

Point of view

What is the fate of the Bush tax cuts?

The Bush tax cuts of 2001 and 2003 are set to expire by the end of 2010 unless Congress acts.

It's open to debate

With the economy still weak, the tax cut issue has led to intense debate between those who support letting tax cuts expire to help reduce the projected debt and those who believe raising taxes now could threaten the economic recovery. The general expectation is that this topic will be hotly debated in the Congress this fall.

Three possible scenarios

The table below outlines three possible scenarios and summarizes the main points and rates currently being discussed. Please note that additional topics, such as whether Congress will meaningfully address the Alternative Minimum Tax (beyond the year-to-year fixes), whether the marriage penalty will be re-instated, and any discussion of the estate tax, have not been included.

Tax Rates

Income brackets	Current tax rates	Scenario 1 All tax cuts expire	Scenario 2* All tax cuts extended	Scenario 3 Tax cuts extended for all but the wealthiest (administration's proposal)
Bottom	10%	15%	10%	10%
Second	15%	15%	15%	15%
Third	25%	28%	25%	25%
Fourth	28%	31%	28%	28%
Fifth	33%	36%	33%	36%
Top	35%	39.6%	35%	39.6%

Capital Gains and Dividend Taxes

Income brackets	Current tax rates	Scenario 1	Scenario 2*	Scenario 3
Bottom 2 brackets	0%	Differential tax rates on capital gains and dividends (10% for the bottom bracket and 20% for all others on capital gains) + (Dividends taxed as ordinary income)	0%	0%
Middle 2 brackets	15%		15%	20%
Upper 2 brackets	15%		15%	20%

Implications and probabilities

The following table summarizes the potential implications and probability of the three scenarios.

Scenario	Implications	Economist Forecasted Probability** (see Blue Chip Economic Indicator forecast below)
<p>Scenario 1</p> <p>Congress does nothing, and all tax cuts expire for all income groups, reverting to pre-2001 levels</p>	<ul style="list-style-type: none"> • Higher taxes for most income groups. • Letting all tax cuts expire could have a significant impact on reducing projected debt, but this is the least likely scenario as most economists believe increasing taxes across the board in a struggling economy would be a sure way to derail a fragile economic recovery – an outcome nobody wants. • Moreover, in this scenario, a differential tax rate on capital gains and dividends could potentially create unwanted and significant challenges for investors and capital markets. 	<p>Least likely scenario</p>
<p>Scenario 2</p> <p>Congress acts to extend tax cuts for all income groups</p>	<ul style="list-style-type: none"> • No tax increase for anyone. • According to the US Department of Treasury, the full extension of all tax cuts is estimated to increase the deficit by \$3.7 trillion over next decade.¹ • The Congressional Budget Office also paints a severe fiscal picture for this scenario. It states that the extension of tax cuts would result in lower revenues. The growing imbalance between revenues and non-interest spending, combined with spiraling interest payments, would swiftly push debt to unsustainable levels.² • This scenario is likely to find support only from those who believe that given the fragile nature of consumer spending the current tax rates should be left unchanged.³ 	<p>Low to medium</p>
<p>Scenario 3</p> <p>Congress adopts President Obama's proposal</p> <p>Tax cuts to be extended for all but the highest earners (individuals making \$200,00 or more and couples making \$250,000 or more)</p>	<ul style="list-style-type: none"> • Higher taxes on income, capital gains and dividends for the highest earners only. Net effect to this group will be an increase in the top marginal income tax rates from current 33% and 35% to 36% and 39.6% and taxes on capital gains and dividends will go up from 15% to 20%. • This scenario affects approximately the top 2% to 3% of the earners leaving tax rates unchanged for the rest. • This scenario is expected to result in \$36 billion of additional tax revenue in 2011. Although this number is too small to have any meaningful impact on deficit reduction, it will nonetheless signal a small step toward it. • Supporters of this scenario believe that additional tax revenue and deficit reduction would have a positive impact on people's level of confidence regarding the nation's economic future. 	<p>Russell believes this to be the "most likely scenario" as it balances both the economic and political considerations associated with this decision.</p>

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* Scenario 2 is the same as the current tax rates.

** In August 2010 issue of Blue Chip Economic Indicators, out of the 50 economists on the panel, an overwhelming 83% of them believe that the tax cuts will expire only for those with incomes of \$250,000 or more, 14.9% believe that none of the tax cuts will expire, and only 2.1% believe that all tax cuts will expire at the end of 2010.

¹ "Geithner Pushes Tax Boost for Wealthy," by John D. McKinnon, *Wall Street Journal*, August 5, 2010.

² "The Budget and Economic Outlook: An Update," August 2010, Congress of the United States, Congressional Budget Office, p. 20.

³ "FY11 Deficit Outlook," by Joe Lieber, *Washington Analysis*, August 19, 2010.

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First used: September 2010

RFS 10-3897