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The Bush Tax Cuts and the Economy

Abstract

[Excerpt] A series of tax cuts were enacted early in the George W. Bush Administration by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27). These tax cuts, which are collectively known as the Bush tax cuts, are scheduled to expire at the end of 2010. Beginning in 2011, many of the individual income tax parameters (such as tax rates) will revert back to 2000 levels. The major tax provisions in EGTRRA and JGTRRA that are part of the current debate over the Bush tax cuts are the reduced tax rates, the reduction of the marriage penalty (and increase in the marriage bonus), the repeal of the personal exemption phaseout and the limitation on itemized deductions, the reduced tax rates on long-term capital gains and qualified dividends, and expanded tax credits. This report examines the Bush tax cuts within the context of the current and long-term economic environment.

Keywords

tax cuts, George W. Bush Administration, economic growth, budget deficits

Comments

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The Bush Tax Cuts and the Economy

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Summary

A series of tax cuts were enacted early in the George W. Bush Administration by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27). These tax cuts, which are collectively known as the Bush tax cuts, are scheduled to expire at the end of 2010. Beginning in 2011, many of the individual income tax parameters (such as tax rates) will revert back to 2000 levels. The major tax provisions in EGTRRA and JGTRRA that are part of the current debate over the Bush tax cuts are the reduced tax rates, the reduction of the marriage penalty (and increase in the marriage bonus), the repeal of the personal exemption phaseout and the limitation on itemized deductions, the reduced tax rates on long-term capital gains and qualified dividends, and expanded tax credits. This report examines the Bush tax cuts within the context of the current and long-term economic environment.

The U.S. economy entered into a recession in December 2007. Between the fourth quarter of 2007 and the second quarter of 2009, the economy shrank with real gross domestic product (GDP) falling by 4.1%. The unemployment rate increased from 4.9% in December 2007 to 10.1% by October 2009, and is currently still over 9%. As a result of reduced economic activity and government efforts to stimulate the economy, the federal budget deficit increased from 1.2% of GDP in FY2007 to 9.9% of GDP in FY2009. Most economic forecasts suggest the economic outlook over the next few months is not bright and will likely be characterized by high unemployment and sluggish economic growth. The long-term fiscal situation is unsustainable.

There are several options that Congress can consider regarding the Bush tax cuts, and each of the options strikes a different balance between fostering economic growth and restoring fiscal sustainability. Allowing the Bush tax cuts to expire as scheduled will somewhat improve the fiscal condition, but could stifle the economic recovery. At the other extreme, permanently extending all of the Bush tax cuts would not undercut the economic recovery, but would worsen the longer-term fiscal outlook and possibly signal a lack of progress in dealing with the long-term fiscal situation. The Obama Administration has proposed allowing the Bush tax cuts to expire for high income taxpayers and permanently extending the tax cuts for middle class taxpayers. Compared to permanently extending all of the Bush tax cuts, this proposal is projected to increase tax revenues by \$252 billion over five years and by \$678 billion over 10 years, but still leaves federal debt on an unsustainable path. A temporary extension of the Bush tax cuts could provide time for Congress to consider tax reform and also provide a deadline to complete deliberations. Furthermore, allowing the tax cuts targeted to high income taxpayers to expire as scheduled could help reduce budget deficits in the short-term without stifling the economic recovery.

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A series of tax cuts were enacted early in the George W. Bush Administration by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA; P.L. 108-27).¹ These tax cuts, which are collectively known as the Bush tax cuts, are scheduled to expire at the end of 2010. Beginning in 2011, many of the individual income tax parameters (such as tax rates) will revert back to 2000 levels.

The pending expiration of the Bush tax cuts has generated a great deal of attention as reflected by editorials and opinion pieces in national newspapers, and Congressional hearings. The current proposals regarding the Bush tax cuts are generally not about whether or not to let the tax cuts expire as scheduled, but rather about which tax cuts to extend and for how long. This report examines the Bush tax cuts within the context of the current and long-term economic and budgetary environment.

The major tax provisions in EGTRRA and JGTRRA that are part of the current debate over the Bush tax cuts are the reduced individual income tax rates, the reduction of the marriage penalty (and increase in the marriage bonus), the repeal of the personal exemption phaseout and the limitation on itemized deductions, the reduced tax rates on long-term capital gains and qualified dividends, and expanded tax credits. Other provisions that were included in EGTRRA and JGTRRA, such as the estate tax, are not considered in this study.

Economic and Budgetary Environment

The U.S. economy entered into a recession in December 2007.² Between the fourth quarter of 2007 and the second quarter of 2009, the economy shrank with real gross domestic product (GDP) falling by 4.1%. The unemployment rate increased from 4.9% in December 2007 to 10.1% by October 2009, and still is over 9%. As a result of reduced economic activity and government efforts to stimulate the economy, the federal budget deficit increased from 1.2% of GDP in FY2007 to 9.9% of GDP in FY2009.

The Economy

The recession beginning in December 2007 is the most severe recession since the Great Depression and has been referred to as the Great Recession. The economy started to grow after mid-2009. One measure that has tracked economic activity fairly well in the past is the Federal Reserve Board's industrial production index.³ The industrial production index started to turn up after May 2009 and the Federal Reserve Bank of St. Louis suggests that the turning point for the recession was July 2009.⁴ Although the economy has been growing for the past year, NBER's Business Cycle Dating Committee has not yet determined the date of the end of the recession.⁵

¹ See CRS Report R41111, *Expiration and Extension of the Individual Income Tax Cuts First Enacted in 2001 and 2003: Background and Analysis*, by Maxim Shvedov, for more details.

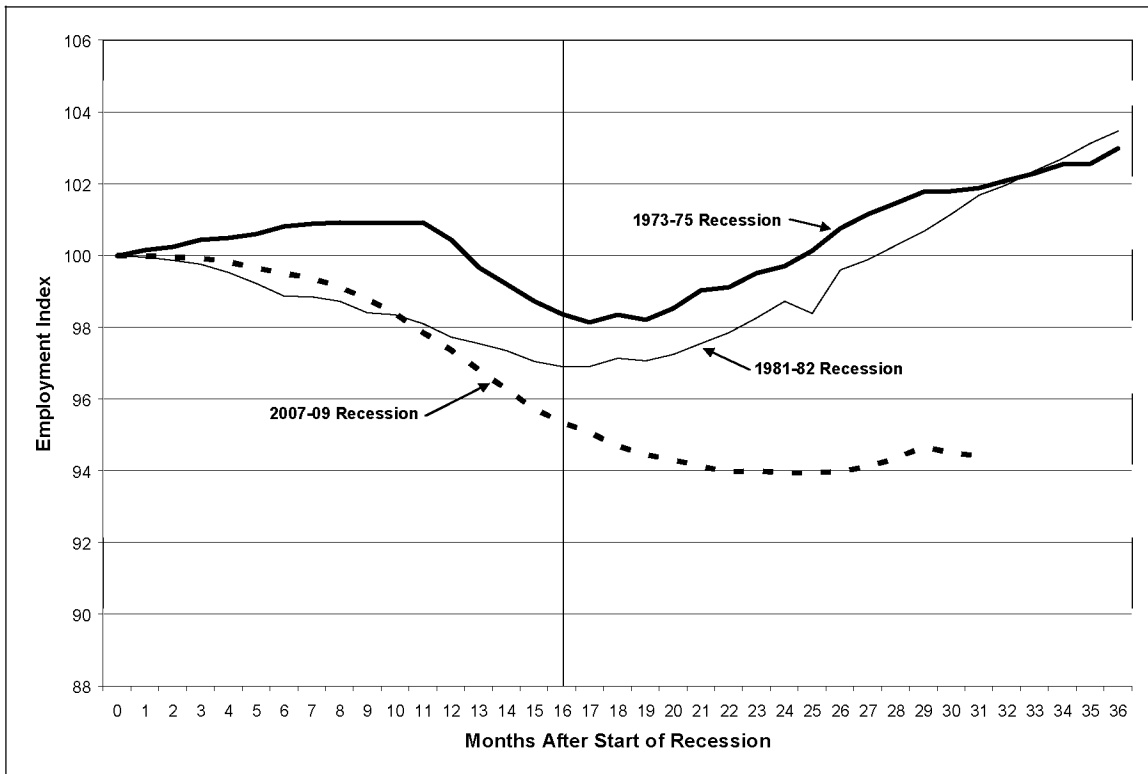
² Business cycle peaks (start of a recession) and troughs (end of a recession) are determined by the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER).

³ This measure is one of the economic indicators used by the Business Cycle Dating Committee in its determination of the economy's turning points.

⁴ Their suggested turning point is based on a model developed in Marcelle Chauvet and Jeremy Piger, "A Comparison (continued...)"

The economic recovery, however, remains fragile and the labor market has not recovered. **Figure 1** shows employment for the first month of the recession and the next 30 months. The trend in employment (as a percentage of employment in the first month of the recession) is compared to two other deep and prolonged recessions of similar duration (assuming the 2007-2009 recession ended in July 2009). For these latter two recessions, the employment level began increasing within a month or two after the end of the recession (the end of the recessions is denoted by the vertical line in the figure). In the 2007-09 recession, employment did not hit bottom until about 25 months after the start of the recession (in December 2009). Furthermore, the employment level has fallen since May 2010, and by July 2010 stood at 94% of the December 2007 level.

Figure 1. Employment Levels During Selected Recessions



Source: CRS analysis of Bureau of Labor Statistics data.

Weakness in the labor market is further indicated by the proportion of the labor force that has been unemployed for at least six months (the long-term unemployed). **Figure 2** displays the monthly unemployment and long-term unemployment rates since 1948. The long-term unemployment rate has generally tracked the unemployment rate over the business cycle. Over a business cycle, the long-term unemployment rate is at its lowest point at or near the beginning of a recession and then reaches a peak a few months after the end of the recession (typically within six months). Like the unemployment rate, the long-term unemployment rate is a lagging

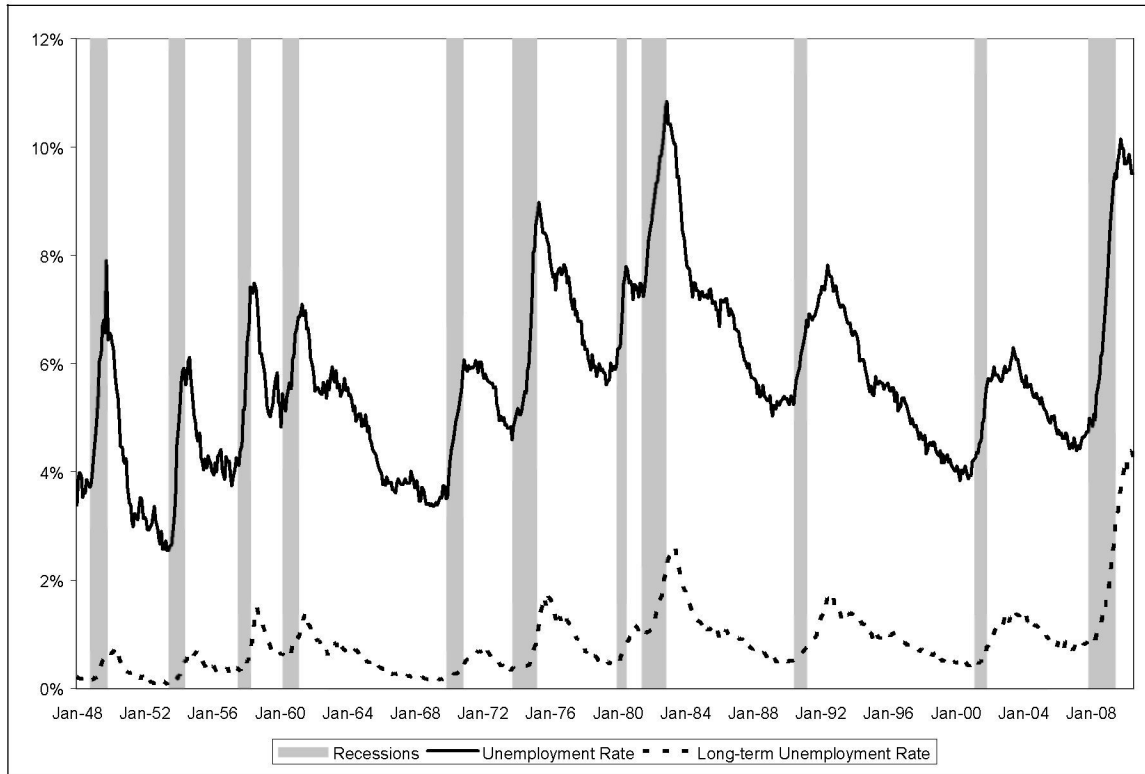
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of the Real-Time Performance of Business Cycle Dating Methods,” *Journal of Business and Economic Statistics*, vol. 26 (2008), pp. 42-49.

⁵ The latest communication from the Business Cycle Dating Committee was issued April 12, 2010 and is available at <http://www.nber.org/cycles/april2010.html>.

indicator—the labor market does not begin to recover from the recession until some time after the official end of the recession. After the 1990-91 and 2001 recessions, however, the long-term unemployment rate did not reach its peak until 15 and 19 months, respectively, after the recession ended. The long-term unemployment rate is currently higher than at any time over the past 62 years—in July 2010, 4.3% of the labor force or about 45% of the unemployed had been out of work for six months or more.

Figure 2. Monthly Unemployment Rate and Long-Term Unemployment Rate, 1948-2010



Source: CRS analysis of Bureau of Labor Statistics data.

In early August 2010, the Federal Reserve Board reported that “the pace of recovery in output and employment has slowed in recent months.”⁶ Robert Shiller of Yale University reportedly put the chances of a double-dip recession at more than 50-50 because of the high unemployment.⁷ In addition to the labor market, the housing market continues to be weak. In its latest release, the National Association of Realtors reports that existing home sales declined by 27.2% between June and July 2010. Mark Zandi of Moody’s Analyticals has reportedly said the housing market is in a double-dip recession.⁸

⁶ Board of Governors of the Federal Reserve System, Press Release, August 10, 2010 available at <http://www.federalreserve.gov/newsevents/press/monetary/20100810a.htm>.

⁷ Cynthia Lin, “Shiller sees double-dip recession if jobs aren’t created,” *Marketwatch*, August 11, 2010 available at <http://www.marketwatch.com/story/shiller-sees-double-dip-if-jobs-arent-created-2010-8-11>.

⁸ Michelle Lodge, “Housing in ‘Double-Dip’: Economist Zandi,” *CNBC*, August 23, 2010, available at <http://www.cnn.com/38820610>.

The economic outlook over the next few months is not bright and will likely be characterized by high unemployment and sluggish economic growth. For example, the Blue Chip consensus forecast has the unemployment rate staying above 9% until the fourth quarter of 2011.⁹ And Carmen Reinhart and Vincent Reinhart show that real per capita GDP growth rates tend to be low during the decade following a severe financial crisis and synchronous world-wide shocks.¹⁰

The Federal Budget

Before the Bush tax cuts were enacted the Congressional Budget Office (CBO) projected gradually rising federal budget surpluses—from 2.7% of GDP in 2001 to 5.3% of GDP by 2011.¹¹ Within a few years, CBO was projecting budget deficits. The Bush tax cuts, with a \$1 trillion 10-year price tag, contributed to this shift from budget surpluses to deficits. Other major contributing factors included the 2001 recession, the increase in defense spending for the wars in Iraq and Afghanistan, and the Medicare prescription drug benefit (enacted in the Medicare Prescription Drug, Improvement, and Moderation Act of 2003; P.L. 108-173). By the time the 2007-2009 recession started, CBO was projecting deficits between FY2008 and FY2011 equivalent to over 1% of GDP (with budget surpluses after 2011).¹²

Nonetheless, federal budget conditions before the 2007-2009 recession were not much different from the conditions before previous recessions. **Figure 3** shows the budget deficit as a percentage of GDP for three years—the fiscal year before the start of the recession, the fiscal year in which the recession started, and the next fiscal year. The 2007-2009 recession is compared to the average of the prior six recessions. In the year before the Great Recession (2006), the budget deficit was 1.2% of GDP compared to 1.6% of GDP, on average, for the previous six recessions. The situation, however, is very different for the next two fiscal years. The federal deficit increased to 3.2% of GDP in the year the 2007-2009 recession started (compared to 1.4% of GDP for previous recessions) and then to almost 10% of GDP in the next year (compared to 2.2% of GDP in previous recessions). The dramatic increase in the federal deficit after 2007 is due to the recession and the federal government's efforts to promote economic recovery, such as the Economic Stimulus Act of 2008 (P.L. 110-185) and the American Recovery and Reinvestment Act of 2009 (P.L. 111-5).

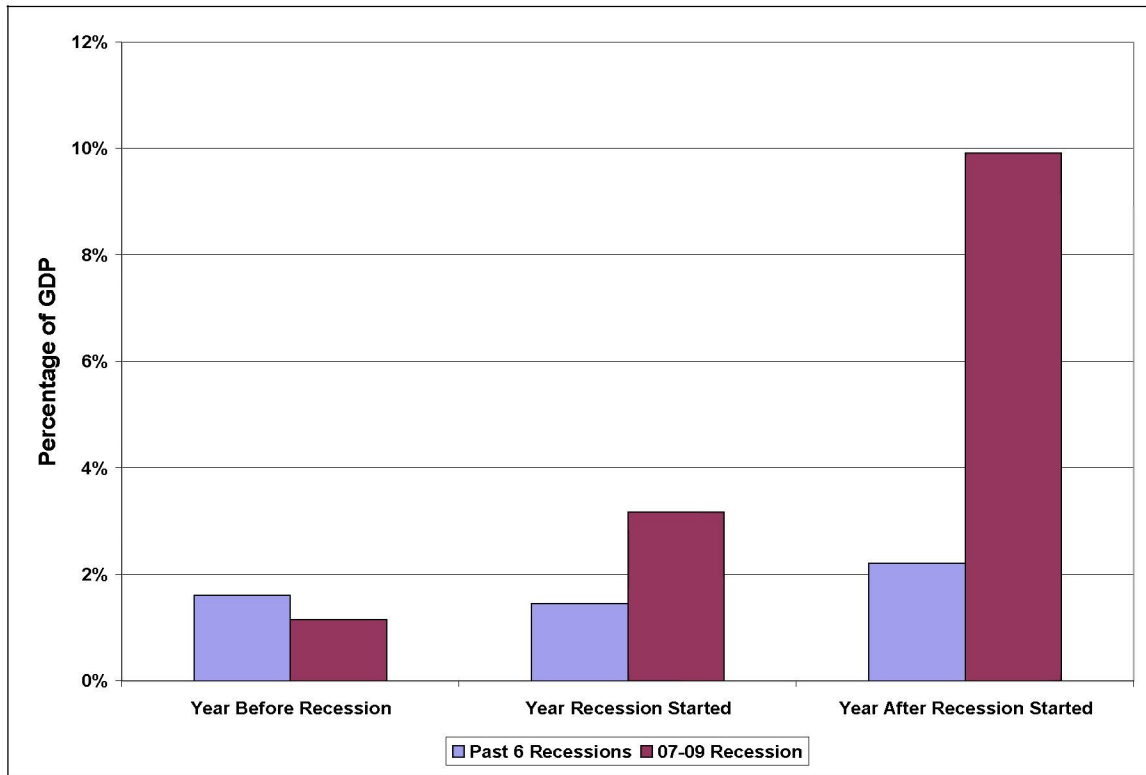
⁹ *Blue Chip Economic Indicators*, vol. 35, no. 8 (August 10, 2010).

¹⁰ Carmen M. Reinhart and Vincent R. Reinhart, "After the Fall," presented at the Federal Reserve Bank of Kansas City Jackson Hole Symposium, Jackson, WY, August 26-28, 2010.

¹¹ CBO, *The Budget and Economic Outlook: Fiscal Years 2002-2011*, January 2001.

¹² CBO, *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008.

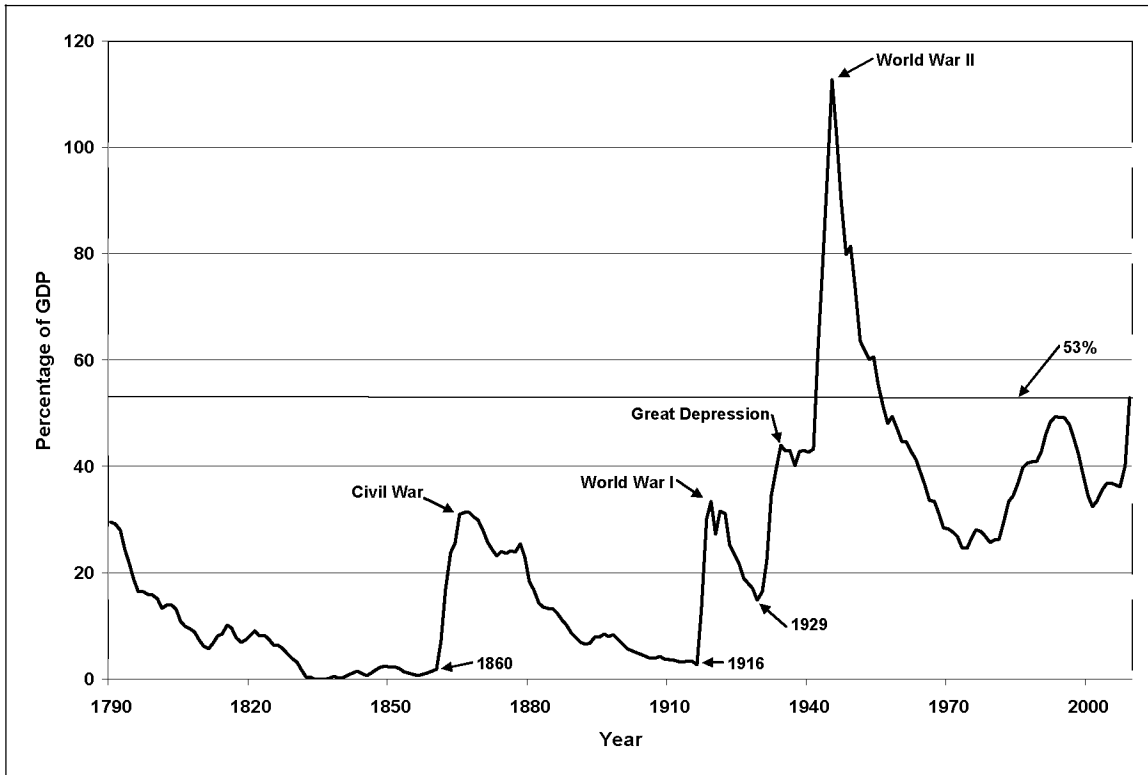
Figure 3. Deficits as a Percentage of GDP, 2007-09 Recession Compared to Prior Recessions



Source: CRS calculations based on OMB data.

The deficit is just one facet of the fiscal condition. Another is federal debt held by the public. **Figure 4** displays federal debt held by the public as a percentage of GDP from 1790 to 2009. Federal debt in 2009 was equal to 53% of GDP—a level higher than at any time in U.S. history except for World War II. Between 2007 and 2009, federal debt increased by almost 17% of GDP. Most large increases in debt have been due to wars (the Civil War, World War I, and World War II) and to the Great Depression, but debt also increased dramatically between 1981 and 1994—by 23%—when taxes were reduced and defense spending increased.

Figure 4. Debt Held by the Public as a Percentage of GDP, 1790-2009



Source: CBO and OMB.

The Bush Tax Cuts

Several tax provisions were included in EGTRRA and JGTRRA. However, only a few are the focus of debate, which are

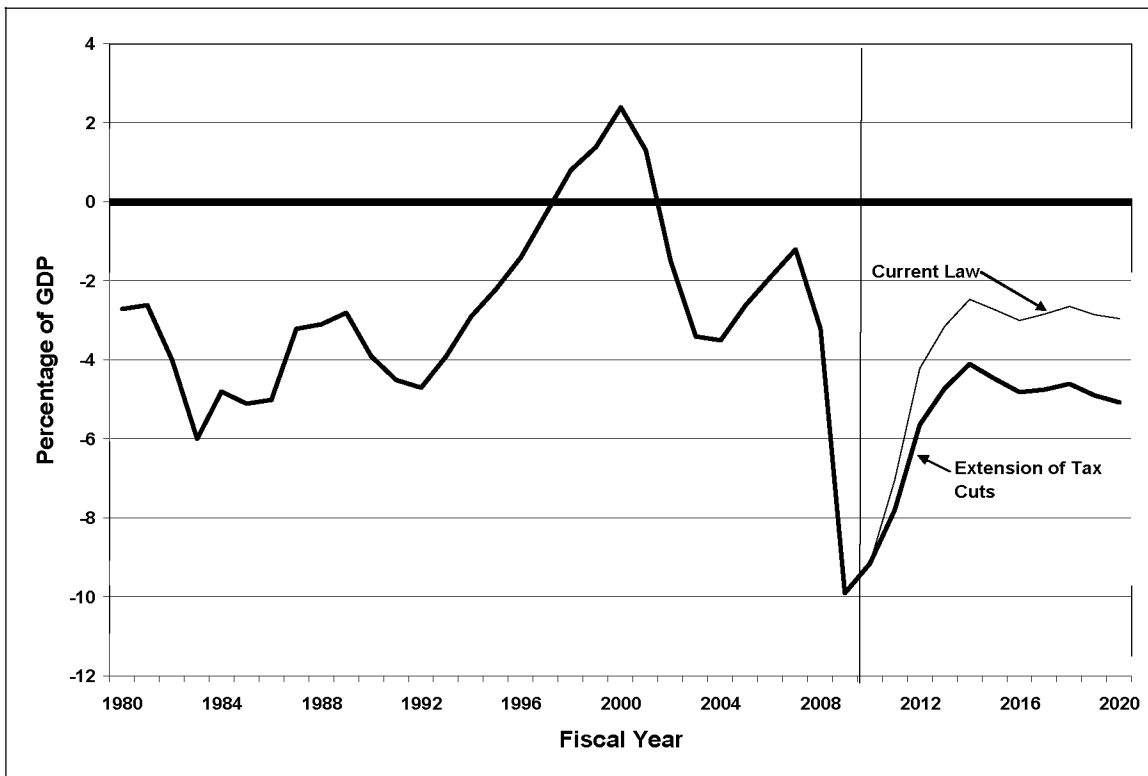
- the 10%, 25%, and 28% tax rates: the 10% tax rate was introduced and the 28% and 31% tax rates were reduced to 25% and 28%, respectively;
- the 33% and 35% tax rates: the 36% and 39.6% tax rates were reduced to 33% and 35%, respectively;
- the reduced marriage penalty: expanded the 15% tax bracket and increased the standard deduction for couples;
- the repeal of the personal exemption phaseout (PEP) and the limitation on itemized deduction (Pease): both PEP and Pease were gradually phased out and eliminated in 2010;
- the reduced long-term capital gains tax rate: tax rate was reduced from 10% and 20% to 0% and 15%;
- the reduced tax rate on qualified dividends: qualified dividends are taxed at long-term capital gains tax rates rather than at the same tax rates as ordinary income; and

- the expanded tax credits: the child tax credit, the earned income tax credit (EITC), and education incentives were expanded.

The Bush tax cuts are scheduled to expire at the end of 2010, and the tax parameters revert back to their 2000 values (the current law baseline). Some policymakers have proposed to permanently extend the Bush tax cuts. CBO estimates that permanently extending the tax provisions of EGTRRA and JGTRRA would increase the deficit by \$1,215 billion over five years and by \$3,312 billion over 10 years.¹³

Figure 5 displays the trend in federal deficits as a percentage of GDP from 1980 to 2020. Under current law the federal deficit is projected to decline from 9.2% of GDP in 2010 to 3% of GDP by 2020. If all the Bush tax cuts are permanently extended (including the repeal of the estate tax) the deficit is projected to be 5.1% of GDP in 2020 and on a clearly unsustainable path of increasing deficits. Neither of the projections take into consideration likely annual changes to the alternative minimum tax (AMT), with a projected 10-year cost of about \$1,500 billion.¹⁴

Figure 5. Federal Deficits as a Percentage of GDP, Two Scenarios



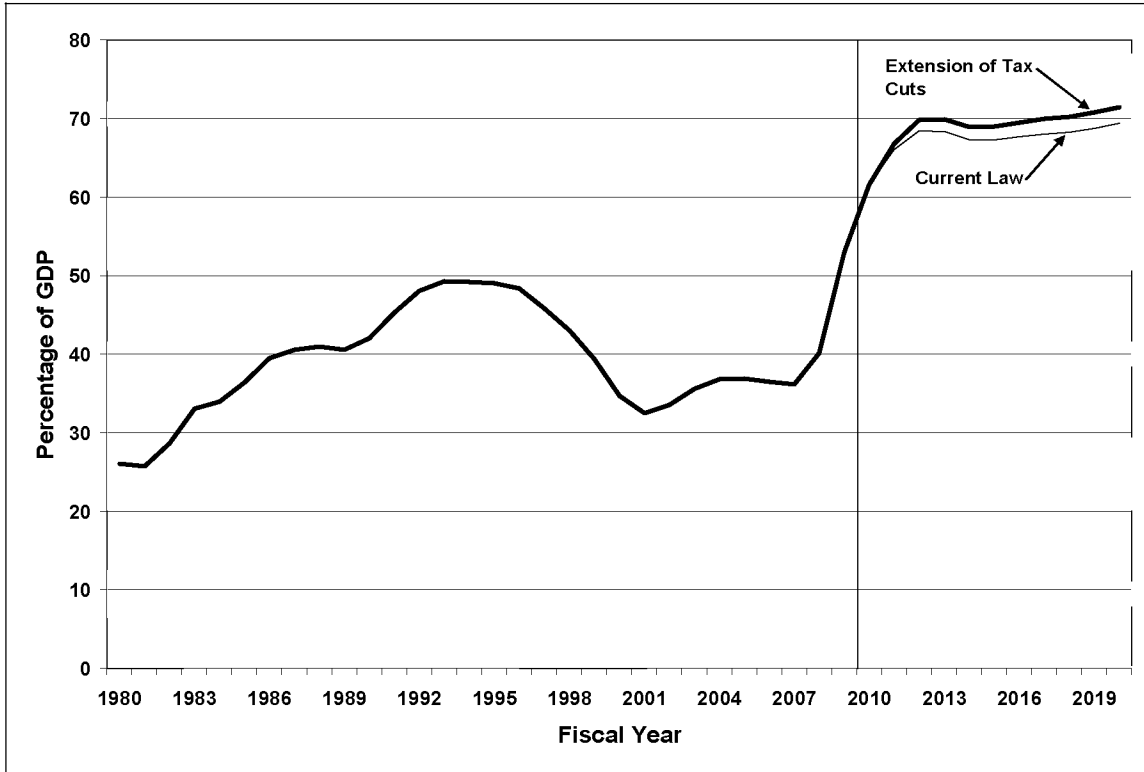
Source: CRS analysis of CBO and JCT estimates.

¹³ CBO, *The Budget and Economic Outlook: An Update*, August 2010, Table 1.7. The increase in debt service is included in these estimates.

¹⁴ The Tax Policy Center estimates that 28.5 million taxpayers would be subject to the AMT without the annual AMT fix. In 2009, 4 million taxpayers were subject to the AMT. See Tax Policy Center, *Aggregate AMT Projections, 2009-2020*, Table T10-0106, May 3, 2010.

Figure 6 shows the trend in debt held by the public as a percentage of GDP. Under both current law and the permanent extension of the Bush tax cuts, debt as a percentage of GDP is much higher in 2020 than in 2009. Furthermore, under both scenarios debt is trending upward relative to GDP after 2014.

Figure 6. Debt Held by the Public as a Percentage of GDP, Two Scenarios



Source: CRS analysis of CBO and JCT estimates.

Revenue Loss from the Bush Tax Cut Provisions

The estimated budgetary costs of permanently extending the provisions of the Bush tax cuts are reported in Table 1. Over five years, extending the provisions are estimated to reduce tax revenues by \$1,141 billion. The 10-year revenue loss is estimated to be \$2,805 billion. By far the costliest provision to extend is the reduced individual income tax rates (which includes keeping the 10%, 25%, 28%, 33%, and 35% tax rates), accounting for over 50% of the total revenue loss. The estimated cost of extending these provisions amounts to over half of the estimated budget deficit that would result from allowing the Bush tax cuts to expire as scheduled.¹⁵

¹⁵ Interactions with the alternative minimum tax (AMT) are not included in these estimates.

Table I. Revenue Estimates of Bush Tax Cut Provisions, 2011-2020

Millions of dollars

Provision	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2011-15	2011-20
Reduced tax rates	-80,985	-124,474	-135,234	-145,800	-155,995	-166,159	-176,260	-186,268	-196,332	-206,691	-642,488	-1,574,198
Repeal PEP/Pease	-6,167	-13,079	-14,641	-16,269	-17,842	-19,369	-20,905	-22,416	-23,850	-25,177	-67,998	-179,715
Reduced capital gains tax rate	-7,737	-1,535	-4,883	-9,429	-12,275	-13,288	-14,211	-15,107	-15,959	-16,772	-35,859	-111,196
Reduced dividends tax rate	-22,869	-4,070	-12,415	-21,501	-26,648	-27,634	-28,619	-29,378	-29,884	-30,236	-87,503	-233,254
Reduced marriage penalty	-15,030	-27,580	-29,169	-30,945	-32,741	-34,288	-35,916	-37,574	-39,051	-40,431	-135,465	-322,725
Expanded tax credits	-5,170	-41,724	-41,648	-41,787	-41,826	-42,011	-42,126	-42,363	-42,588	-42,798	-172,155	-384,041
Total	-137,958	-212,462	-237,990	-265,731	-287,327	-302,749	-318,037	-333,106	-347,664	-362,105	-1,141,468	-2,805,129

Source: Department of Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010.

Distributional Effects of the Bush Tax Cut Provisions

The various provisions making up the Bush tax cuts have different distributional impacts. **Table 2** reports what the percentage change in after-tax income for each the tax provision would be in 2012 if it were permanently extended.¹⁶ The baseline is current law in which the Bush tax cuts are allowed to expire as scheduled at the end of 2010. This estimate provides information on who benefits from each provision and by how much. The Suits index is also calculated and reported for each provision. The Suits index is a measure of the progressivity of tax benefits and varies between -1 (completely regressive) and +1 (completely progressive).¹⁷ The Suits index is negative (and tax benefits are regressively distributed) if the benefits from the provision are predominately received by taxpayers in the upper part of the income distribution. It is positive if the benefits predominately go to lower income taxpayers. It is zero if the benefits are proportionately distributed throughout the income distribution.

The second and third columns in **Table 2** report the distributional effects of extending the reduced tax rate provisions. The two columns split the tax rate reductions into those targeting lower and middle income taxpayers and those targeting high income taxpayers. Extending the 10%, 25%, and 28% tax rates benefits taxpayers throughout the income distribution (see column 2). The Suits index is slightly positive (0.0895) but is much closer to zero than to one—the benefits are slightly progressive but close to being proportional. The benefits of extending the 33% and 35% tax rates are entirely confined to the richest 5% of taxpayers (see column 3) and the richest 1% would see their after-tax income increase by about 2% (or about \$21,500). The Suits index is -0.7979, suggesting that the benefits are highly regressive.

Extending the repeal of PEP and Pease would also benefit high income taxpayers (the richest 5%)—the benefits are very regressively distributed (the Suits index is -0.7325). The reduced tax rates on capital gains and dividends (see columns 5 and 6) primarily benefit upper income taxpayers and are regressively distributed. The reduced rates on capital gains benefits the upper 60% of the income distribution but the richest 1% see the largest increase in after-tax income while the reduced dividends tax rates benefits the upper 20%. In both cases, the Suits index is negative.

Extending the reduction in the marriage penalty would benefit married taxpayers throughout the income distribution. The Suits index is 0.1048 suggesting that the benefits are slightly progressive, but close to being proportional. The extension of the expanded tax credits primarily benefits taxpayers below the 80th percentile in the income distribution. The Suits index (0.6733) shows that the benefits are progressively distributed.

¹⁶ The estimates were prepared by the Urban-Brookings Tax Policy Center.

¹⁷ See the **Appendix** for more details on the Suits index.

Table 2. Percentage Change in After-Tax Income Due to Bush Tax Cut Provisions by Income Category

Income Category	Reduced Tax Rates: 10%, 25%, 28%	Reduced Tax Rates: 33%, 35%	Repeal PEP/Pease	Reduced Capital Gains Tax Rate	Reduced Dividends Tax Rate	Reduced Marriage Penalty	Expanded Tax Credits	Average After-Tax Income
Poorest Quintile	0.1	0.0	0.0	0.0	0.0	0.2	0.9	\$10,702
Quintile 2	1.0	0.0	0.0	0.0	0.0	0.3	1.3	\$23,359
Quintile 3	1.3	0.0	0.0	0.1	0.0	0.1	0.7	\$38,362
Quintile 4	1.3	0.0	0.0	0.1	0.0	0.4	0.4	\$61,176
80-90 percentile	1.6	0.0	0.0	0.1	0.1	0.7	0.1	\$88,999
90-95 percentile	1.8	0.0	0.0	0.2	0.1	0.5	0.0	\$124,146
95-99 percentile	1.5	0.1	0.3	0.4	0.2	0.3	0.0	\$213,506
Richest 1%	0.3	1.9	0.9	1.3	0.8	0.1	0.0	\$1,071,100
All	1.2	0.3	0.2	0.3	0.2	0.3	0.3	\$58,277
Suits index	0.0895	-0.7979	-0.7325	-0.5768	-0.6641	0.1048	0.6733	

Source: CRS analysis of Tax Policy Center estimates.

With the benefits of the different tax provisions accruing to taxpayers in different parts of the income distribution, decisions regarding the Bush tax cut provisions will affect income inequality. In a recent article, Thomas Hungerford examined the impacts of various tax provisions (including selected provisions of the Bush tax cuts) on income inequality.¹⁸ The results show that the reduction in the tax rates increased income inequality as did the reduction in the capital gains and dividends tax rate, and the repeal of PEP and Pease. Both the child tax credit and earned income tax credit (EITC) reduce income inequality.

Options Regarding the Bush Tax Cuts

There are several options that Congress can consider regarding the Bush tax cuts. The two extreme options have been discussed along the following lines. Allowing the Bush tax cuts to expire as scheduled will somewhat improve the fiscal condition, but could stifle the economic recovery. At the other extreme, permanently extending all of the Bush tax cuts would not undercut the economic recovery, but would worsen the longer-term fiscal outlook and possibly signal a lack of progress in dealing with the long-term fiscal situation. In either case, the U.S. is facing increasing budget deficits and federal debt levels. A recent study by Alan Auerbach and William Gale projects that tax revenue would have to be permanently increased by 4.6% of GDP just to keep the debt-to-GDP ratio at the current level over the next 75 years under the current law scenario (i.e., allow the Bush tax cuts to expire).¹⁹ They refer to this as a fiscal gap of 4.6%.²⁰ If the Bush tax cuts were permanently extended the estimated fiscal gap rises to 7.2%. They project that by 2085, debt as a percentage of GDP would approach 600% under the current law scenario and 900% if the Bush tax cuts are extended—extraordinary levels that are unprecedented for the U.S. (see **Figure 4**).

Obama Administration Proposal

The Obama Administration has proposed to allow the Bush tax cuts expire for high income taxpayers (single taxpayers with income over \$200,000 and married taxpayers with income over \$250,000—the richest 2% of taxpayers) and permanently extend the tax cuts for other taxpayers (the middle income tax cuts). The specific proposals are to reinstate the 39.6% tax rate, reinstate the 36% tax rate for high income taxpayers, reinstate PEP and Pease for high income taxpayers, and increase the long-term capital gains and qualified dividend tax rate to 20% for high income taxpayers. Compared to permanently extending all of the Bush tax cuts, this proposal is projected to increase tax revenues by \$252 billion over five years and by \$678 billion over 10 years.²¹ Auerbach and Gale, however, estimate that the fiscal gap under the Obama Administration proposal is 6.4%, and still leaves federal debt on an unsustainable path, which would approach 750% of GDP by 2085.

¹⁸ Thomas L. Hungerford, “The Redistributive Effect of Selected Federal Transfer and Tax Provisions,” *Public Finance Review*, vol. 38, no. 4 (July 2010), pp. 450-472.

¹⁹ Alan J. Auerbach and William G. Gale, “Deja Vu All Over Again: On the Dismal Prospects for the Federal Budget,” *National Tax Journal*, vol. 63, no. 3 (September 2010), pp. 543-560.

²⁰ Auerbach and Gale define the fiscal gap as the size as a percentage of GDP of the immediate and permanent tax increase or reduction in non-interest federal spending that would keep the long-run debt-to-GDP ratio at the current level.

²¹ Department of Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, available at <http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf>.

The Obama Administration argues that the middle class tax cuts are necessary to keep the economic recovery on track by preventing a sharp fall in the disposable income of consumers.²² They further argue that allowing the tax cuts expire for high income taxpayers will contribute to restoring fiscal responsibility. Senate Finance Committee Chairman Max Baucus has expressed support for proposals broadly consistent with the Obama Administration proposal.²³

The President established the National Commission on Fiscal Responsibility and Reform by executive order on February 18, 2010. The commission is tasked with looking for policies, including tax policies, to improve the medium-term fiscal situation and achieve long-term fiscal sustainability. The commission's report is due in December 2010. Given the long-term fiscal condition and a recognition that tax policy is an important tool to be used, it is unlikely that the tax code and the middle class tax cuts will remain unchanged for long.

Temporary Extension of Some or All Bush Tax Cut Provisions

Some have proposed temporarily extending some or all of the Bush tax cuts. Those wanting to extend all of the Bush tax cut provisions argue that raising taxes during a weak recovery could reduce economic growth and possibly push the economy back into recession. Mark Zandi and some Democrats have reportedly advocated permanently extending the middle class tax cuts and temporarily extending the tax cuts targeted to high income taxpayers.²⁴

Others have advocated temporarily extending the middle class tax cuts and allowing the tax cuts targeting high income taxpayers to expire as scheduled at the end of 2010.²⁵ It can be argued that permanently extending all of the Bush tax cuts could make future tax reforms to deal with unsustainable deficits and debt trends more difficult. A temporary extension could provide time for Congress to consider tax reform and also provide a deadline to complete deliberations. Furthermore, allowing the high income tax cuts to expire as scheduled could help reduce budget deficits in the short-term without stifling the economic recovery.²⁶ Research has shown that tax cuts directed to high income taxpayers have a small stimulative effect because they tend to save any additional income.²⁷ Increasing tax rates for the richest 2% of taxpayers (by allowing the high income tax cuts to expire) will likely neither significantly decrease consumer expenditures nor adversely affect small business and job growth.²⁸ Some argue this policy could allow Congress to make progress toward restoring fiscal sustainability.

²² See Timothy Geithner, *Remarks as Prepared for Delivery at Center for American Progress*, August 4, 2010, TG-814.

²³ U.S. Senate, Committee on Finance, *Baucus Examines Options for Extending Middle-Class Tax Cuts*, News Release, July 14, 2010.

²⁴ Lori Montgomery, "Shaky economy alters tax-cut dynamic in Congress," *Washington Post*, August 27, 2010, p. A2.

²⁵ See, for example, Leonard E. Burman, Statement before the Senate Committee on Finance, hearings on The Future of Individual Tax Rates: Effects on Economic Growth and Distribution, July 14, 2010.

²⁶ Tax cuts to the wealthy tend to be saved rather than spent and have little impact on short-term economic growth. See CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte.

²⁷ See CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte.

²⁸ See CRS Report R41392, *Small Business and the Expiration of the 2001 Tax Rate Reductions: Economic Issues*, by Jane G. Gravelle.

Appendix. The Suits Index

The progressivity measure used is a modified Suits index. The Suits index was originally developed to measure the progressivity of the tax burden.²⁹ Since benefits from tax provisions are considered, the modified Suits index is the negative of the original Suits index.

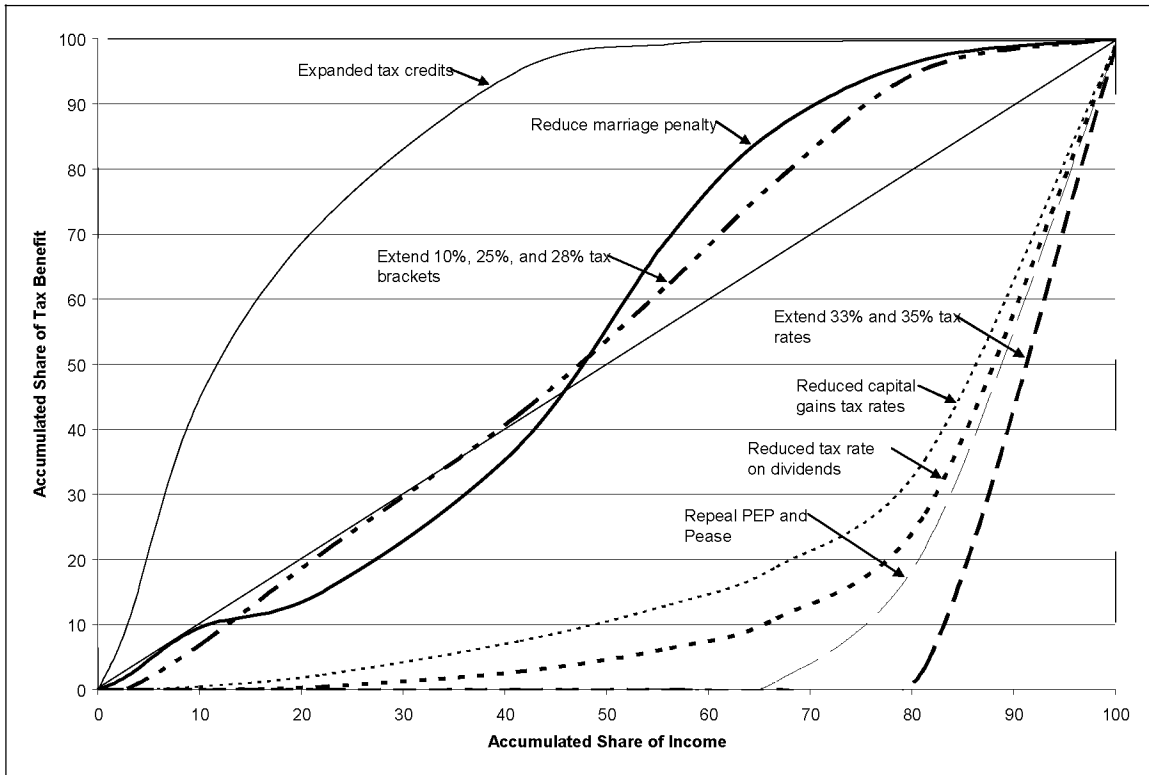
The index is based on the Lorenz curve. **Figure A-1** displays the Lorenz curves for the seven tax provisions making up the Bush tax cuts that are considered in this study. The horizontal axis is the accumulated share of income when tax units are ranked by income from lowest to highest. The vertical axis is the accumulated share of tax benefits from the tax provisions. The diagonal line is the Lorenz curve for a proportionally distributed tax benefit. A progressive benefit will have its Lorenz curve above the diagonal line (for example, see the Lorenz curve for expanded tax credits). This means that tax units with lower incomes receive benefits that are a larger proportion of their income than higher income tax units. Conversely, a regressive benefit (for example, the repeal of PEP and Pease) will have a Lorenz curve below the diagonal line.

Let the area under the Lorenz curve be denoted as L —it is the area bounded from below by the horizontal axis and from above by the Lorenz curve. Let the area under the diagonal line be denoted as K . The Suits index, S , is therefore defined as:

$$S = \frac{L - K}{K}.$$

²⁹ Daniel B. Suits, "Measurement of Tax Progressivity," *American Economic Review*, vol. 67, no. 4 (September 1977), pp. 747-752.

Figure A-I. Lorenz Curves of Bush Tax Cut Provisions, 2012



Source: CRS analysis of Tax Policy Center estimates.

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