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The Bush Tax Cuts Explained: Where Are They Now?

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The first round of what have come to be known as the Bush tax cuts went into effect 12 years ago. Now that a more than decade-long debate has mercifully ended, like a story on where the stars of popular 1980s sitcoms are today, it is instructive to look back and see what happened to the Bush tax cuts.

Their Origin. Back in 2001, President George W. Bush had just entered office and a recession that had its roots during President's Clinton second term began.[1] In order to help right the flagging economy and set it on a permanently stronger foundation for growth going forward, President Bush accomplished a reduction of income tax rates that phased in slowly over time and other tax cuts for the middle class, such as a doubling of the child tax credit, through Congress.

This paper, in its entirety, can be found at **http://report.heritage.org/ib3855**

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By 2003, it was clear that the economic benefits from lower rates were not materializing fast enough because the rate reductions were phasing in too slowly. So President Bush and Congress agreed to speed up those rate reductions and reduce the bias against investment by lowering rates on capital gains and dividends and phasing out the estate tax (better known as the "death tax").[2]

It was at that point that the beneficial effects from these policies began to take hold and the economy began to exhibit stronger growth.

Tax Policy with an Expiration Date. The Bush tax cuts were always meant to be permanent improvements to the tax code. Instead, they came with a 10-year expiration date, because Congress passed them through an arcane budget process known as "reconciliation" that later became famous for allowing Obamacare to become law.

The original expiration date was the end of 2010. Then, President Obama and Congress cut a deal to extend almost all of the Bush tax cuts for two more years. (The phase-out of the death tax was left out of the deal.) It was that extension that largely led to the morass known as the "fiscal cliff" that the nation just suffered through.

The Fiscal Cliff Deal Brought Permanence. The fiscal cliff deal raised taxes by allowing some of the Bush tax cuts to expire. A silver lining of the deal is that it made other Bush-era policies permanent.[3] Detailed below are all the policies set by the Bush tax cuts and where those policies stand now:

- **Marginal income tax rate reductions.** The Bush tax cuts reduced the then 39.6 percent rate to 35 percent, the 36 percent rate to 33 percent, the 31 percent rate to 28 percent, and the 28 percent rate to 25 percent. It created a new 10 percent bracket, and there was no change to the 15 percent rate. The fiscal cliff deal retained all those rates except the top rate, which it allowed to rise back to 39.6 percent.[4]

- **PEP and Pease elimination.** The Bush tax cuts eliminated the personal exemption phase-out (PEP) and the phase down of itemized deductions (Pease) for incomes over $100,000 for Pease and $150,000 for PEP. The fiscal cliff deal misguidedly brought these policies back for married filers with adjusted gross income over $300,000 ($250,000 for single filers). PEP is bad policy because it reduces work incentives for families, Pease because it makes taxes less neutral, which slows growth. The revenue they raise is an enormous tax increase—more than $150 billion over 10 years.[5] It is a major failing of the fiscal cliff deal that it allowed these policies to return.

- **Capital gains and dividends rate reductions.** Prior to the Bush tax cuts, the tax rate on capital gains was 20 percent. Dividends were taxed at the same rate as wage and salary income; therefore, most were taxed at 39.6 percent. The Bush tax cuts reduced both of these rates to 15 percent to greatly reduce the tax bias against investment. The fiscal cliff deal allowed the rate on capital gains to rise back to 20 percent and set the rate on dividends at that rate as well. However, Obamacare began levying a 3.8 percent surtax on both this year, so their full rate is now 23.8 percent.

- **Estate tax (death tax) repeal.** The Bush tax cuts phased out the death tax. It was supposed to be completely eliminated after 2009. However, after being dormant for one year in 2009, the 2010 deal between President Obama and Congress brought it back to life at 35 percent with a $5 million exemption. The fiscal cliff deal kept the exemption at $5 million (indexed for inflation) and increased the rate from 35 percent to 40 percent.

- **Other Bush tax cuts.** The Bush tax cuts included several other policy changes:
  - They doubled the child tax credit from $500 to $1,000;
  - They reduced the marriage penalty by doubling the standard deduction for married filers compared to single filers and doubling the income threshold for the 15 percent bracket for married filers compared to single filers;
  - They increased the earned income tax credit (EITC);
  - They raised the annual contribution limit for Coverdell education savings accounts to $2,000 per year and relaxed other limitations;
  - They extended the exclusion for employer-provided educational assistance;
  - They eliminated the 60-month rule and the disallowance for voluntary payments for the student loan deduction;
  - They eliminated tax on certain scholarships;
  - They reduced taxes on bonds for school construction;
  - They increased the dependent care tax credit;
  - They increased the adoption credit;
  - They provided credit for employer-provided child care; and
  - They changed tax treatment of Alaska Native Settlement Trusts.

The fiscal cliff deal made each of these policies permanent.

Tax Reform Needed. There is never a "last tax bill." Congress will keep changing the tax code every year, so there is hope that it will soon rectify the mistakes it made in the fiscal cliff deal. Until then, taxpayers can take solace in the fact that they have certainty about taxes for the time being—and that the drive for fundamental tax reform that could fix the fiscal cliff errors, and other major tax flaws, remains strong.

Despite the tax increase caused by the fiscal cliff deal, there are still some in Washington who want to raise taxes further. In fact, some—including President Obama—have

1. See Curtis S. Dubay, "Setting the Tax Record Straight: Clinton Hikes Slowed Growth, Bush Cuts Promoted Recovery," Heritage Foundation *Backgrounder* No. 2601, September 11, 2011, http://www.heritage.org/research/reports/2011/09/setting-the-tax-record-straight-clinton-hikes-slowed-growth-bush-cuts-promoted-recovery.
2. For a full list of the Bush tax cuts, see Curtis S. Dubay, "Taxmageddon: Massive Tax Increase Coming in 2013," Heritage Foundation *Issue Brief* No. 3558, April 4, 2012, http://www.heritage.org/research/reports/2012/04/taxmageddon-massive-tax-increase-coming-in-2013.
3. See Curtis S. Dubay, "Fiscal Cliff Deal: Tax Increase Spoils Permanent Victory for Most Taxpayers," Heritage Foundation *Issue Brief* No. 3821, January 9, 2013, http://www.heritage.org/research/reports/2013/01/fiscal-cliff-deal-how-it-will-affect-taxpayers-and-the-economy.
4. The fiscal cliff deal set the top tax rate higher but created a new tax bracket with a 35 percent rate. For further explanation, see ibid.
5. White House Office of Management and Budget, "Deficit Reduction in the American Taxpayer Relief Act of 2012 (H.R. 8)," http://www.whitehouse.gov/sites/default/files/omb/communications/misc/cboscore_hr8_20130101.pdf (accessed February 15, 2013).

gone so far as to distort the meaning of tax reform to mean tax increases.[6] America has a deficit and debt problem because Washington is spending too much, not because it is taxing too little. That was true before the fiscal cliff tax increase and remains true today. Congress and the President should focus on cutting spending to fix deficits and debt, not taking even more of taxpayers' hard-earned income.

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6. News release, "Remarks by the President," The White House, February 5, 2013, http://www.whitehouse.gov/the-press-office/2013/02/05/remarks-president (accessed February 20, 2013).