion
Subtotal	\$1.488 trillion
<i>Add: last 6 years of AMT fix</i>	\$0.206 trillion
Full Ten-Year Tax Cut	\$1.693 trillion
<i>Add: Expiring Provisions</i>	\$0.12 trillion
Subtotal	\$1.81 trillion
<i>Add: Extra Interest payments</i>	\$413 billion
TOTAL COST:	\$2.2 trillion

In recent years, lawmakers have become quite adept at concealing the true long-term cost of proposed tax cuts by postponing the effective date of their proposed cuts until near the end of the ten-year budget window. In the 2001 bill, lawmakers took this trick to new depths.

- Taxpayers will not enjoy the full benefit of the cuts in the top marginal tax rates until 2006.
- The phaseout of two prominent “marriage penalty” provisions won’t even *begin* until 2005—and won’t be complete until 2009.
- The doubling of the \$500 per-child tax credit has the longest phase-in of any provision in the tax bill—ten years.

Taxpayers expecting a \$1000 credit for each child should be prepared to wait until 2010, when the phase-in is complete.

- The estate tax—styled as the “death tax” by its opponents—will be kept on life support straight through until 2010, when it is finally repealed.

2: Riding Into the Sunset

Perhaps the most striking feature of the 2001 tax bill is that all of its 113 pages of tax cuts—the estate tax repeal, the income tax rate cuts, the doubling of the child credit—vanish into thin air on December 31, 2010. On January 1, 2011, the estate tax as we currently know it will reappear, with an exemption of \$1 million and a top rate of 55%; the top marginal tax rate will jump back up to 39.6 percent; and the child credit will be halved to \$500. The speed with which the Bush tax cut turns into a pumpkin at midnight on January 1 has nothing to do with sound tax policy—and everything to do with fiscal chicanery. Congress is required to estimate the cost of the tax bill through September of 2011—the end of the federal government’s 2011 fiscal year—but by “sunsetting” the entire tax cut on January 1, Congress ensured that there would be nothing to estimate in the last nine months.

While indefensible from a tax policy perspective, this “sunset” provision was instrumental in helping Congress meet its \$1.35 trillion goal. An analysis by the Joint Committee on Taxation found that the sunset provision reduced the cost of the tax bill by \$138 billion over ten years.

3: AMT Relief—In the Short Run

Legislators on both sides of the aisle agree that the growing number of taxpayers subject to the Alternative Minimum Tax (AMT) is a problem which must be addressed. The rate-reduction provisions in the Bush plan, taken by themselves, would make the long-term impact of the AMT on middle-class taxpayers even worse. But the tax bill does include a provision to offer a modicum of middle-class AMT relief by increasing the AMT exemptions from \$45,000 to \$49,000. However,

the tax bill only authorizes this AMT relief for four years: in 2005, the exemptions revert to their 2001 level. From a cost-cutting perspective, this maneuver makes even more sense than the 2011 “sunset” provision, reducing the reported cost of the Bush plan by a whopping \$206 billion. But from a common-sense perspective, this provision is the most inexcusable dodge in the entire tax bill. Lawmakers have no intention of allowing 35 million taxpayers to fall into the AMT by 2010—yet this is precisely what will happen if the AMT “sunset” provision is taken at face value.

4: Extenders

One element of the Bush plan which fell victim to the negotiation of Congressional conferees was the extension of the Research and Development tax credit. Designed to encourage additional R&D investment by corporations, this credit is currently set to expire in 2004. Yet there is general agreement among lawmakers that the R&D tax credit—along with several other so-called “extenders” due to expire in the near future—will ultimately be re-enacted. Since the credit does not expire for more than two years, however, Congress was more than willing to drop these extenders from the tax bill when push came to

Timing of the Tax Changes in the 2001 Tax Bill (calendar years)

	Agreed-Upon Phase-in Schedule									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
New 10% Tax Bracket	■									
Upper Tax Rate Cuts	■	■	■	■	■					
Itemized Deduction Limitation						■	■	■	■	■
Personal Exemption Phaseout Repeal										■
Child Tax Credit Provisions										■
Dependent Care Credit Provisions		■	■							
Marriage Penalty Provisions										■
EITC Eligibility Increase		■	■	■	■	■	■	■	■	■
AMT Exemption Increase										(Repealed in 2005)
Estate Tax Repeal										■
Education IRA contribution limit		■	■							

Note: The shaded areas in this table represent the period during which each major tax provision in the 2001 tax bill is phased in. For example, the new 10 percent tax bracket is completely phased in as of tax year 2001, while the upper income rate cuts are gradually reduced, starting in tax year 2001 and ending in tax year 2006.

shove. By dropping the extenders, Congress deferred the ten-year cost of extenders—recently estimated at \$120 billion—to future tax bills.

5: Losing Interest

Congress is not required to consider the indirect impact of its tax proposals on federal debt. Yet the \$1.8 trillion in tax cuts likely to be doled out over the next ten years as a result of the Bush plan means that the government will have \$1.8 trillion less cash available to pay down the national debt—which means that we will pay more interest on our existing federal debt each year. The additional interest on the national debt over the next ten years is likely to exceed \$400 billion—bringing the total direct and indirect cost of the Bush plan to a whopping \$2.2 trillion.

2001 Rebates: The Check is *Not* in the Mail

Earlier this year, many congressional Democrats were promoting the idea of a one-time tax rebate to stimulate the economy and put some money in the pockets of Americans, especially the neediest. One version pushed by progressive Democrats in the House would have given \$300 to every man, woman and child in the country. A variant would have conditioned rebates on payment of either income or payroll taxes last year.

The budget resolution passed by Congress this year—as part of the supposed scale-back in the size of the Bush tax cuts—envisioned a rebate along those lines, calling for \$100 billion in fiscal stimulus this year. But by the time the final tax bill was enacted, the rebate had been sharply scaled back, even though the rhetoric stayed the same.

How are the Rebates Calculated?

The final tax bill's version of the rebate was designed to provide taxpayers with an advance payment of the amount of tax savings they are likely to receive from the new 10 percent rate when they file their 2001 tax forms next April. Because taxpayers won't know their 2001 tax savings from the new tax rate until they file their taxes next April, lawmakers allowed taxpayers to use their taxable income from the 2000 tax year as an estimate of their taxable income in 2001. The amount of the credit is limited by two factors: first, taxpayers must have *taxable income* (that is, income after all deductions and exemptions) equal

to the total amount of income taxed at the new 10 percent rate. In other words, since the 10 percent rate applies to the first \$12,000 of taxable income for married couples, a couple must have taxable income of at least \$12,000 to claim the full credit. A second limitation is that the rebate cannot exceed the taxpayer's 2000 tax after certain non-refundable credits—such as the \$500 per-child credit and the dependent care credit.

The table below shows how the rebate works for married couples with two children—and how these limitations can reduce the rebate below the maximum. Married couples can earn up to \$28,000 before qualifying for even a penny in rebate, and close to \$33,000 before getting the full \$600. The fact that a couple making \$28,000 pays almost \$2,000 in worker payroll taxes isn't taken into account in computing the rebates.

Who Will Receive the Rebate?

Example of 2001 Rebate Break-down

Examples	Married, 2 kids		
	< \$28,415	\$30,415	> \$32,415
Total income			
Standard deduction	7,350	7,350	7,350
Personal exemptions	<u>11,200</u>	<u>11,200</u>	<u>11,200</u>
Taxable income	9,865	11,865	13,865
Tax before credits	1,480	1,780	2,080
\$500/kid credit	1,000	1,000	1,000
Child-care credit	<u>480</u>	<u>480</u>	<u>480</u>
Maximum rebate, lesser of:			
Income tax after credits	—	300	600
5% of taxable up to limit	493	593	600
Rebate	\$ —	\$ 300	\$ 600
Notes	none	half	full

As public interest in the 2001 rebate increased, newspaper reports began parroting the administration's claims that "everyone" will get a rebate equal to \$600 for couples, \$500 for single parents, and \$300 for others. A June 1 CTJ analysis checked up on these claims. Our analysis found that almost 40 percent of American taxpayers—51 million taxpayers—will get less than the full amount of the advertised rebates. More than a quarter of taxpayers nationwide will actually get nothing at all from the 2001 rebates.

By making the rebate non-refundable—that is, limiting the rebate to the amount of federal income taxes paid in 2000—lawmakers effectively excluded most poor Americans from eligibility. More than three-quarters of the very poorest taxpayers—the twenty percent of taxpayers earning less than \$15,000 in 2001—will receive no rebate at all. And just 3 percent of taxpayers in this group will receive the advertised “\$300/\$500/\$600” amount. No other income group is as systematically excluded from the plan’s benefits: almost half of the taxpayers with reduced or zero rebates are concentrated in this group. On the flip-side, the tax bill extends the benefits of the rebate to about two million upper-income taxpayers who will not actually benefit from the

excluded from the benefits of these rate reductions because they don’t currently pay

Late this summer and into the fall, every single American who pays income taxes will receive a check. Single taxpayers will receive a check of \$300. Single parents who are heads of households will receive a check of \$500, and married couples will receive a check of \$600.

—President Bush, 5/26/01

income tax at any of the rates above 15 percent.

The analysis also showed that of the 35 million taxpayers receiving some tax cut from the upper-income rate reductions, the vast majority—29 million—would receive an average tax cut of \$101—or \$3.88 a week—during the remainder of tax year 2001. By contrast, the less than 1 percent of all taxpayers who currently pay at the 39.6 tax bracket will receive an average tax cut of \$3,894 during the remainder of 2001. Thus, for most Americans, the post-2001 Bush tax cuts offer meager gain but lots of pain. Not only will the majority get little more in tax reductions after the first year, they will lose large amounts in public services as the remaining upper-income tax cuts are phased in. (President Bush's March budget submission envisions cutting domestic appropriations by as much as a third as a share of the economy by fiscal 2011 to pay for his tax cuts.) It's hard to figure how this could possibly be a good deal.

**How the "\$300/ \$500/ \$600" Rebate Works--
And What Taxpayers Really Get**

Filer Type	Single Filers	Married Joint Filers	Single Parents
Max. Amount of Income Subject to 10% rate in 2001	6,000	12,000	10,000
Tax Paid on This Income:			
At Old 15% Rate	900	1,800	1,500
At New 10% rate	600	1,200	1,000
Maximum Rebate	\$ 300	\$ 600	\$ 500
Actual Average 2001 Rebate By Filing Type:			
All Income levels	\$ 195	\$ 459	\$ 239
Bottom 60%	\$ 174	\$ 213	\$ 183
Poorest 20%	\$ 60	\$ 1	\$ 4
% with No Rebate	28%	18%	44%

new 10 percent rate bracket because they currently pay the Alternative Minimum Tax. Like the rest of the Bush tax plan, the rebates have been carefully designed to give as little as possible to those who need the money—and as much as possible to those who don’t.

Cuts in Top Tax Rates Won’t Help Most

Lost in the hubbub over the “rebate” due to the new retroactive 10 percent rate has been the implementation of the first reductions in the upper four income tax brackets. Effective July 1 of this year, each of the top four income tax rates (28, 31, 36 and 39.6 percent) dropped by 1 percent. A June 27 CTJ analysis found that almost three-quarters of all taxpayers will be entirely

Did you know?

CTJ analyses of federal tax proposals are now available on a state-by-state basis. To find out how the Bush tax plan—or the 2001 tax rebate—affects taxpayers in your state, check out our website at <http://www.ctj.org>

From the CTJ Mailbox...

Q: Why should low-income Americans get rebates when they don't pay taxes?

A: A major misconception in this tax debate has been that anyone not receiving the 2001 tax rebate doesn't pay federal taxes. In fact, low-income taxpayers—almost all of whom are ineligible for the maximum tax rebate—do pay taxes. But their federal tax liability is concentrated in taxes other than the federal income tax, such as the FICA payroll tax and excise tax liability. In fact, a 1999 CTJ analysis based on data from the Joint Committee on Taxation (JCT) found that federal income taxes actually accounted for less than half of the federal tax burden for *all* income groups except those earning over \$100,000. CTJ's analysis found that income taxes average only 38% of total federal taxes in the under \$100,000 income groups, where payroll taxes and excise taxes dominate. By contrast, income taxes are 75 percent of total federal taxes for those making more than \$100,000.

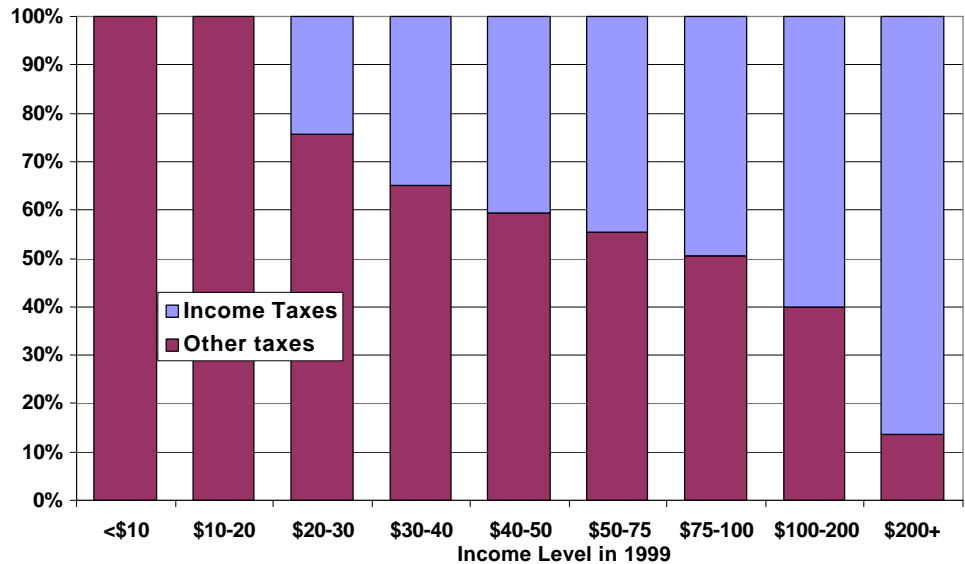
The chart at right breaks down the composition of federal tax liability by income group into income taxes and all other taxes. If

rebates were truly meant to “provide real tax relief to all taxpayers, especially those at the low end of the economic ladder” (President Bush, 5/26/01), lawmakers clearly chose the wrong tax to rebate.

What Surplus?

While most analysts were focused on the long-term fiscal consequences of the Bush plan, last month the chickens quietly came home to roost. In early June, the Congressional Budget Office lowered its estimate of the current year's budget surplus. Rather than the \$96 billion surplus predicted in January (excluding Social Security and Medicare), CBO now projects a fiscal 2001 surplus of only \$14 billion. In fact, CBO's figures indicate that in the last four months of this fiscal year, there will be an on-budget *deficit* of \$20 billion—meaning that \$20 billion will be siphoned from the Medicare trust fund to cover the first-year cost of the Bush tax cut plan. The long-run impact of the Bush plan on the available surplus remains uncertain—but in fiscal year 2001, the tax cuts have already come back to haunt us.

Composition of the Federal Tax Burden, 1999



Welcome... and Farewell

In May, CTJ and ITEP said goodbye to several important staff members. Cheryl Brown, Sara Hinkley and JaNyce Whiteside left CTJ and ITEP. They will be missed. ITEP extends a warm welcome to its new State Tax Policy Director, Richard Sims, and its new analysts, Norton Francis and Will Gooma. We also extend our thanks and best wishes to our hard-working summer interns: Katherine Blauvelt, Johanna Jones, and Benedict Schweigert.

What's a Tax Rebate Good For?

If you are among the people expecting a tax refund who think that the federal tax cut is not in the best interest of the country, consider donating your tax cut as an act of protest to an organization who has worked hard to oppose this egregious plan. There are many non-profit organizations who would benefit greatly from your support. And of course, **Citizens for Tax Justice** and the **Institute on Taxation and Economic Policy** are two groups that would greatly appreciate your contribution.

Tax-cut rebates go out soon, and the White House savors the buzz from ads such as Pizza Hut's, seeking a piece of the cash. Democrat James Carville says, "I'm giving my \$300 to Citizens for Tax Justice," a liberal think tank opposed to the Bush cuts. He expects wife, Mary Matalin - a Cheney aide - will use it for "a down payment" on something for herself.

-Wall Street Journal, July 13

Resources for Further Investigation

The IRS website now has a page designed to help taxpayers determine the amount of their tax rebate—and **when they can expect their check**. Go to http://www.irs.gov/ind_info/apinfo/index.html .

For our full **analysis of the 2001 rebates**, visit <http://www.ctj.org/html/rebate01.htm> .

Want more **details on the tax bill**? An in-depth analysis of the bill's provisions can be found on the Joint Committee on Taxation (JCT) website at <http://www.house.gov/jct/x-50-01.pdf> .

The Bush tax cut is already affecting federal budgeting in 2001. Yet many states are likely to feel the pinch too, thanks to various linkages between federal and state tax structures. A May 2001 CTJ analysis estimates **the effect of the Bush plan on state tax revenues** for each of the fifty states. The analysis is on the CTJ website at <http://www.ctj.org/html/statefx.htm>.

The work you do is not easy, and it may never make you popular. But over the years Citizens for Tax Justice has established a reputation for the integrity of its numbers. We in Congress who have used your numbers in arguing tax policy issues know just how dependable they are. If we lose on a tax policy vote, we know it won't be because we relied on faulty data.

-Sen. Kent Conrad
