

# The 2001 Tax Cut: A New Direction for Fiscal Policy



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# The 2001 Tax Cut: A New Direction for Fiscal Policy

In 1998, the federal budget unexpectedly began to run surpluses. The government subsequently paid down \$600 billion of its outstanding debt, as policy makers left the emerging surpluses largely untouched.

Now, Congress and President Bush have charted a new direction for fiscal policy by adopting the Economic Growth and Tax Relief Act of 2001. This law reduces the surpluses and gives Americans \$1.35 trillion of broad-based tax relief.

I will discuss the budgetary background that led to the new law, describe some of its major provisions, and examine its potential economic consequences.

## Background

### *Budget Turned Around After 1992*

The background of the new law begins with the turnaround in the federal budget after fiscal 1992. The budget balance improved in each of the eight years after fiscal 1992, moving from a \$290 billion deficit to a \$237 billion surplus in fiscal 2000 (**figure 1**). This total includes a \$152 billion Social Security surplus, a \$30 billion Medicare Part A surplus, and a \$55 billion surplus in the remainder of the budget.

The improved budget balance resulted from both a decline in spending and a rise in revenue, as shares of GDP (**figure 2**). The spending share fell steadily after fiscal 1992. In fiscal 2000, it declined to 18.2 percent, its lowest level since fiscal 1966. The revenue share rose steadily during this period. The 20.6 percent revenue share in fiscal 2000 was the second highest in all of U.S. history, exceeded only by fiscal 1944.

Figure 1

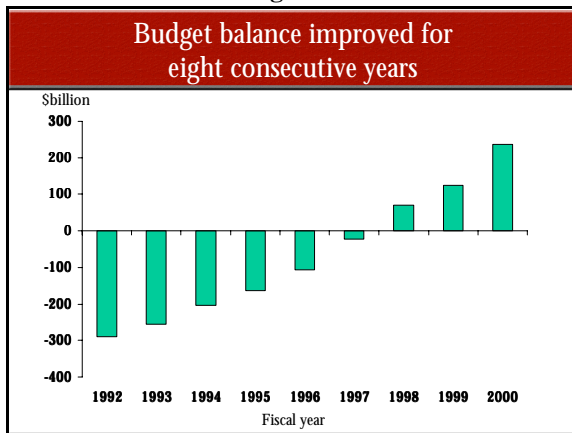
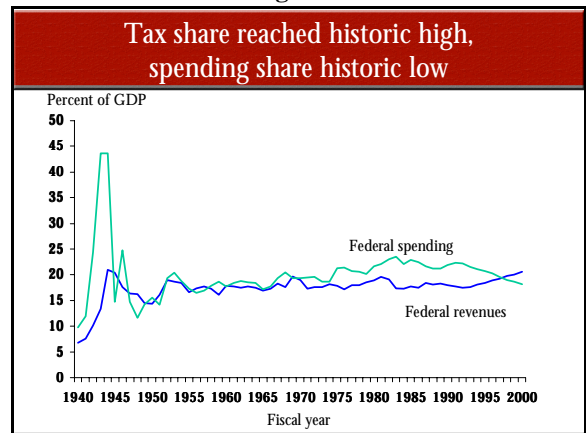


Figure 2



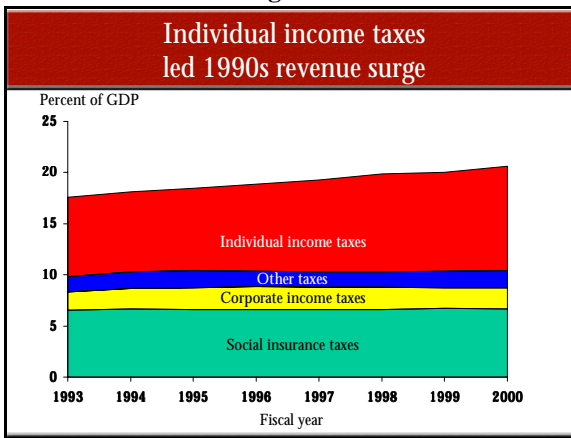
**Figure 3** reveals that the growth of the revenue share was driven by a surge in individual income tax revenues. Corporate income taxes remained relatively stable as a share of GDP, as did social insurance taxes. (Social insurance taxes are the payroll and self-employment taxes that finance Social Security, Medicare Part A, and unemployment compensation.)

The surge in income tax revenue had many causes. I will discuss two important factors – the impact of economic growth on tax brackets and the increased volume of capital gains.

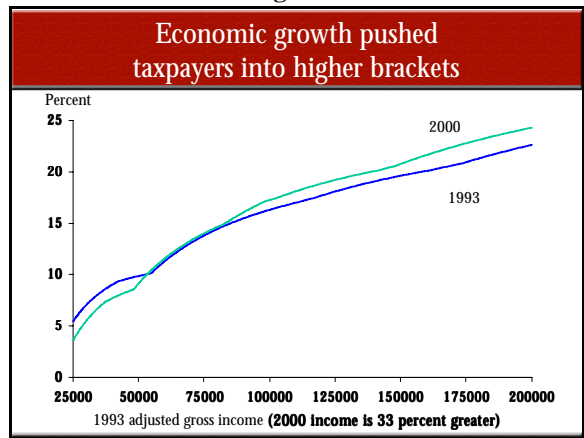
Income tax brackets are adjusted each year for inflation, so that taxpayers are not pushed into higher brackets when their incomes merely keep up with inflation. However, real economic growth that causes incomes to rise faster than inflation does push taxpayers into higher brackets.

**Figure 4** illustrates these effects for the interval from 1993 to 2000. Inflation was 17 percent during this period but economic growth raised average personal income by 33 percent. The blue line shows the fraction of income paid in income tax by a married couple with two children at various income levels in 1993 (under certain assumptions). The green line shows the corresponding fraction these families paid in 2000, if each family’s income rose at the 33 percent national average.

**Figure 3**

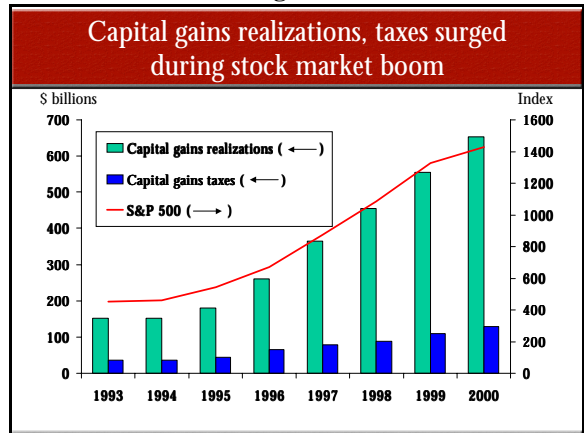


**Figure 4**



For example, a family earning \$100,000 in 1993 paid 16.3 percent of its income, while a family earning \$133,000 paid 17.3 percent seven years later. The fraction of income claimed by the income tax rose at most income levels, often by two percentage points, as income growth moved taxpayers into higher brackets. (At lower income levels, tax payments declined as a fraction of income because Congress expanded the Earned Income Tax Credit and created the \$500 child credit during this seven-year interval.)

**Figure 5**



Capital gains are not part of GDP but are subject to individual income tax. A larger volume of capital gains therefore increases individual income tax revenues as a share of GDP. **Figure 5** shows the sharp rise in the stock market, measured by the S&P 500, in the 1990s and the resulting increases in realized capital gains and the taxes paid on those gains. Capital gains tax payments more than tripled from 1993 to 2000.

## Budget Projections Turned Around After 1997

In part, the tax cut was a response to the current and past budget developments described above. But, it was also a response to dramatically revised projections of *future* budgets. After 1997, budget projections moved away from deficits “as far as the eye can see” to mounting surpluses and retirement of the entire federal debt. I look at the changes in the projections made by the Congressional Budget Office (CBO), which are similar to the changes that other forecasters experienced.

As shown in **figure 6**, CBO projected in January 1997 that the deficit would steadily increase throughout the upcoming decade under the policies then in place. At the time, CBO estimated that the sustainable rate of real economic growth was 2.1 percent per year. However, CBO steadily revised its budget projections in subsequent years, as strong economic growth and improved budget performance continued.

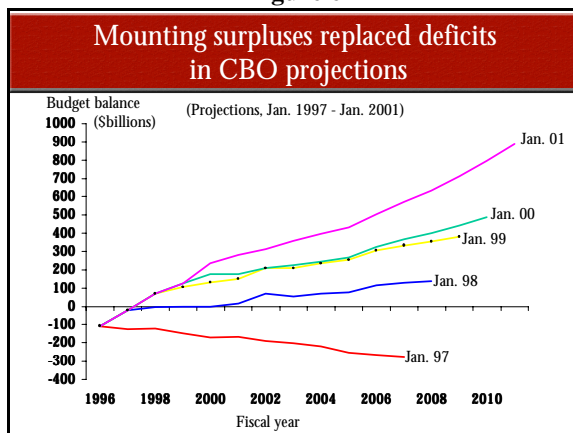
In January 2001, CBO estimated a 3.3 percent sustainable growth rate for the economy. Under the policies then in place, CBO projected that surpluses would continue and mount throughout the upcoming decade. For fiscal 2011, CBO projected a staggering \$889 billion surplus, including a \$331 billion Social Security surplus, a \$34 billion Medicare Part A surplus, and a \$524 billion surplus in the remainder of the budget.

The changes in these projections had a dramatic cumulative effect on the projected path of the federal government’s publicly-held debt (**figure 7**). CBO’s January 1997 projection showed debt rising from \$4 to \$6 trillion over the upcoming decade. In contrast, the January 2001 projection showed the entire federal debt being retired early in fiscal 2009.

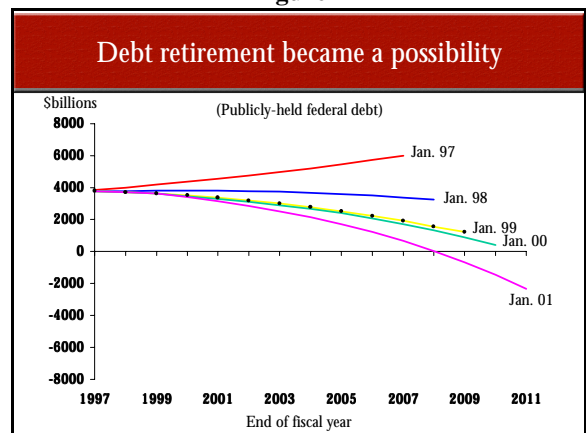
Of course, these projections remain subject to uncertainty. Under CBO’s optimistic scenario, which assumes 0.4 percent faster economic growth and makes other favorable assumptions, the debt is retired early in fiscal 2007. Under the pessimistic scenario, with 0.8 percent slower economic growth and other unfavorable assumptions, over \$1.6 trillion of debt remains outstanding at the end of fiscal 2011.

The arrival of the surpluses and the projection that they would continue prompted Congress and the president to adopt the new law. I now describe some of its major provisions.

**Figure 6**



**Figure 7**



## Major Provisions

The new law has one unique feature never before included in major tax legislation. A broad “sunset” provision causes the entire law to expire at midnight on December 31, 2010. Unless Congress extends the law before then, the previous version of the Internal Revenue Code will spring back to life in 2011, as if the new law had never been adopted.

Another timing feature of the new law is that many of its provisions are phased in slowly. Many do not become fully effective until 2006, 2008 or 2010.

The law’s centerpiece is a cutback in individual income tax rates. **Figure 8** shows the rate reductions for married couples when they take full effect in 2008 – a 10 percent bracket replaces part of the 15 percent bracket, the 15 percent bracket is lengthened, the 28, 31, and 36 percent brackets are each reduced by 3 percentage points, and the top bracket is reduced from 39.6 to 35 percent.

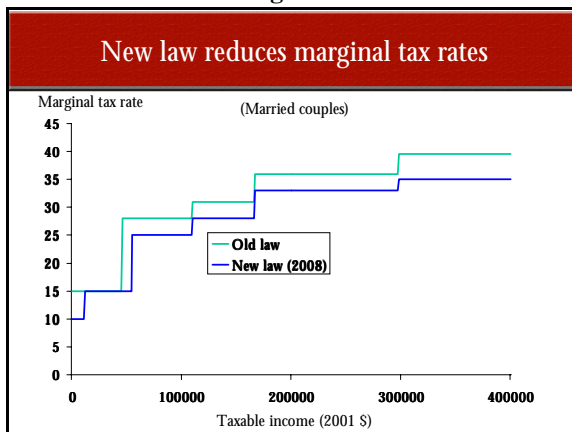
In 2010, the new law also repeals the personal-exemption phaseout and the itemized-deduction limitation, which apply to higher-income taxpayers. The repeal lowers effective marginal tax rates by more than one percentage point for the affected taxpayers.

**Figure 9** shows the phase-down of the top tax rate, which is fully completed in 2006. Of course, the rate jumps back to 39.6 percent when the new law expires.

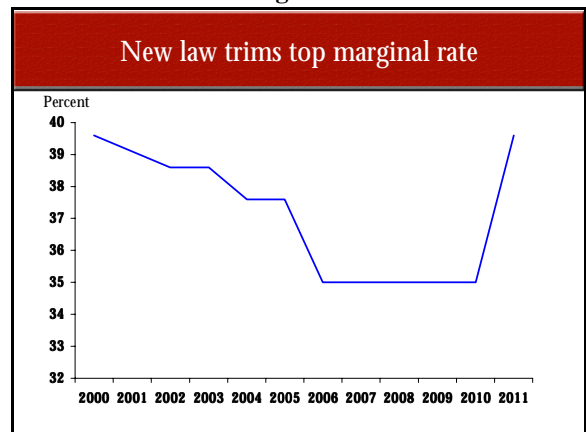
The law expands a variety of saving and education incentives. It also doubles the \$500 child credit to \$1000 by 2010 – of course, it returns to \$500 the following year. Also, some low-income workers who do not owe income tax will be allowed to receive part of their child credits as cash payments.

Most provisions of the new law apply to both married and unmarried taxpayers. However, some of the tax cuts are reserved for married couples, including the longer 15 percent bracket mentioned above, a larger standard deduction, and a more generous Earned Income Tax Credit. The new law therefore increases the economic reward to marriage.

**Figure 8**



**Figure 9**



**Figure 10** presents calculations (under certain assumptions) for three married couples, each of whom have two children and earn \$100,000. The couple in which one spouse earns all the income enjoyed a marriage bonus under the old law – their combined taxes would have been \$3300 higher if they divorced, each taking one child. The couple in which both spouses earn \$50,000 suffered a marriage penalty under the old law – their combined taxes would have declined by \$3500 if they divorced. The intermediate couple, in which one spouse earns \$75,000 and the other spouse earns \$25,000, faced a smaller marriage penalty. When the new law is fully effective in 2010, it increases the marriage bonus for the one-earner to \$4400. The penalty for the couple with equal earnings is reduced to \$2100 and the penalty for the intermediate couple is also reduced.

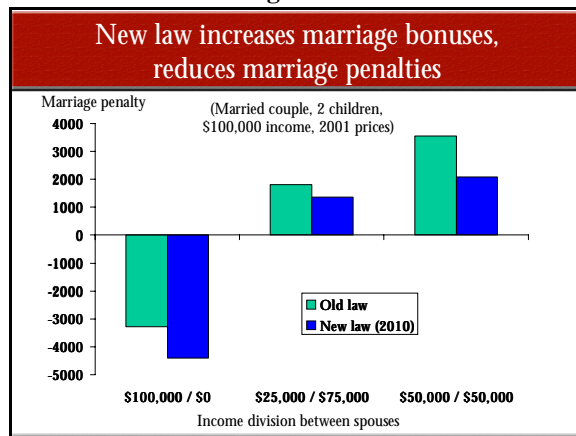
The new law also changes the estate tax. It gradually reduces the tax for people dying in 2002 through 2009, as illustrated in **figure 11** for the case of a \$10 million estate. The law then repeals the tax entirely for people dying in 2010. Of course, the estate tax returns in full force for people dying in 2011, after the new law expires. From a tax avoidance perspective, any day in 2010 is a good day to die.

Some things are not in the new tax law. The law makes no reduction in social insurance taxes. These taxes are likely to be addressed in the president’s Social Security reform plan. Also, the law makes no reduction in corporate income taxes. Proposed tax reductions for a variety of industries are now pending in Congress.

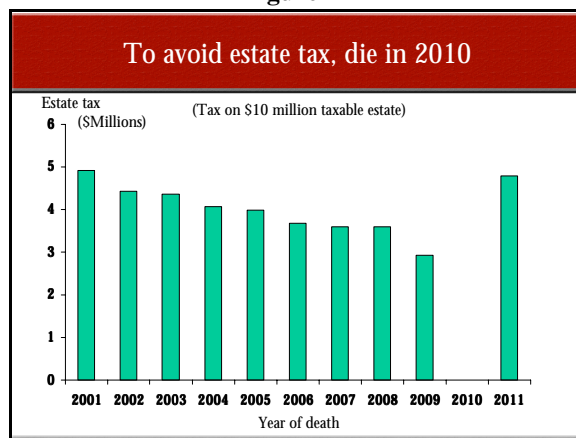
The new law also does not change the special 20 percent tax rate for long-term capital gains. Congress is considering proposals to reduce the capital-gains rate. The new law does not repeal the gift tax, even when the estate tax is repealed.

One important omission is that the new law offers little relief from the alternative minimum tax (AMT). The AMT is a complicated tax that is imposed on a broad measure of income and allows very few deductions and credits. Taxpayers must pay the AMT if it is higher than their regular income tax. As shown in **figure 12**, only about 1 million taxpayers were on the AMT last

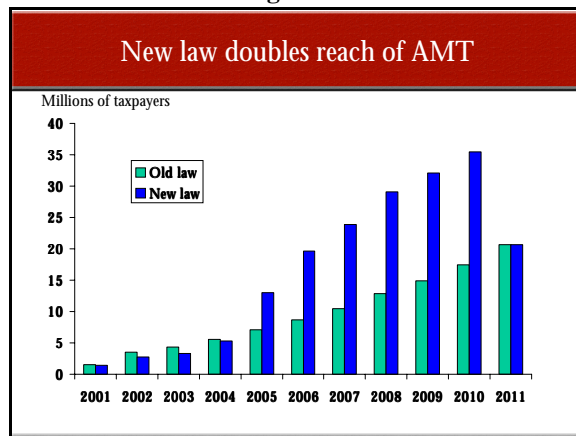
**Figure 10**



**Figure 11**



**Figure 12**



year. Unlike the regular income tax, however, the AMT is not adjusted each year for inflation. Under the old law, inflation was expected to push an additional 20 million taxpayers onto the AMT by 2010. This group includes many middle-class taxpayers that the AMT was not originally intended to reach.

The new law makes no reductions in the AMT tax rates and offers little other AMT relief. This has two separate implications. First, the taxpayers already slated to be on the AMT under the old law do not benefit from the rate cuts and many other provisions of the new law.

Second, because the new law slashes the regular income tax while leaving the AMT largely unchanged, many other people (previously on the regular income tax) will find that their AMT liability is now higher than their regular tax and will therefore move onto the AMT. Under the new law, by 2010, the AMT rolls will swell to 35 million (one-quarter of all taxpayers), including a large portion of the middle class. Congress will undoubtedly consider AMT relief in upcoming years.

## Economic Consequences

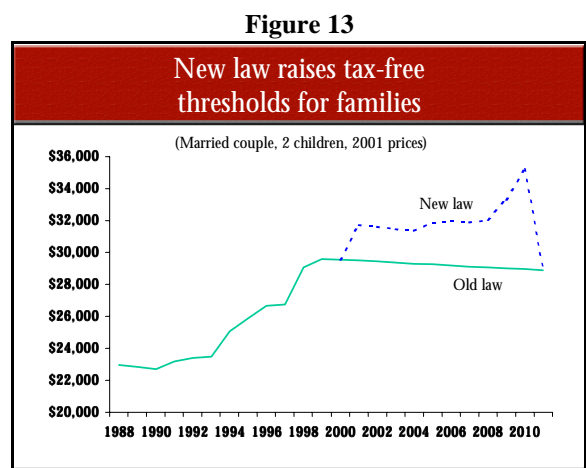
The new law will have a wide range of economic consequences. I discuss its impact on the distribution of after-tax income, its role as an economic stimulus during the current slowdown, its incentive effects, and its budgetary implications.

### *Distributional Effects*

At the lower end, the law moves some moderate-income families off the income tax rolls. However, the largest tax savings in dollar terms go to the wealthy, who currently make the largest tax payments.

**Figure 13** graphs the tax-free threshold for various years (in 2001 prices). This threshold is the highest income someone can earn and still owe zero income tax, after claiming tax credits. The calculation is for a married couple with two children, under certain assumptions. This tax-free threshold, about \$29,000 last year, has risen significantly since 1988, due to expansion of the Earned Income Tax Credit and creation of the \$500 child credit.

The new law raises this tax-free threshold – ultimately to \$35,000 (in 2001 prices). Of course, the threshold falls back again after the new law expires. The law also increases the tax-free threshold for unmarried parents and childless taxpayers, but by much smaller amounts.



A distributional analysis by the Joint Tax Committee of the U.S. Congress provides a broader picture of how the tax cuts are distributed. This analysis is not the final word – it omits the estate tax changes and some income-tax provisions and it looks only at the changes that are in effect in 2006. But, it offers useful information about how the tax savings are divided among five different income groups (figure 14).

The three lower-income groups file most of the tax returns. However, the higher-income groups currently pay a large portion of individual income, payroll, and excise taxes. They also receive a large portion of the tax cut from the new law. For example, the top 3 percent of taxpayers, with incomes above \$200,000, are currently paying 32 percent of total income, payroll, and excise taxes and will receive 32 percent of the total tax cut offered by the new law. (Their fraction of the tax cut would be somewhat larger if the estate tax changes were included.) The bottom 30 percent of taxpayers, with incomes below \$20,000, are currently paying 1.6 percent of total income, payroll, and excise taxes and will receive 2.8 percent of the total tax cut.

Of course, policy makers and citizens continue to debate the fairness of different distributions of the tax burden and tax reductions.

The tax law will also have broader effects on the economy. In the short run, the tax cut will help to stimulate the economy. In the longer term, its incentive and budgetary effects are more important.

### *Short-Run Stimulus*

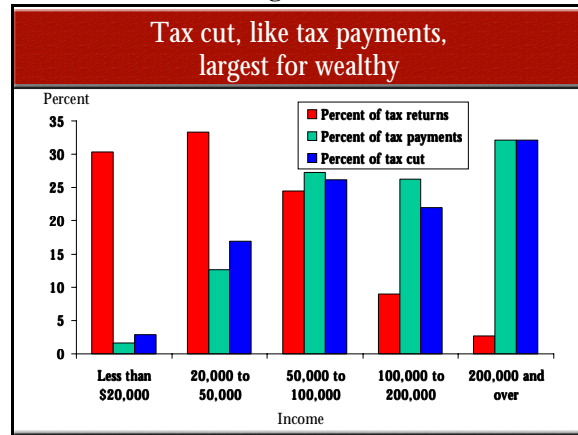
The tax cut is likely to provide a stimulus to the economy during the current slowdown. To speed up the stimulus, Congress directed the IRS to mail \$38 billion of rebate checks to taxpayers this summer. Economic evidence suggests that much of the rebate is likely to be spent, propping up consumer spending in the face of sluggish income growth and stock prices.

In this respect, the law has achieved a rare distinction – it is a fiscal stimulus that takes effect before the slowdown it is intended to address ends on its own. If the tax cut does stimulate the economy, less easing by the FOMC may be required.

### *Incentive Effects*

Economists have long viewed marginal rate cuts as an appealing form of tax relief because high tax rates penalize work, entrepreneurship, and private saving. The rate cuts will benefit the many small businesses that operate as proprietorships, partnerships, LLCs, and S corporations, because these firms are taxed under the individual, rather than the corporate, income tax.

Figure 14



High tax rates also encourage other forms of tax avoidance, such as tax shelters, fringe benefits, homeownership, and charitable giving. For good or ill, the rate cuts will also tend to reduce these activities.

The effects of tax-rate changes are difficult to isolate and their size is still disputed. It is clear, though, that the rate cuts in the new law are likely to have much smaller effects than the rate cuts adopted in 1962, 1981, and 1986. The rate cuts in the new law are smaller, slower, and made from lower levels. **Figure 15** illustrates this point with reference to the top marginal tax rate. The new law reduces the top rate by approximately 5 percentage points over a five-year period. In contrast, the 1981 law slashed the top rate by 20 percentage points, fully effective five months after its adoption. The new law still leaves the top rate above its level before the 1993 tax increase. Also, unlike the 1962 and 1981 tax cuts, this law does not include any investment incentives.

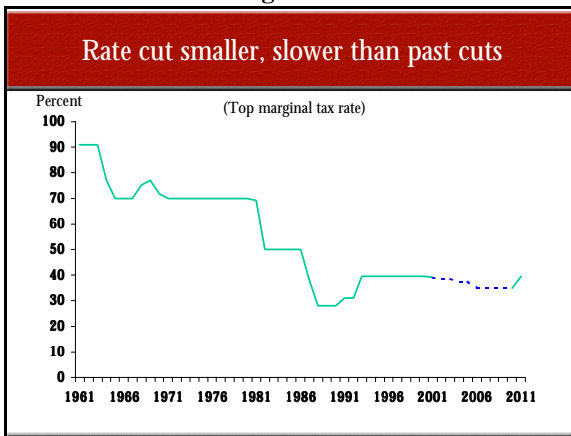
In the next several years, the incentive effects may even go the wrong way because people may decide to postpone work and other economic activity until the rate cut takes full effect. The new law also introduces uncertainty that complicates planning. While most people expect some extension of the law beyond 2010, they do not know which parts will be extended, when, with what modifications, or for how long.

*Budgetary Implications*

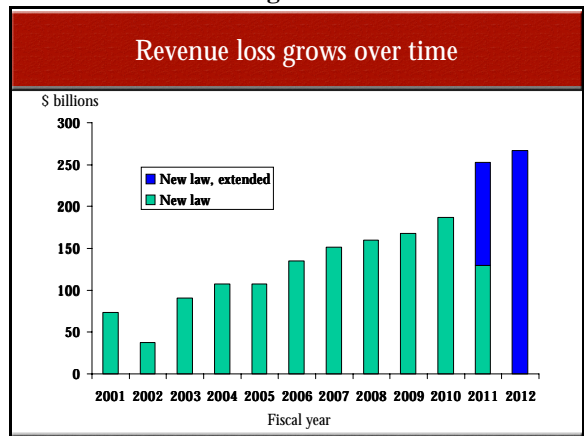
The new law has important budgetary effects because it reduces revenues (**figure 16**). These estimates by the Joint Tax Committee do not reflect any changes in work, saving, and investment, although they reflect other behavioral changes.

The revenue loss grows throughout the 10-year period, as more provisions are phased in. The revenue loss tapers off in fiscal 2011, because the law expires on December 31, 2010 (three months after fiscal 2011 starts). There is essentially no revenue loss in fiscal 2012. However, if the law is extended, the revenue losses continue to mount in fiscal 2011 and 2012.

**Figure 15**



**Figure 16**



Without the tax cut, CBO projected that federal revenue (as a share of GDP) would decline from its historic high of 20.6 percent in fiscal 2000 to 20.3 percent in fiscal 2010. The new law has a revenue loss equal to 1.2 percent of GDP in that year and brings the revenue share down to 19.1 percent (**figure 17**).

For good or ill, this revenue loss is likely to induce pressure to restrain federal spending. The greatest impact may be on the programs that are the subject of current political debate, such as Medicare, education, agriculture, and defense. Supporters of the tax cut hope that it will derail misguided spending increases that would otherwise be fueled by the availability of large surpluses. Opponents of the tax cut fear that it will drain funds from vital programs that meet important national needs.

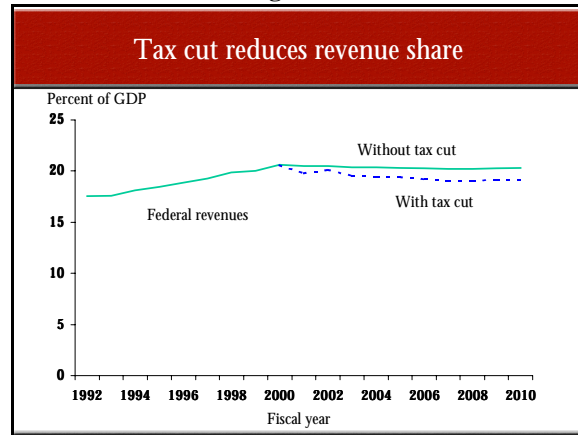
If spending remains unchanged (or even if it is reduced by less than the revenue loss), the tax cut will reduce the surpluses. **Figure 18** shows the reduction in the surplus, assuming that spending remains on the current-policy baseline calculated by CBO. In fiscal 2010, the new law reduces revenues by \$187 billion and adds about \$65 billion to the government's interest expense. It therefore reduces that year's surplus from \$806 billion to about \$554 billion. Excluding Social Security and Medicare Part A, the surplus is reduced from \$458 billion to about \$206 billion.

The smaller surpluses translate into slower debt repayment (**figure 19**). Continuing to assume that spending remains on the current-policy baseline, the tax cut delays the retirement of the federal debt by two years, from early in fiscal 2009 to early in fiscal 2011.

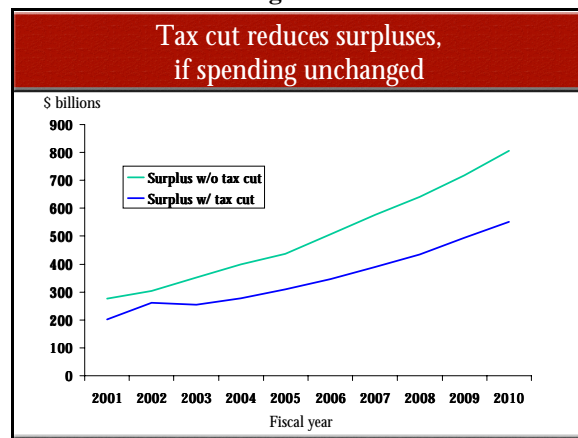
If spending increases and additional tax cuts currently under consideration are adopted, the surpluses would be still smaller. The retirement of the federal debt would be further delayed or prevented.

Slower debt repayment has a number of economic implications, which I discuss only briefly.

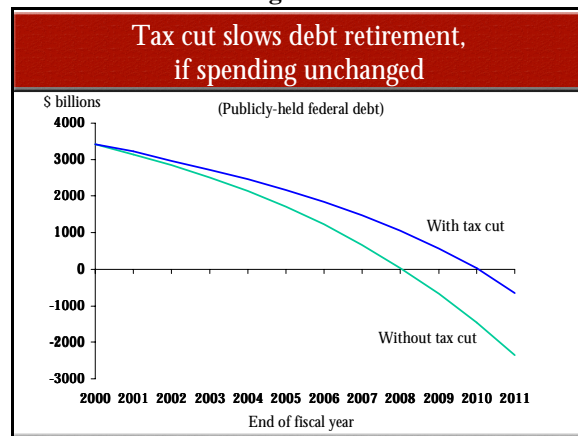
**Figure 17**



**Figure 18**



**Figure 19**

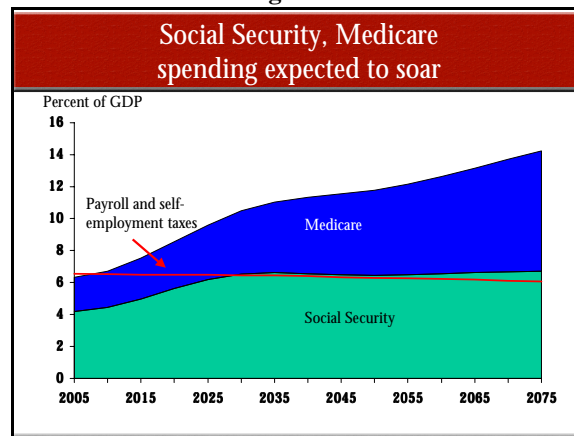


Delaying debt retirement preserves the market in Treasury securities, which many investors value for their liquidity. It also postpones the dilemma of whether the government should buy corporate stocks and bonds if it runs additional surpluses after the debt is retired.

Unless private saving rises to offset the reduction in the surpluses, national saving declines. A decline in national saving increases current consumption but reduces future consumption due to lower capital accumulation.

Slower debt repayment also means that future tax increases or spending cuts will be required to service the debt. This adds to the fiscal challenge posed by the sharp increase in Social Security and Medicare spending projected over the next 75 years (**figure 20**). This increase reflects the retirement of the baby boomers, longer life expectancy, and rising medical costs. The federal share of Medicaid spending (not shown) is also expected to rise sharply.

Figure 20



Running smaller surpluses is beneficial to current generations but poses burdens on future generations. Resolving these tradeoffs requires weighing the rights, needs, and obligations of different generations.

## Conclusion

Since 1998, policy makers have left the surpluses largely untouched, allowing government debt to be paid down. Now, the new tax law charts a new direction for fiscal policy by reducing the surplus and offering broad-based tax relief. As discussed above, the new law is likely to have significant economic consequences. Because the law leaves a number of issues unresolved, its ultimate impact will depend on future economic events and policy decisions.