

# CRS Issue Brief for Congress

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## Major Tax Issues in the 108<sup>th</sup> Congress

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## Major Tax Issues in the 108<sup>th</sup> Congress

### SUMMARY

Tax policy received considerable attention throughout the 107<sup>th</sup> Congress, but the context of the policy debate changed substantially over 2001-2002. At the outset of 2001, surpluses were projected. Politically, both chambers of Congress had Republican majorities. An important part of newly elected President Bush's election campaign was a proposed large tax cut. Supporters of the cuts argued that a part of projected budget surpluses should be returned to taxpayers, which, they argued, would also help steer the slowing economy away from recession. Tax cut opponents argued that long-run budgetary considerations and the looming retirement of the baby-boom generation made a large tax cut imprudent and maintained that the proposal would favor high-income taxpayers.

In May 2001, Congress passed a sizeable 10-year tax cut as the \$1.35 trillion Economic Growth and Tax Relief Reconciliation Act (EGTRRA; P.L. 107-16). The Act's principal provisions reduced individual income tax rates, phased out the estate tax, provided tax cuts for married couples, and increased the per-child tax credit. To comply with Senate budget rules, the tax cuts were scheduled to expire at the end of 2010.

By the fall of 2001, the context of the tax debate had changed. Politically, Democrats had assumed control of the Senate. Economically, a recession was recognized as having begun, and the weakened economy — along with EGTRRA's tax cuts — diminished budget surplus projections. The attacks of September 11 added to uncertainty about the

economy. The new atmosphere led some policymakers to call for new tax cuts that would provide economic stimulus, and the House passed tax-cut bills in both October and December. However, the measures' opponents objected to the cuts' size and composition, and the bills were not passed by the Senate. The stimulus measure that was ultimately enacted in March 2002 (the Job Creation and Worker Assistance Act; P.L. 107-147), was smaller than those initially passed by the House. Its principal elements were temporary expensing and depreciation benefits 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.

In 2003, with Republicans again in the Senate majority, the debate over a possible tax cut resumed. President Bush's FY2004 budget proposed a set of tax cuts amounting to an estimated \$1.57 trillion over 2003-2013, including a stimulus plan amounting to \$726 billion over ten years.

On May 23, the House and Senate both approved H.R. 2, Jobs and Growth Tax Relief Reconciliation Act (JGTRRA; P.L. 108-27). The measure was signed by the President on May 28 and contains an estimated \$320 billion in tax cuts over 10 years and \$30 billion in spending increases. The principal tax cuts include an acceleration of several cuts for individuals scheduled for phase-in under EGTRRA, a reduction in the tax rates for capital gains and dividends, and investment incentives for businesses.

## **MOST RECENT DEVELOPMENTS**

The tax policy debate in the first part of 2003 focused on a range of tax cuts. In February, the Administration included a set of tax cut proposals with its budget plan; the entire package proposed to reduce taxes by an estimated \$1.57 trillion from FY2003 through FY2013. The President's proposals include a stimulus package, some additional tax cuts, and permanent extension of the 2001 tax cut. On May 6, the House Ways and Means Committee approved H.R. 2, the Jobs and Growth Tax Relief and Reconciliation Act, containing an estimated \$550 billion in tax cuts over the period 2003-2013. The full House approved the bill on May 9. On May 8, the Senate Finance Committee approved S. 2 (later replaced by S. 1054), a package of tax cuts and revenue-raising measures that would reduce taxes (and increase outlays) by a net amount of \$350 billion over 2003-2013. The full Senate approved a modified version of the bill (now H.R. 2, amended) on May 15. On May 23, both chambers approved a conference agreement containing \$320 billion in tax cuts and \$30 billion in spending increases. None of the revenue-raising items in the Senate bill were included in the final bill. The President signed the measure into law on May 28, P.L. 108-27.

For primers on subject specific tax legislation in the 108<sup>th</sup> Congress, see CRS Electronic Briefing Book, *Taxation*, at [<http://www.congress.gov/brbk/html/ebt1r1.shtml>]. For details on the legislative developments of current tax-related legislation, see CRS Report RS21386, *Fact Sheet on Congressional Tax Proposals in the 108<sup>th</sup> Congress*, by Don C. Richards.

## **BACKGROUND AND ANALYSIS**

### **The Economic Context**

Tax policy is frequently considered by policymakers as a tool for boosting economic performance in various ways, and the likely economic effects of tax policy are often hotly debated. A brief overview of the current economic context is thus a good starting point for looking at tax issues facing the current Congress. The overview of major tax issues begins by describing three aspects of the economic context in which the tax policy debate during the 108<sup>th</sup> Congress is likely to occur: the general state of the U.S. economy; the position of the federal budget; and the level of taxes in the United States.

### **The State of the Economy**

At the outset of 2001, the U.S. economy had recorded nine consecutive years of continuous expansion. Thus, consideration of tax policy as a counter-cyclical device to stimulate the economy out of recession had not occurred in recent years. 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.<sup>1</sup> As 2001 progressed, there were increasing signs of economic weakness, and

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<sup>1</sup> Mark Felstenthal, "Bush Cites Economic Concerns As Justification for Tax Cut Plans," *BNA Daily Tax Report*, Dec. 18, 2000, p. G-4.

in November, the National Bureau of Economic Research (NBER; the organization that tracks business cycles) determined that a recession had begun in March of that year.

Economic data now show that the economy contracted during the first three quarters of 2001 before registering positive growth again in the fourth quarter of that year and in all four quarters of 2002. (See NBER's January 13 press release, available on the NBER Web site at [<http://nber.org/cycles/recessions.html>].) However, employment continues to decline and the NBER has not yet announced an ending date for the recession. If the recession that began in 2001 has indeed ended, it will have been of about average severity and duration for economic recessions of the post-World War II era.<sup>2</sup>

The economy registered positive growth in all four quarters of 2002. In November congressional testimony Federal Reserve Chairman Alan Greenspan termed the U.S. economy "remarkably resilient" and characterized U.S. economic growth over the first part of the year as "well maintained" and "respectable." Nonetheless, he observed several forces placing a drag on the economy: a long adjustment in capital spending; the "fallout" from revelations of corporate malfeasance; declines in the stock market; and increased "geopolitical risks." Mr. Greenspan further stated that evidence suggested the economy had hit what he termed a "soft patch" as a likely result of these factors. In February 2003 testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Chairman Greenspan observed that economic growth slowed markedly in the last quarter of 2002 and termed the pattern "choppy." (Testimony available on the Federal Reserve Web site at [<http://www.federalreserve.gov/boarddocs/testimony/2002/20021113/default.htm>].) For his part, President Bush, in November 2002, stated that he was not satisfied with the economy's performance and characterized it as merely "bumping along."<sup>3</sup>

For further reading, see CRS Report RL31237, *The Current Economic Recession: How Long, How Deep, and How Different from the Past*, by Marc Labonte and Gail Makenin.

## 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.<sup>4</sup>

As the 107<sup>th</sup> Congress progressed, however, the budget picture changed markedly. Indeed, 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

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<sup>2</sup> CRS Report RL31237, *The Current Economic Recession: How Long, How Deep, and How Different from the Past*, by Marc Labonte and Gail Makenin, p. 29.

<sup>3</sup> Nancy Ognanovich and Brett Ferguson, "Bush Reiterates Interest in Stimulus To Address Sluggish U.S. Economy," *BNA Daily Tax Report*, Nov. 14, 2002, p. G-9.

<sup>4</sup> U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2002-2011* (Washington: GPO, 2001), p. 51.

year and as a result of economic weakness.<sup>5</sup> In January 2002, CBO reduced its projected 10-year surpluses further and predicted that the federal budget would move into deficit in FY2002 and FY2003 before returning to surplus.<sup>6</sup> And in August, CBO again revised its projections downwards, predicting deficits in FY2002 - FY2005 and reducing estimates of surpluses in the out years.<sup>7</sup> The changed projections were the result of enacted legislation, changed economic conditions, and changes in the make-up of aggregate income. In its January 2003 report, CBO revised its budget projections slightly downwards again.

The longer-term budget situation is a concern to many policymakers, chiefly because of demographic pressures posed by an aging population that will begin with the retirement of the “baby boom” generation and that will continue afterwards. Because of the expected growing ratio of retirees to wage earners, the gap between Social Security and Medicare revenues and outlays will increase substantially in future years under current tax and entitlement laws. The Congressional Budget Office has estimated that beginning in 2010, outlays under the Social Security and Medicare programs will exceed the programs’ tax revenues and Medicare premiums. (This estimate excludes trust fund revenues consisting of transfers from other Treasury Department accounts.) By 2040, outlays under the programs are projected to reach 12.1% of gross domestic product (GDP) while revenues are expected to be about 7%.<sup>8</sup>

For additional information, see CRS Report RL31784, *The Budget for Fiscal Year 2004*, by Philip D. Winters, CRS Report RL31778, *The Size and Scope of Government: Past, Present, and Projected Government Revenues and Expenditures*, by Don C. Richards, and CRS Report RL31176: *Financing Issues and Economic Effects of Past American Wars*, by Mark Labonte.

## The Federal Tax Burden<sup>9</sup>

At the outset of the preceding (107<sup>th</sup>) Congress, some pointed to the historically 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 19.8% in FY2001 and 18.0% in FY2002. These levels are 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. According to CBO, the increased level of tax revenues prior to FY2002

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<sup>5</sup> U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update* (Washington: GPO, Aug. 2001), p. ix.

<sup>6</sup> U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2003-2012* (Washington: GPO, 2002), p. xiv.

<sup>7</sup> U.S. Congressional Budget Office, *The Budget and Economic Outlook: An Update* (Washington: GPO, Aug. 2002), p. x.

<sup>8</sup> U.S. Congressional Budget Office, *The Impact of Social Security and Medicare on the Federal Budget*, (Washington: November 14, 2002). Posted on the Congressional Budget Office’s Web site at [<http://www.cbo.gov/showdoc.cfm?index=3982&sequence=0>].

<sup>9</sup> Authored by Gregg A. Esenwein, Specialist in Public Finance, Government and Finance Division.

was due to economic growth, an increase in capital gains realizations (for example, from sales of appreciated stock) and increases in real incomes. The decline in FY2002 revenues was due to slower economic growth, declines in capital gains realizations, and slower growth of very high incomes.

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 opposing 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.

While the overall level of federal taxes has been relatively stable, its composition has shifted. In particular, the share of federal receipts made up by corporate income taxes and excise taxes has declined, falling from 30% and 18%, respectively, of total receipts in FY1946 to 10.4% and 3.4% in FY2002. The share comprised of Social Security taxes has increased over the same years from 7.9% to 36.4%, and is now the second largest source of federal revenues after individual income taxes.

For further information, see CRS Report RS20087, *The Level of Taxes in the United States, 1940-2002*, by David L. Brumbaugh and Don C. Richards.

## Recent Tax Cut Legislation

### The President's Proposal

On January 7, 2003, President Bush announced the details of a new tax cut proposal intended to provide a stimulus to the economy (see the White House website at [<http://www.whitehouse.gov/omb/budget/fy2004/index.html>]). According to estimates by the Joint Committee on Taxation, the revenue reduction from the “economic stimulus” elements of the plan amounted to \$726 billion over FY2003-FY2013. The total cost of all the components of the plan (including not only the stimulus proposals, but additional tax cut provisions) was estimated at \$1.575 trillion. Based on CBO baseline budget projections of revenues, this amounts to a reduction in revenues of about 5.3% over that period. However, the revenue losses estimated for last few years in the “estimating window” under the Administration’s proposal were substantially larger than for the first few years — a reflection of the proposal to make EGTRRA permanent instead of allowing it to expire after 2010. The tax cut over the last five years of the “estimating window” (i.e., over FY2009-FY2013) was \$1.046 trillion, or 6.5% of anticipated revenue.

The principal tax proposals in the President’s budget were as follows:

- Acceleration of several tax cuts for individuals that were enacted by EGTRRA in 2001 but that were scheduled to be phased in gradually. The Administration proposed to make the reduction in tax rates fully effective on January 1, 2003; the rate reductions were scheduled by EGTRRA to be

phased in over the period 2001-2006. The President's plan also proposed to accelerate a broadening of the 10% rate bracket that was not scheduled to occur until 2008. The plan also proposed to move up EGTRRA's scheduled tax cuts for married couples to 2003; the tax cuts were originally not scheduled to be fully effective until 2009. The President's plan also proposed to increase the per-child tax credit to \$1,000 from \$600 in 2003. The full increase was not scheduled to occur until 2010 under EGTRRA's initial provisions.

- The plan proposed to move towards "integration" of the taxation of corporate-source income by eliminating individual income taxes on dividends and by permitting a "step up in basis" for capital gains resulting from retained earnings.
- The Administration also proposed to increase the so-called "expensing" allowance for business investment in equipment to \$75,000 from current law's \$25,000 and would index the amount for inflation.

Each of these proposals were included in the stimulus package the President outlined in January. Prominent among the additional tax cuts proposed with the budget — aside from making EGTRRA's tax cuts permanent — were the following items:

- two new tax-favored savings vehicles that would replace Individual Retirement Accounts (IRAs) and that would have less binding restrictions than current law's IRAs;
- a set of new tax incentives for charitable giving, including a deduction for non-itemizers;
- a number of tax benefits related to health care, including a long-term care insurance deduction for non-itemizers;
- a set of tax benefits related to energy production and conservation; and
- permanent extension of current law's temporary research and experimentation tax credit.

According to Joint Committee on Taxation estimates, the acceleration of EGTRRA's tax cuts would reduce revenue by \$263.9 billion over FY2003-FY2013, accounting for 17% of the total estimated tax cut over that period. The estimated revenue loss from the tax exclusion for dividends is \$395.8 billion, or 25% of the total tax cut. The estimated revenue loss from rescinding EGTRRA's expiration was \$624.2 billion, or 40% of the total.

For additional information on the President's tax proposal, see CRS Report RS21420, *President Bush's 2003 Tax Cut Proposal: A Brief Overview*, by David L. Brumbaugh; and CRS Report RL31907, *Tax Cut Bills in 2003: A Comparison*, by David L. Brumbaugh and Don C. Richards.

## House Bill

On May 6, the House Committee on Ways and Means approved H.R. 2, the Jobs and Growth Tax Act of 2003. The full House approved the bill on May 9. The Joint Committee on Taxation estimated the bill would reduce revenues by \$550 billion over the period FY2003 through FY2013. The bill was similar in many respects to the economic stimulus part of the President's tax proposal, including the acceleration of several of the tax cuts initially included in EGTRRA. Two principal differences between the President's proposal and H.R. 2 were the partial rather than full elimination of individual taxes on corporate dividends and capital gains and the expiration of several of the bill's tax cuts earlier in the estimating window. Although the total revenue reduction included in H.R. 2 was within the reconciliation instructions provided to the House Committee on Ways and Means, it was larger than the \$350 billion tax cut in reconciliation instructions given to the Senate Finance Committee by the FY2004 budget resolution (H.Con.Res. 95).

For additional information on the House bill, see CRS Report RL31904, *The Jobs and Growth Tax Act of 2003 (H.R. 2): A Brief Overview of the House Tax-Cut Bill*, by David L. Brumbaugh, and CRS Report RL31907, *Tax Cut Bills in 2003: A Comparison*, by David L. Brumbaugh and Don C. Richards.

## Senate Bill

On May 15, the Senate incorporated S. 1054 into H.R. 2 and approved the package as amended. Similar to the House version of H.R. 2 and the President's proposal, the Senate's version included an acceleration of many of the 2001 tax cuts (including rates, marriage penalties, child credits, and expansion of rate brackets) enacted in EGTRRA. One of the major differences between the Senate's version, the House bill, and the President's proposal was the taxation of dividends. The Senate legislation would have reduced the taxation of dividends for foreign and domestic corporations by 50% in 2003 and provided a 100% exclusion in 2004, 2005, and 2006. The Senate proposal also established a fund of \$20 billion for federal aid to state and local governments.

In order to comply with the directions within the budget reconciliation (H.Con.Res. 95), a series of revenue offsets were also included in the bill and held the total estimated impact from FY2003 through FY2013 to \$350 billion. The principal revenue-raising items included a set of provisions aimed at restricting tax shelters generally, including a provision clarifying the "economic substance" doctrine that courts have applied to tax shelters. (This doctrine generally denies tax benefits with respect to transactions that do not change a taxpayer's economic position in a substantive way.) The bill's largest single revenue-raising item was a proposed repeal of the foreign earned income exclusion provided by Section 911 of the tax code. Under current law, U.S. citizens residing abroad are permitted to exclude up to \$80,000 of income from foreign employment along with a certain amount of housing costs. The Senate bill would have repealed the exclusion.

For additional information on the Senate bill, see CRS Report RL31907, *Tax Cut Bills in 2003: A Comparison*, by David L. Brumbaugh and Don C. Richards.

## **The Bill as Enacted: P.L. 108-27, the Jobs and Growth Tax Relief and Reconciliation Act**

On May 23, the House and Senate agreed to the conference report for H.R. 2, the Jobs and Growth Tax Relief and Reconciliation Act (JGTRRA; P.L. 108-27). The President signed the bill into law on May 28. JGTRRA contained an estimated \$350 billion in reduced revenues and increased outlays from FY2003 through FY2013, including \$320 billion in tax cuts and \$30 billion in outlay increases. In contrast to the Senate provision, which had the same net cost, the conference package did not include any revenue raising measures acting as offsets. The principal outlay provisions in the package established a \$20 billion fund to provide fiscal relief to state governments. The principal tax components of JGTRRA were:

- Acceleration to 2003 of the individual income tax cuts enacted and phased in under EGTRRA. Specifically, income tax rates above 15%, currently scheduled to decline in 2004 and 2006, were accelerated to their 2006 levels in 2003. The application of the 10% tax bracket, scheduled by EGTRRA to increase in 2008, was accelerated to 2003 and 2004.
- The child tax credit initially scheduled to be \$600 for 2003 and 2004 was increased to \$1,000 for 2003 and 2004 but will revert to the levels scheduled by EGTRRA for 2005 - 2010 (\$700 in 2005 - 2008, \$800 in 2009, and \$1,000 in 2010).
- For 2003 and 2004 only, the standard deduction and 15% tax bracket for married taxpayers will become twice that of singles. Beginning in 2005, these provisions will revert to EGTRRA's schedule, which provides for a phased-in increase to the levels of twice that of singles over several years.
- The alternative minimum tax exemption amount was increased by \$9,000 for married couples and \$4,500 for singles for 2003 and 2004.
- Maximum expensing benefit for small business investment was temporarily increased from current law's \$25,000 to \$100,00 for 2003, 2004, and 2005. The provision's phase-out threshold is increased from \$200,000 to \$400,000 over the same time period.
- The temporary "bonus" depreciation allowance originally passed in March of 2002 is increased and extended to allow for a 50% first year deduction (up from 30%) for the period between May 5, 2003, and December 31, 2004.
- The conference agreement reduced the tax rate on both dividends and capital gains to 15% for taxpayers in the higher tax brackets and 5% for those in the lower tax brackets for 2003 through 2008. (The tax rate for those in the lower tax brackets would be 0% in 2008.) The dividend provision will apply to both domestic and foreign corporations.

**The Policy Debate.** As the tax-cut measure worked its way through Congress, the policy debate tended to focus on three broad issues: the bill's likely revenue cost and impact on the budget; whether a tax cut would stimulate the economy and/or promote long-run growth; and how it would affect tax fairness. With respect to cost, opponents of the measure – and those objecting to tax cuts larger than those ultimately adopted – generally voiced concern about the impact of a tax cut on the federal budget. As noted above (see the section on the federal budget), the budget has moved from surplus into deficit in recent years and also faces long-term pressures posed by the looming retirement of baby-boomers and succeeding generations; these pressures would be accentuated by any sizeable tax cut. In response, the bill's supporters generally emphasized the beneficial effect a tax cut might have on tax receipts if it were successful in stimulating economic growth.

In the area of economic performance, the tax cut's proponents argued that the particular measures under consideration would benefit the economy in two ways: by providing a short-run stimulus that would help overcome the economy's recent sluggishness; and by increasing long-run economic growth. Skeptics, however, have pointed out that particular tax-cut measures most likely to increase long-run growth are not well-suited to providing short-term stimulus, and have questioned the beneficial impact of the measure that was adopted on the economy. In the area of tax equity, the tax cut's impact on the fairness of the tax system has been criticized by some. Several analyses have indicated that the tax cut that was enacted will likely benefit upper-income individuals more than others. In addition, the enacted tax cut benefits some groups – for example, families with children and investors owning corporate stock and assets producing capital gains – more than others

**Additional Issue: Refundable Child Tax Credit.** Shortly after the passage of JGTRRA, the Senate approved H.R. 1308, Relief for Working Families Act, on June 5. While the size of the child tax credit was increased under JGTRRA from \$600 to \$1,000, the refundability of the credit, currently limited to 10% of earned income in excess of \$10,500 was not altered. The Senate's version of H.R. 1308 would increase the percent used to calculate the limit from 10% to 15% in 2003, presently scheduled to increase in 2005. The bill would also provide a uniform definition of a child for tax purposes and, in 2008, increase the income threshold for couples at which the credit is phased down. As estimated by the Joint Committee on Taxation, the \$9.8 billion cost of the changes over 11 years would be offset by revenue raising measures, specifically, the extension of customs user fees.

On June 12, the House approved its own version of H.R. 1308, which would reduce revenues by an estimated \$82 billion from FY2003 through FY2013. Similar to the Senate's measure, the House version would accelerate the refundability calculation to include 15% rather than 10% in 2003. The income phase-out included in the Senate's version would be increased immediately in 2003. Further, the House bill would maintain the child tax credit at \$1,000, currently scheduled to decrease to \$700 in 2005 before increasing gradually. Finally, the bill incorporates tax relief for members of the armed services but unlike the Senate version does not include any revenue offsets.

**Democratic Tax Cut Proposals.** On May 6, Senate Minority Leader Daschle announced a tax cut proposal as an update to a plan he proposed in January. The anticipated total cost of the plan is \$125 billion in 2003 and \$152 billion over 11 years. The proposal includes:

- an immediate \$300 tax cut for each adult and up to two children per family,
- expanded standard deduction for married couples and earned income tax credit,
- an increase in the child tax credit (an additional \$100 in 2003, for a total of \$700 and another \$100 in 2004, for a total of \$800),
- an increase in the equipment depreciation allowance from 30% to 50% in 2003,
- an increase the amount of equipment that can be expensed for small businesses from \$25,000 to \$75,000, and
- tax credits for health insurance premiums for small businesses and for Internet infrastructure.

In addition to these tax-related components, the plan would provide \$40 billion in assistance to state and local governments and extend unemployment benefits.

On May 7, House Democratic leaders outlined a tax cut proposal they stated would reduce taxes by \$58 billion in 2003 and 2004 and by \$106 billion over 11 years.<sup>10</sup> Some of the components are similar to the provisions offered by Senator Daschle. Among the plan's principal elements are the following:

- an increase in the child tax credit to \$800 per child (under current law the child tax credit is \$600 per child for 2001 through 2004);
- acceleration of the expansion of the 10% tax rate bracket and the marriage penalty relief (expansion of the 15% rate bracket for married couples filing jointly and an increase in the basic standard deduction amount for joint returns);
- an increase in the depreciation "bonus" provided by the tax stimulus package enacted in March 2002 with the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147). Under the 2002 Act, firms can claim a first-year depreciation deduction equal to 30% of the cost of new equipment investments made in 2002-2004. The House Democratic proposal would increase the depreciation bonus to 50% for the next 12 months before returning to 30% for the balance of 2004;
- an increase in the expensing benefit to \$75,000, from the current law's \$25,000, for equipment investment made by small businesses through 2004.

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<sup>10</sup> The proposal is described on the Democrat's side of the House Budget Committee's Web site: [[http://www.house.gov/budget\\_democrats/analyses/econ\\_stimulus/dem\\_jobs\\_plan\\_may03.pdf](http://www.house.gov/budget_democrats/analyses/econ_stimulus/dem_jobs_plan_may03.pdf)].

Further, the proposal includes \$177 billion in revenue offsets during FY2003 through FY2013 in order to pay for the proposed tax reductions previously outlined. Offsets specifically include closing tax shelters and freezing the top-bracket rates, which are currently scheduled to decline under current law.

Non-tax elements of the proposal include an extension of unemployment benefits for 26 weeks and a \$44 billion package of assistance to state and local governments, \$18 billion of which is directed to address areas including Medicaid.

## **Selected Issues**

Although predicting a likely tax agenda is full of uncertainty, the following issues have been mentioned by policymakers and analysts as likely legislative topics remaining on the 2003 tax agenda.

### **Expiration of the 2001 Tax Act**

The Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA) provided a substantial tax cut that is scheduled to be phased in over the 10 years following its enactment. The Act's most prominent provisions are a reduction in individual income tax rates, tax cuts for married couples, phase-out of the estate tax, a larger per-child tax credit, education tax benefits, and tax cuts for Individual Retirement Accounts and pensions. The estimated size of the scheduled tax cut is \$1.35 trillion over FY2001-FY2011.

However, a Senate procedural rule, the "Byrd rule," provides that a point of order can be raised against any provision of budget reconciliation bill that is "extraneous" to the budget reconciliation legislation. Included among the several types of provisions the Byrd rule defines as extraneous are those that would increase the budget deficit (or reduce the budget surplus) for a fiscal year beyond that covered by the reconciliation measure being considered. To avoid application of the Byrd rule, EGTRRA contains language providing for the expiration of its provisions at the end of calendar year 2010. The passage of JGTRRA will not modify the expiration of those provisions scheduled to expire under EGTRRA. Further, new provisions in JGTRRA such as the reduction in taxes on dividends and capitals gains and increased depreciation deduction also include scheduled expiration dates during the next ten years.

During 2002, the House passed a number of bills that would have made some or all of EGTRRA's tax cuts permanent. H.R. 586, approved by the House in April, would have repealed all of EGTRRA's sunset provisions. H.R. 2143, H.R. 4019, and H.R. 4931 were passed in June and would have (respectively) made EGTRRA's estate tax repeal, marriage penalty benefits, and retirement and pension tax cuts permanent. The Senate did not adopt the bills. In the 108<sup>th</sup> Congress, the House on June 18 approved H.R. 8, which would make EGTRRA's estate tax repeal permanent.

## Tax Cuts for Economic Stimulus

The possibility of tax cuts to stimulate the economy has occupied the attention of policymakers in Congress and elsewhere for several years. In 2001, a sluggish economy was one reason for enactment of the sizeable tax cut contained in EGTRRA. Economic data now show that a recession was underway at the time: the economy contracted during the first three quarters of 2001. Since then, the economy in general has returned to positive economic growth, but remains sluggish; business spending and employment have remained weak. As described in the preceding section, economic stimulus was one reason for enactment of P.L. 108-27.

Will the tax cut improve economic performance, as intended? Economic analysis generally approaches such questions by distinguishing between a tax cut's possible effects on long-term growth and its efficacy as a short-term economic stimulus. In the long run, according to economic theory, tax cuts can conceivably growth by increasing basic economic elements that contribute to long-run growth: specifically, labor supply and saving (the supply of capital). In principle, a cut in the tax rates applicable to labor income and/or saving might encourage individuals to save more or supply more labor. Economic analysis, however, also suggests several reasons to be skeptical. To begin, economic theory is uncertain as to whether a tax cut actually increases private saving or labor supply because of two offsetting effects. In the case of saving, for example, a tax cut might induce individuals to increase their saving because the after-tax return it produces is higher; on the other hand, if a saver's goal is accumulate a particular sum, a tax cut will enable him to do so at a lower level of saving. Theory predicts similar conflicting effects on labor supply. Economic theory, in short, is agnostic on whether tax cuts increase or reduce saving and labor supply. Given the ambiguity of theory, a firm conclusion necessarily relies on empirical evidence. Most evidence does not suggest a large savings response from a tax cut.

But whether a tax cut increases private saving or labor supply may be moot because of a revenue reduction's budgetary effects. A tax cut that is not matched by reductions in government spending increases the government's budget deficit above what would otherwise occur, and thus boosts the government's borrowing requirements. As a consequence, real interest rates faced by private investors may increase, "crowd out" private investment and more than offset any increase in investment resulting from an increase in private saving. Another way of looking at this effect is to recognize that total, national saving consists of private saving minus government borrowing. A tax cut will thus probably reduce national saving and may therefore reduce long-run growth.

Shifting to short-run considerations, would a tax cut similar to those considered stimulate the economy out of its sluggish performance? In recent decades, economists have grown more doubtful of the efficacy of tax cuts as a short-run stimulative tool, especially compared to monetary policy, its counter-cyclical alternative. There are several reasons for this skepticism. First, the modern world economy has become more open, and – via mechanisms such as capital flows and exchange rate adjustments – much of the stimulative force of tax cuts is thought by economists to be dissipated in the larger world economy. Beyond this consideration, monetary policy is thought to have an advantage over fiscal policy because changes in monetary policy can be implemented with more alacrity than those of fiscal policy; monetary authorities can recognize the need for stimulus and implement money-supply changes more quickly than tax-cut or spending legislation can work its way

through Congress. Given that the tax cut at hand has been passed, the implications of this point for the current bill is not clear. However, it might raise the question of whether additional economic stimulus is, at this time, necessary, given the recent tax cuts and interest-rate reductions by the Federal Reserve. For example, Federal Reserve Board chairman Alan Greenspan, in April 2003 congressional testimony, suggested that a stimulus fiscal-policy package is not needed.

For further reading see CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle and CRS Report RL30839, *Tax Cuts, the Business Cycle, and Economic Growth: A Macroeconomic Analysis*, by Marc Labonte and Gail Makinen.

## International Taxation

The U.S. economy is increasingly open, in terms of both trade and investment flows; the openness has helped make international tax issues among the most prominent tax questions Congress has faced in recent years. Specific international tax issues are numerous and include whether to reform the U.S. system by moving to a “territorial” system that exempts foreign-source income from U.S. tax; whether to adopt more incremental tax cuts for U.S. firms in order to help them compete internationally; how to resolve the export tax benefit controversy with the European Union (EU) over the U.S. extraterritorial income (ETI) tax benefit for exports; whether to adopt measures designed to curb corporate “expatriations” or “inversions” where firms reincorporate abroad to save taxes; whether and to what extent to cooperate with foreign governments in reducing international tax evasion and avoidance; and how the Internal Revenue Service should proceed in reducing U.S. tax evaders that use offshore tax havens.

At least one of these issues, the ETI controversy, is time sensitive. The EU has been authorized by the World Trade Organization (WTO) to impose retaliatory tariffs on U.S. products. Thus, ETI will likely be considered during the 108<sup>th</sup> Congress and may be the occasion for a broader policy debate on international taxation in general. The origins of the ETI controversy stretch back more than 30 years to enactment in 1971 of the Domestic International Sales Corporation (DISC) export tax benefit. European countries complained that DISC was an export subsidy, and as such, it violated the General Agreement on Tariffs and Trade (GATT, the WTO’s predecessor). In 1984, the United States attempted to remedy the situation by replacing DISC with a new export tax benefit, the Foreign Sales Corporation (FSC) provisions. However, in 1997, the European Union began proceedings against FSC under the new WTO agreements. Several WTO panel rulings concluded that FSC, like DISC before it, was a prohibited export subsidy. In 2000, the United States again attempted to revamp its export tax benefit with a WTO-compatible provision, in this case, ETI. However, WTO panels again supported the EU position, and in 2002, the WTO ruled that the EU can impose up to \$4 billion in retaliatory tariffs against U.S. products. EU officials have stated that the tariffs will not be imposed as long as the United States is seen to be making progress on making its export tax provisions WTO-compatible.

In the 107<sup>th</sup> Congress, Chairman Thomas of the House Ways and Means Committee introduced H.R. 5095, a broad international tax bill that addressed the ETI controversy by proposing repeal of the export benefit. The bill also proposed to promote U.S. competitiveness by cutting taxes on U.S. multinational firms in a variety of other ways.

Congress did not take action on the measure before it adjourned, in part due to opposition from policymakers who favor attempting to negotiate with the EU. In 2003, Representative Crane introduced H.R. 1769, which would phase out ETI while phasing in a tax deduction for firms' domestic production.

For further information, see CRS Report RS20746, *Export Tax Benefits and the WTO: Foreign Sales Corporations and the Extraterritorial Replacement Provisions*, by David L. Brumbaugh and CRS Report RL31717, *U.S. Taxation of Overseas Investment and Income: Background and Issues in 2003*, by David L. Brumbaugh.

## Other Possible Tax Issues

Other particular tax issues that might become prominent in the 108<sup>th</sup> Congress include the following items.

**Fundamental Tax Reform.** Congress actively considered fundamental tax reform — for example, shifting from an income to a consumption tax — in the mid-1990s, but such legislation never progressed beyond the committee level. Administration officials have recently indicated they are considering fundamental tax reform as a proposal for long-run tax policy, although it would be proposed apart from any stimulus package. In past Congresses, a number of Members introduced legislation that would adopt fundamental tax reform, suggesting congressional interest in the topic. For further information, see CRS Issue Brief IB95060, *Flat Tax Proposals and Fundamental Tax Reform: An Overview*, by James Bickley.

**Business Taxation.** The stimulus tax cut that Congress approved in March 2002 contained several tax cuts for business. However, these were temporary and scaled-back from the business tax cuts passed by the House (but not the Senate) in earlier versions of the stimulus package. In addition, participants in President Bush's August 2002 economic summit proposed eliminating the double-taxation of corporate dividends as a desirable reform for business taxation, a type of reform known among tax professionals as tax integration. Against this background, JGTRRA contained an increase and extension for "bonus" depreciation, making certain property eligible for a 50% immediate deduction. For further information, see CRS Report RL31597, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues*, by Gregg Esenwein and Jane Gravelle and CRS Report RL31782, *The Effect of the President's Dividend Relief Proposal on Corporate Tax Subsidies*, by Gregg Esenwein and Jane Gravelle.

**Small Business Taxation.** Taxation of small business is a continuing concern to Congress, and it is not likely that the 108<sup>th</sup> Congress will be an exception. Possible topics for consideration may be tax simplification, reform of the Subchapter S rules for taxing closely-held businesses, and enactment of investment incentives. Among the investment incentives adopted in 2003 tax-cut legislation was an increase in the "expensing" allowance for small business investment. For further information, see CRS Report RL31052, *Small Business Tax Relief: Selected Economic Policy Issues for the 107th Congress*, by Gary Guenther.

**Family Tax Issues.** Several family tax issues may be debated in the 108<sup>th</sup> Congress. For example, the earned income tax credit for low-income families has been suggested as a

focus of simplification efforts and the individual alternative minimum tax's impact on families has been a focus of concern. In addition, several prominent family-oriented tax provisions were part of the EGTRRA's tax cut, including benefits for married couples and the child tax credit. Thus, it appears likely that family tax issues will be an important part of the debate over making EGTRRA's tax cuts permanent. For further information, see CRS Report RS20988, *The Child Tax Credit After the Economic Growth and Tax Relief Reconciliation Act of 2001*, by Gregg Esenwein.

**Estate Tax.** One of the largest and most debated aspects of EGTRRA was its phase-out and repeal of the estate tax. Given the liveliness of the estate tax debate, and in view of its place as a fundamental part of the tax structure (albeit a small one), the estate tax may become a prominent part of the tax policy debate, apart from its place in the debate over making EGTRRA permanent. For further information, see CRS Report RL30600, *Estate and Gift Taxes: Economic Issues*, by Jane Gravelle.

**Individual Alternative Minimum Tax (AMT).** Under current law, an individual pays either the regular tax or AMT, whichever is larger. (The two will ordinarily differ because the AMT has lower rates but fewer and smaller tax benefits than the regular tax.) The individual alternative minimum tax presents a looming tax issue because key provisions of the AMT are not indexed for inflation, and an increasing number of individuals will find themselves subject to the AMT. In addition, tax benefits enacted by EGTRRA and other acts have placed an increased number of persons at or near AMT status. The March 2002 stimulus package included a provision allowing personal credits to offset a person's AMT, but that provision is scheduled to expire at the end of 2003, adding to the time-sensitive nature of the AMT issue and increasing the possibility that Congress will address it as an issue in the coming year.

**Expiring Tax Provisions.** The 2002 stimulus package extended a number of temporary tax provisions but extended many of the most prominent and popular of these "extenders" only through 2003. Some examples are the AMT treatment of personal tax credits (see the above issue), the work incentive tax credit, the welfare to work credit, and suspension of a limit on percentage depletion for oil wells. Given the time-sensitive nature of these provisions, Congress may address them in 2003, although it has allowed them to expire for brief periods in the past before retroactively extending the provisions.

**Energy Taxation.** In 2002, both the House and Senate passed legislation (H.R. 4) containing tax benefits related to energy, primarily tax benefits for particular categories of energy producers and consumers. Although a conference committee convened, the 107<sup>th</sup> Congress adjourned without acting on the bill. Both the House and Senate are likely to return to energy tax issues in 2003. On April 11, the House passed H.R. 6, which includes tax-related provisions that may affect energy supply, conservation, and efficiency. For further information, see CRS Issue Brief IB10054, *Energy Tax Policy*, by Salvatore Lazzari.

**Pension Tax Policy.** Both the House and Senate passed pension bills in 2002, but legislation was not enacted. In the 108<sup>th</sup> Congress, the House has approved H.R. 1000, the Pension Security Act of 2003, which — in the wake of the Enron controversy — proposes to mandate employee diversification rights in 401(k) plans. Additional pension issues that could be considered include a revision of tax rules to protect employee pensions from abuse and relaxation of rules relating to taxation of IRA withdrawals after retirement. For further

information, see CRS Report RS20629, *Pension Reform: The Economic Growth and Tax Relief Reconciliation Act of 2001*, by Patrick Purcell.

**Tax Policy and Health Insurance.** The 107<sup>th</sup> Congress evinced interest in enacting additional tax benefits related to health insurance. For example, the House passed a patients' protection bill (H.R. 2563) that included provisions making tax-favored Medical Savings Accounts a permanent rather than temporary part of the tax code, a tax credit for small employers, and expansion of tax benefits for the self-employed. The 108<sup>th</sup> Congress may take up health tax policy again. For further information, see CRS Issue Brief IB98037, *Tax Benefits for Health Insurance: Current Legislation*, by Bob Lyke and Christopher Sroka.

**Internet Taxation.** The growth of the Internet has placed pressure on the states' sales and use tax systems, raising questions such as: How should use of the Internet be taxed? and How should commerce conducted via the Internet be taxed? The federal government has a role in regulating Internet taxation by virtue of the Constitution's Commerce Clause, and in 2001 a moratorium was enacted prohibiting new taxes on Internet access and multiple or discriminatory taxes on Internet commerce. The moratorium, however, expires on November 1, 2003, suggesting that Congress may take up the issue of Internet taxation again in 2003. For further information, see CRS Report RL31177, *Extending the Internet Tax Moratorium and Related Issues*, by Nonna Noto.

**Internal Revenue Service (IRS) Oversight.** Oversight of the IRS may be an issue Congress addresses in 2003. The IRS Restructuring and Reform Act of 1998 mandated significant changes in the way the IRS operates along with a change in its "culture"; Congress may examine the extent to which the IRS has accomplished the Act's goals. In addition, the apparent growth of tax shelters has been of increasing concern to some policymakers; an issue before Congress may be the effectiveness of IRS efforts to restrain abusive tax shelters.

**Charitable Contributions.** As a component of President Bush's faith based initiative, the House passed H.R. 7 in the 107th Congress. This legislation would have expanded benefits for charitable giving and charities. In the 108th Congress, similar legislation has already been revisited. Key tax-related issues are likely to include providing charitable deductions for nonitemizers, allowing tax-free distributions from individual retirement accounts for charitable purposes, and extending the deduction for food inventory to all businesses. For further information, see the CRS Electronic Briefing Book, *Taxation*, "Charitable Contributions" by Jane G. Gravelle, available online only from the CRS Web site at [<http://www.congress.gov/brbk/html/ebttxr80.html>].