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Major Tax Issues in the 108th Congress

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David L. Brumbaugh, Coordinator
Government and Finance Division

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SUMMARY

As 2004 progresses, the congressional tax policy debate continues to focus on several issues it considered in 2003. One such focus is the broad tax cuts Congress enacted in May 2003, as the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA; P.L. 108-27). At issue in 2004 is whether to extend a number of JGTRRA's tax reductions that are scheduled to expire at the end of the current year. A second prominent issue is the controversy over the extraterritorial income (ETI) tax benefit for U.S. exports, which was found to be impermissible by the World Trade Organization (WTO); both the House and Senate tax-writing committees passed legislation repealing ETI in late 2003. The legislation also contains broader provisions affecting U.S. and overseas investment, and Congress continued to debate the bills through the first months of 2004. Other tax issues that Congress has addressed in the first part of 2004 include pension reform legislation, extension of a moratorium on internet taxation, and taxes related to highway funding.

The principal tax cuts contained in JGTRRA were actually "accelerations" of reductions previously enacted in 2001 with the Economic Growth and Tax Relief Reconciliation Act (EGTRRA; P.L. 107-16). EGTRRA provided a gradual phase in of a variety of tax cuts, including reduction of individual income tax rates and tax cuts for married couples and families. JGTRRA moved the effective date of EGTRRA's gradual tax cuts forward to 2003. However, several of JGTRRA's accelerations are scheduled to expire at the end of 2004, including an increase in the child tax credit, tax cuts for married couples, reduction of the alternative minimum tax, and tax incentives for business. (EGTRRA's tax cuts are themselves scheduled to expire at the end of 2010). During the first half of 2004, the House passed a number of bills that would extend or make permanent large parts of the EGTRRA and JGTRRA tax cuts, including the tax cuts for married couples, the 10% tax bracket, the increased child tax credit, and the increased alternative minimum tax exemption. In early fall 2004, it appeared that H.R. 1308, a bill relating to refundability of the child tax credit, would become a vehicle for consideration of extending the expiring measures.

The ETI controversy is a long-simmering dispute between the European Union (EU) and the United States, with the EU lodging complaints with the WTO about current law's ETI benefit, as well as its statutory predecessors, the Foreign Sales Corporation (FSC) and Domestic International Sales Corporation (DISC) provisions. In late spring 2004, the House and Senate each passed bills (H.R. 4520 and S. 1637, respectively) that would both repeal the contentious ETI provisions and implement different mixes of benefits for domestic and foreign investment. Final passage would require action by a conference committee. For its part, the EU received permission from the WTO to impose retaliatory tariffs on imports from the United States and began to phase in the tariffs on March 1.

In February 2004, President Bush delivered his FY2005 budget proposal. It includes a proposed net tax cut of $1.2 trillion over 10 years. The largest component is a proposal to make EGTRRA's tax cuts permanent. The proposal would also make JGTRRA's acceleration of EGTRRA permanent.

Most Recent Developments

During the first quarter of 2004, a principal focus of the congressional tax policy debate has been legislation addressing the export tax-benefit (ETI) dispute between the United States and the European Union. Legislation seeking to solve the dispute by repealing ETI has been approved by both chambers, as H.R. 4520 in the House and S. 1637 in the Senate. In the case of each bill, the legislation goes beyond repeal of ETI to include both tax incentives for domestic business investment and tax cuts for the overseas operations of U.S. firms. There are, however, differences between the bills, and a conference committee version of the legislation had not been developed by early September. In the meantime, the EU began to phase in retaliatory tariffs on U.S. products on March 1. Other tax legislation that Congress considered during the first part of 2004 included transportation-related taxes and pensions as well as legislation (in the House) that would extend or make permanent large parts of the 2001 and 2003 tax cuts. There are indications that H.R. 1308, a bill addressing refundability of the child tax credit, may become a vehicle for both chambers to consider the tax-cut extensions.

For primers on subject specific tax legislation in the 108th Congress, see CRS Electronic Briefing Book, *Taxation*, at [http://www.congress.gov/brbk/html/ebtxr1.shtml]. For details on the legislative developments of current tax-related legislation, see CRS Report RS21386, *Fact Sheet on Congressional Tax Proposals in the 108th Congress*, by Pamela J. Jackson.

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 2004 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

In the first half of 2004 the economy continued its expansion and recovery from the 2001 recession; real output grew at an average rate of 3.0% in 2003, up from 1.9% in 2002. Real growth was 4.5% in the first quarter of 2004 and 3.0% in the second quarter. The favorable economic performance is qualified, however, by relatively slow growth in employment (leading some to characterize the current situation as a "jobless recovery"), but most prognosticators expect economic growth to continue in 2004 and beyond.

Although the current economic context of tax policy is thus one of growth, one principal focus of the tax policy debate in recent years has been the efficacy of tax cuts as an economic stimulus. The tax cuts of 2001, 2002, and 2003 were enacted, in part, as a means of stimulating a still-sluggish economy, and although the recession has ended and economic growth has picked up momentum, the debate over the merits of tax cuts as economic stimulus continues to resonate. For example, one subject of current debate is the extent to which tax cuts are responsible for the economy's rebound and the extent to which factors such as monetary policy or the end of the war in Iraq are responsible. It is thus informative to review the main outlines of economic performance over the past few years.

The economic boom of the 1990s lasted nine consecutive years, but by late 2000, the economy began to show signs of weakness. President-elect Bush had called for a tax cut during the election campaign for philosophical reasons and to spur long-term growth, but as 2000 came to an end, he added that a tax cut would now also be advisable as a means of providing a near-term fiscal stimulus to the sluggish economy. The tax cut he proposed in January 2001 ultimately became the basis for the large reduction enacted as EGTRRA in June 2001.

As 2001 progressed, there were increasing signs of economic weakness, and 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. The recession ended in November 2001, having lasted eight months. The recession was of about average severity and duration for economic recessions of the post-World War II era.[1]

Following the recession, the economy registered positive growth in all four quarters of 2002, but still exhibited signs of sluggishness. Business investment spending was weak and employment continued to decline through 2002. Further, the pattern of growth was uneven, leading observers to characterize the economy's performance since the end of the recession as "choppy" and "sub-par." Several factors were thought to be 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," including the war in Iraq

Positive economic growth continued through all four quarters of 2003 and accelerated; growth continued into 2004. Real gross domestic product (GDP) grew at an annualized rate of 2.0% in the first quarter of 2003, 3.1% in the second quarter, 8.2% in the third quarter, and 4.0% in the fourth quarter. Real growth was 4.5% in the first quarter of 2004 and 3.0% in the second. Payroll employment, however, remains below the peak it registered before the 2001 recession. The unemployment rate in 2004 has fluctuated between 5.5% and 5.7%, and has remained at a generally higher level than those registered during the boom of the 1990s.

For further reading, see CRS Report RL30329, *Current Economic Conditions and Selected Forecasts*, by Gail Makinen.

[1] CRS Report RL31237, *The Current Economic Recession: How Long, How Deep, and How Different from the Past?*, by Marc Labonte and Gail Makinen, p. 29.

The Federal Budget

In its September 2004 update on the budget and economic outlook, the Congressional Budget Office (CBO) reported that the federal budget registered a deficit in FY2003 amounting to 3.5% of GDP and estimated that the deficit will increase slightly to 3.6% of GDP in FY2004, assuming current policies remain in place. A deficit in FY2004 would be the third year in a row the budget has registered a deficit, with the size of the deficit growing in each successive year. Beginning with FY2005, however, CBO projects a gradual decline in the deficit as percentage of GDP, shrinking to a position of near-balance (a deficit of 0.4% of GDP) by 2012. As described below, however, if the assumption that current policies remain in place is dropped, the outlook changes — an important consideration given congressional interest in extending or making permanent the 2001 and 2003 tax cuts.

A broader historical perspective shows several reversals in the federal budget situation in recent years. The budget was in deficit throughout the 1970s, 1980s, and most of the 1990s before registering a surplus in FY1998, a result of both the booming economy and legislation designed to enforce budget discipline. The budget surplus grew for the next two years, reaching a peak of 2.4% of GDP in FY2000 before declining in FY2001 and moving into deficit in FY2002 and FY2003. The difference between the surplus in FY2000 and the deficit in FY2003 amounts to 5.9% of GDP. The budget data indicate that the change was a result of both a growth in outlays and a decline in revenues. The decline in revenues was more pronounced, however; revenues declined from 20.9% of GDP in FY2000 to 16.5% in FY2003, a drop of 4.4 percentage points. Outlays declined by only 1.5 percentage points over the same period. The decline in revenues has two sources: the recession of 2001 and subsequent sluggish economic growth, and enacted tax cuts.

The outlook, however, may change. As described elsewhere in this issue brief, the tax cuts enacted in 2001 by EGTRRA expire at the end of calendar year 2010; parts of JGTRRA's acceleration of EGTRRA expire at the end of 2004. Extending the tax cuts would have a substantial impact on the budget, particularly after 2010. To illustrate, the President's FY2005 budget proposes extending some, but not all, of the EGTRRA and JGTRRA tax cut provisions (it would not extend, for example, the increased minimum tax exemption, an omission that limits the revenue loss from extending the tax cuts). According to estimates by CBO and the Joint Committee on Taxation, the extension would reduce revenues by $252 billion in FY2012, the first full fiscal year after EGTRRA's expiration. This amounts to 7.8% of revenues that are otherwise estimated to occur and 1.5% of anticipated GDP.

The longer-term budget situation is a concern to many policymakers, chiefly because of the combination of rising health care costs and demographic pressures posed by an aging population that will begin with the retirement of the "baby boom" generation. Under current law, spending on Social Security, Medicare, and Medicaid is expected to increase substantially as a share of the economy. The Congressional Budget Office has estimated that combined spending on the three programs will grow from 8% of GDP in 2004 to over 14%

in 2030 and to almost 18% by 2050.[2] According to CBO, either substantial increases in taxes or cuts in spending will likely be necessary in the future if fiscal stability is to be maintained.[3]

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 RS21786, *The Federal Budget Deficit: A Discussion of Recent Trends*, by Gregg Esenwein, Marc Labonte, and Philip Winters.

The Federal Tax Burden[4]

At the outset of the preceding (107th) 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 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 some fluctuations in the distribution of the federal tax burden have occurred over the last 20 years, the fluctuations have been concentrated at the opposing ends of the income spectrum. During the 1980s, the combined burden of all federal taxes 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. Families in the middle-income brackets, however, experienced smaller changes 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 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.

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[2] U.S. Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005-2014* (Washington: GPO, 2004), p. 8.

[3] U.S. Congressional Budget Office, *The Long-Term Budget Outlook* (Washington: December, 2003), p. 9.

[4] Authored by Gregg A. Esenwein, Specialist in Public Finance, Government and Finance Division.

Tax Proposals in President Bush's Fiscal Year 2005 Budget

On February 2, President Bush released the details of his fiscal year (FY) 2005 budget proposal, including its tax components. In general terms, the plan calls for a tax cut of $1.24 trillion over 10 years and $213 billion over five years. By far the largest element of the plan is a proposal to make EGTRRA's tax cuts permanent rather than allowing them to expire after 2010, as currently scheduled; the proposal would reduce revenues by an estimated $883.3 billion. (See the discussion is the next section.) The budget proposal would also extend through 2010 JGTRRA's acceleration of EGTRRA's scheduled tax cuts rather than permitting tax rates and other provisions to revert to EGTRRA's slower phase-in schedule at the end of 2004, as currently scheduled.

Other elements of the President's proposal are more targeted. Prominent items include revamped and expanded tax-favored savings accounts. The proposal would consolidate current law's several types of Individual Retirement Accounts (IRAs) into a single Retirement Savings Account with more generous rules. The plan would also combine existing non-retirement savings accounts (e.g., education savings accounts, medical savings accounts) into a single Lifetime Savings Account that could be used for saving for any purpose.

Other targeted proposals are in the areas of health care, charitable giving, education, and energy. Prominent specific proposals include a tax credit of up to $1,000 per adult for the purchase of health insurance, a deduction for charitable contributions that could be claimed by individuals who do not itemize their deductions, and a variety of energy-related tax cuts intended to promote both energy production and energy conservation.

The budget proposal would extend or make permanent a number of targeted temporary tax benefits ("extenders"), many of which expired at the end of 2003. The plan would extend for two years the ability of nonrefundable personal credits to offset taxpayers' alternative minimum tax; make the research and experimentation tax credit permanent; permanently permit the deduction of policyholder dividends by mutual life insurance companies; extend for two years and consolidate the work opportunity and welfare-to-work tax credits, and extend a number of other temporary tax benefits.

The proposal contains a set of revenue-raising items in the general area of tax "loopholes" and tax compliance. Together the proposals would increase revenue by an estimated $44.2 billion over 10 years. The largest single revenue-raiser is more stringent rules for leasing arrangements with "tax-indifferent" (e.g., tax-exempt) parties.

Tax Legislation in 2003

The 2003 Tax Cut: The Jobs and Growth Tax Relief Reconciliation Act (JGTRRA)

On January 7, 2003, President Bush announced the details of a new tax cut proposal intended to provide a stimulus to the economy. 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 also additional tax cut provisions) was estimated at $1.575 trillion.

A principal part of the President's tax proposals was acceleration of several tax cuts for individuals that were enacted by EGTRRA in 2001 but that were scheduled to be phased in only 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 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.

Another prominent part of the plan was a proposal to move toward "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 "expensing" allowance for small business investment in equipment to $75,000 from current law's $25,000.

Each of these proposals was included in the stimulus part of the package the President outlined in January. Prominent among the additional tax cuts proposed with the budget were 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.

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). In broad outline, the act contained the principal elements of the stimulus part of the President's tax-cut proposal. The President signed the bill into law on May 28. While the Senate and House versions of the bill were similar in broad outline, they did contain some differences that were reconciled by the conference agreement. The House bill, for example, would have reduced revenue by $550 billion over approximately 10 years, while the Senate bill proposed a net tax cut and increases in outlays amounting to $350 billion. The Senate bill also contained a set of revenue raising proposals not in the House bill.

JGTRRA's conference agreement 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 those for singles. Beginning in 2005, these provisions will revert to EGTRRA's schedule, which provides for phased-in increases to the levels of twice those for 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 $100,000 for 2003, 2004, and 2005. The provision's phase-out threshold was increased from $200,000 to $400,000 over the same time period.

- The temporary "bonus" depreciation allowance originally passed in March 2002 was 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 applies 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 on the economy of the measure that was adopted. 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.

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

Selected Issues

Expiration of the 2001 Tax Act and its Acceleration by JGTRRA

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 were 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 a 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 contained 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, JGTRRA's acceleration of EGTRRA's tax cuts is itself temporary. While JGTRRA moved up the effective dates of a number of EGTRRA's cuts from those that would apply under EGTRRA's slower phase in, JGTRRA's accelerations themselves generally expire after 2004, meaning that a number of taxpayers could register a tax increase in 2005. These expirations include the increased child tax credit, expansion of the 10% tax bracket, and tax cuts for married couples.

During the first half of 2004, the House passed a number of bills that would extend or make permanent large parts of the EGTRRA and JGTRRA tax cuts. H.R. 4181 would make the tax cuts for married couple permanent; H.R. 4275 would make permanent the 10% tax bracket; H.R. 4359 would apply to the child tax credit, and H.R. 4227 would extend the increased alternative minimum tax exemption through 2005.

For further information, see CRS Report RS21863, *Recent House Legislation Extending Selected Provisions of the 2001 and 2003 Tax Cuts*, by Gregg Esenwein.

Deductibility of State and Local Sales Tax [5]

Under current federal tax laws, federal income tax filers who itemize can deduct state and local income and property taxes when computing federal taxable income, but cannot deduct state and local sales taxes. Thus, taxpayers in states without an income tax are able to deduct less state and local taxes. Taxpayers in non-income tax states argue that this differential tax treatment is inequitable. Several proposals have been made to allow state and local sales taxes paid by individuals to be deducted from federal income tax. Some of these bills would allow taxpayers to choose an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes. Prominent among these proposals is H.R. 4520, the omnibus business tax and ETI proposal approved by the House in June 2004. Other bills would permit those residents who itemize deductions in states without an income tax to deduct state sales taxes when computing federal income tax liability.

For further information see CRS Report RL32455, *State and Local Sales Tax Deductibility: Proposed Legislation*, by Pam Jackson and Steve Maguire.

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? Has it played a role in the recent pick-up in economic growth? 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 stimulate 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 to 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

[5] Authored by Pamela Jackson, Analyst in Public Sector Economics, and Steven Maguire, Analyst in Public Finance, Government and Finance Division.

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. Economic theory predicts that a tax cut will thus probably reduce national saving and may therefore reduce long-run growth.

Shifting to short-run considerations, is a tax cut similar to that enacted likely to stimulate the economy in the near term? Have the recent tax cuts played a role in the recent pick-up of economic 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.

For further information 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" in which 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 is being considered during the 108th Congress and is 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 107th 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 the 108th Congress, Representative Crane introduced H.R. 1769 in April 2003. The bill would phase out ETI while phasing in a tax deduction for firms' domestic production. On July 25, Representative Thomas introduced H.R. 2896, a bill similar to H.R. 5095, but with the addition of several tax benefits restricted to domestic investment; the modified bill thus contained a mix of domestic and overseas investment to accompany repeal of ETI. On October 1, the Senate Finance Committee approved S. 1637 (Senator Grassley), containing a somewhat different mix of domestic and overseas tax benefits. On October 28, the House Ways and Means Committee approved a modified version of H.R. 2896. Congress did not take further action on the ETI issues before it adjourned for the year but resumed work on the matter during the first months of 2004. The full Senate began debate on S. 1637 in March and approved the bill on May 11.

On June 4, Representative Thomas introduced a revised version of the ETI bill as H.R. 4520. As with S. 1637 and H.R. 2896, the bill would phase out ETI and replace it with a mix of tax cuts for domestic and international investment, although the particular mix differs from that contained in the other bills. The House approved H.R. 4520 on June 17.

For further information, see CRS Report RL32066, *Taxes, Exports, and International Investment: Proposals in the 108th Congress*, 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, and CRS Report RL32444, *Comparison of the House and Senate ETI/Business Investment Bills*, by David L. Brumbaugh.

Other Possible Tax Issues

Other particular tax issues that may be on the congressional tax agenda in 2004 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. In the past, Administration officials have indicated they would consider fundamental tax reform as a proposal for long-run tax policy and a number of bills were introduced in the first session of the 108th Congress that proposed fundamental tax reform, suggesting continuing 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 tax cut Congress approved in May 2003 included several tax cuts for business — for example, temporary increases in the expensing benefit for small business investment and in depreciation allowances. In addition, the tax cut reduced taxes on dividends and capital gains tax — a move in the direction of what tax professionals term "tax integration," which is thought to stimulate the flow of investment to the corporate sector. During the first part of 2004, Congress returned to the topic of business taxation in connection with legislation to repeal the ETI export tax benefit (see the discussion above). Each of the ETI bills include tax benefits designed to encourage domestic production for businesses. In some cases, the proposed tax cuts for domestic business are substantially larger than the expected increase in tax revenues from ETI's repeal, and have assumed a prominent role in the debate over the ETI legislation.

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 RL32103, *Comparison of Tax Incentives for Domestic Manufacturing in Current Legislative Proposals*, by Jane Gravelle.

Small Business Taxation. Taxation of small business is a continuing concern to Congress, and it is likely to remain so in 2004. Possible topics for consideration may be tax simplification, reform of the Subchapter S rules for taxing closely-held businesses, and enactment or enhancement of investment incentives such as the expensing benefit for equipment.

Family Tax Issues. Several family tax issues may be debated in 2004. 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 EGTRRA's tax cut and of JGTRRA's acceleration of EGTRRA's phase-ins, 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 the EGTRRA or JGTRRA 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. In 2003, the House approved H.R. 8, which would make EGTRRA's repeal of the estate tax permanent, although the Senate did not take action. Given the liveliness of the estate tax debate, and in view of its place (albeit a small one) as a fundamental part of the tax structure, the estate tax may become a prominent part of the 2004 tax policy debate, apart from its place in any 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 expired at the end of 2003, adding to the time-sensitive nature of the AMT issue and increasing the possibility that Congress will address this issue in the coming year.

Expiring Tax Provisions. Expiring tax provisions may be on the 2004 congressional agenda in several different ways. First, a number of tax cuts enacted by JGTRRA are scheduled to expire at the end of 2004, returning the level of items such as the child tax credit and standard deduction and brackets for married couples to the more gradual phase-ins scheduled by EGTRRA. Further, the EGTRRA tax cuts themselves are scheduled to expire at the end of 2010. Second, apart from the EGTRRA and JGTRRA tax cuts, the tax code contains a number of tax benefits that have been temporary since their inception, that have been scheduled to expire at particular points in time, but that have generally been extended for varying lengths of time on a number of occasions. Several of the most prominent measures — for example, the AMT treatment of personal tax credits (see the AMT issue described above), the work incentive tax credit, the welfare to work credit — were scheduled to expire at the end of 2003, and while Congress began consideration of their extension, it did not enact legislation before the provisions expired. However, Congress has allowed extenders to expire for brief periods in the past before retroactively extending them, and there are indications it may do so in 2004.

Energy Taxation. In 2002, both the House and Senate passed legislation (H.R. 4) containing tax benefits related to energy, including tax benefits for particular categories of energy producers and consumers. Although a conference committee convened, the 107th Congress adjourned without acting on the bill. Both the House and Senate returned to the issue of energy taxation in the 108th Congress. A conference committee completed work on an energy bill in November. The House approved the agreement, but the Senate did not act on the measure before Congress adjourned for the year. There are indications that Congress will return to energy legislation early in 2004. For further information, see CRS Issue Brief IB10054, *Energy Tax Policy*, by Salvatore Lazzari.

Pension Tax Policy. Congress actively considered several pension-related tax bills in 2003 without taking final action; it may return to pensions in 2004. In May 2003, the House passed H.R. 1000, which would permit diversification of 401(k) plans in the wake of the Enron bankruptcy. The Senate did not act on the bill before the end of 2003. In July, the House Ways and Means Committee approved H.R. 1776, containing a variety of pension-related tax provisions, including more generous treatment of IRAs, expansion and extension of the temporary tax credit for contributions to retirement plans, and provisions for annuities and defined benefit and defined contribution plans. For further information, see CRS Report RS20629, *Pension Reform: The Economic Growth and Tax Relief Reconciliation Act of 2001*, by Patrick Purcell.

Internet Taxation. The growth of the Internet has placed pressure on the states' sales and use tax systems, raising questions such as how use of the Internet and commerce conducted via the Internet should be taxed. The federal government has a role in regulating Internet taxation by virtue of the Constitution's Commerce Clause, and in 2001, a temporary moratorium was enacted prohibiting new taxes on Internet access and multiple or discriminatory taxes on Internet commerce (P.L. 107-75). The moratorium expired on November 1, 2003. The House passed legislation (H.R. 49) that would make the moratorium permanent, but the Senate did not do so before Congress adjourned for 2003. For further information, see CRS Report RL31177, *Extending the Internet Tax Moratorium and Related Issues*, by Nonna Noto.

Charitable Contributions. Bills providing tax benefits for charitable contributions passed both the House (H.R. 7) and Senate (S. 476) in 2003. Both bills would temporarily extend the deductibility of donations to non-itemizers and allow tax-free treatment of charitable distributions from IRAs. The bills, however, contain a number of significant differences; a prominent difference is the inclusion of revenue-raising "offsets" in the Senate bill but not the House bill. The differences between the bills were not reconciled before Congress adjourned for 2003, but there were indications that Congress would return to the legislation in 2004. For further information, see the CRS Electronic Briefing Book, *Taxation*, "Charitable Contributions," by Jane G. Gravelle, available online only from the CRS website at [http://www.congress.gov/brbk/html/ebtxr80.html].