Top 10 Tax Stories of the Decade

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The decade that will end tomorrow (2000-2009) will go down in the tax history books as a relatively low-tax decade. The Bush tax cuts combined with annual patches to the Alternative Minimum Tax reduced taxes by trillions of dollars during the decade. Not since Ronald Reagan's tax cuts in the early 1980s had taxes been cut by so much.

Despite all the tax cutting, opportunities for revenue-neutral fundamental tax reform were wasted or defeated by strong special interests. Looking ahead, huge fiscal deficits and new entitlements will likely mean that tax reform may come back on Congress' radar screen—as an avenue for raising revenue.

This decade of lower taxes will likely not extend too far into the next one, as Democrats appear set to raise billions of dollars in new taxes to finance health care reform, just one month into the new decade.

In this commentary, the Tax Foundation staff takes a look back at the top 10 tax stories of the 2000s (as judged by the Tax Foundation Staff), discussing the economics and politics of each story, and looking ahead to how that story may continue to play out in the next decade.

Top 10 Tax Stories of the 2000s

1. The Bush Tax Cuts

2. The Alternative Minimum Tax

3. The IRS, Rebate Checks, and Fiscal Stimulus

4. Influence of the Housing Lobby on the Federal Tax Code

5. Emergence of Environmental Taxation as Key Policy Issue

#1: The Bush Tax Cuts

Candidate George W. Bush campaigned on tax rate reductions throughout 2000, and the rapidly increasing federal surplus helped make his case more persuasive. Even Vice President Gore proposed his own large tax cut plan late in the season.

When elected, President Bush sent Congress a plan of specific rate cuts and credit increases that adhered closely to his campaign promises but disappointed free-market conservatives. Supply-siders thought cuts for capital gains, dividends and the top income tax rates would help the economy most. Instead the 2001 tax cut focused on immediate cuts in wage taxes for low- and middle-income people, especially:

- creating a 10% tax bracket and mailing each taxpayer a check for the current year's savings;
- raising the ceiling of the 15% bracket to protect middle-income couples from the marriage penalty; and
- raising the child tax credit from $500 to $1,000 and making it refundable

The legislation did include tax cuts at the high end of the income spectrum, but those were scheduled to phase in over many years. The top income tax rate of 39.6% was only cut to 39.1% in the first year. No positive economic impact was noticeable during 2002, and pressure built for a supply-side tax cut. That was delivered in May of 2003 in the form of an acceleration of the 2001 phase-ins, plus a new 15% tax rate on capital gains (down from 20%) and a 15% rate on dividends (down from a high of 39.6%). The economy did turn up after passage of the 2003 cuts, and the argument will go on forever about whether the legislation boosted the economy or the economy was on the way up anyway.

One long-term impact of the Bush tax cuts was the rapid growth of so-called nonpayers. In 2000 approximately a quarter of all tax filers ended up owing nothing for the year.

That is, after all their deductions and credits were tallied, they got back every dollar that had been withheld from their wages during the year, and many got even more than that. Out of a desire to "cut the taxes" of these people who already paid none, Bush-era tax policy greatly increased refundable tax credits that result in cash paid out to people who already have a zero tax liability. The largest of those was the child tax credit, which in conjunction with a larger earned income credit expanded the number of people who have no liability to more than a third of all filers.

To comply with Senate budgetary rules, the Bush tax cuts were enacted as 10-year temporary laws. President Obama campaigned against the Bush tax cuts vehemently during 2008, but he has taken no action to hasten their expiration due to the recession. The 2010 Obama budget projects making many of the Bush tax cuts permanent, but rates for capital gains, dividends, and high wages will rise. Estate tax law is expected to freeze at 2009 rates, preserving a portion of the Bush cuts but avoiding repeal.

#2: The Alternative Minimum Tax

The U.S. tax code has long been full of so many loopholes that some skillful taxpayers (often with the aid of their lawyers, accountants and lobbyists) have been able to avoid paying taxes completely. In response to the public relations nightmare of trying to explain why some wealthy individuals legally owed no income tax, Congress created the alternative minimum tax (AMT) in 1969. In theory, it sets a minimum percentage of income that must be paid regardless of credits and deductions.

Most taxpayers could safely ignore the AMT in its early years, but inflation and real income growth gradually pushed more and more taxpayers into the ranks of AMT payers. When Congress indexed most of the tax code's parameters for inflation in the mid-1980s, the AMT was left out, compounding the problem. Because taxpayers pay whichever is higher—their ordinary income tax liability or their AMT liability—the Bush tax cuts of ordinary liability in 2001 and 2003 pushed millions more taxpayers into AMT in the past decade, putting it front and center every year in Washington tax policy.

And so the 2000s witnessed the annual late autumn ritual of waiting for Congress to pass an AMT patch, which would retroactively raise the AMT exemption level just before the end of that tax year. When Democrats took over Congress and instituted Paygo rules, the promise was to "pay for" any AMT patch. But such a promise quickly dissipated as Democrats (who often represent districts hit heavily by AMT) were not ready to play a game of chicken with President Bush over AMT, despite Charlie Rangel's "Mother of All Tax Reforms" proposal that would have eliminated AMT by instituting a surtax on high-income taxpayers. After Bush left office, the final year of the decade saw relative calm on the issue as the AMT patch was passed early for 2009 as part of the $787 billion stimulus package.

#3: The IRS, Rebate Checks, and Fiscal Stimulus

Over the past decade the federal government has repeatedly recruited the IRS to deliver checks to millions of taxpayers. These are not the checks that the IRS would send out routinely—tax refunds to people who overpaid—but rather checks designed to stimulate the economy by increasing federal borrowing and pumping the money into the economy by sending checks to taxpayers.

Of course, in addition to the high-minded idea of improving the economy, politicians have the less high-minded idea that sending unexpected cash to voters is a good political strategy. Vote-buying could hardly be more brazen.

It had been tried in 1975 and was deemed an economic failure by many analysts, but that didn't stop the Bush team from trying it again in 2001. After passage of the first Bush tax cut in May of 2001, the President's team decided that instead of just instructing the nation's employers to adjust their withholding down to the new, lower level of income tax, the IRS would send each taxpayer an advance of $300 ($600 for a couple), which represented the one-year value of the new 10% tax bracket. Even though the IRS's job doesn't include tracking the whereabouts of all taxpayers (thank goodness), the service did a good job of locating most eligible recipients and getting them the checks, albeit at the cost of auditing and other administrative work that was supplanted by this essentially political exercise.

The political value of sending a "here's some money—aren't we great?" cover letter was overwhelmed by the wrong impression it created in the minds of many taxpayers: that this check was the full value of the tax-cutting legislation, when in fact it was only a tiny fraction of the relief.

The foolish exercise was repeated in 2003 with delivery of $400 checks to each taxpayer who was supporting a child 16 years or younger. That represented the one-year value of the higher child tax credit after passage of the second major Bush tax cut in May of 2003. Five years later the IRS had to play Santa Claus again when Congress passed a stimulus package that included sending checks of varying amounts to millions of taxpayers.

The Obama administration also believes in the power of the federal government to micromanage the economy with fiscal stimulus, but at least it repudiated the mailhouse approach. In 2009, the new President's first tax bill adjusted withholding to deliver $400 to each taxpayer ($800 to married couples).

The federal government, and by extension the states, have run amok with the idea of micromanaging the economy with dispersals of cash. The IRS needs a break in the coming decade, but it doesn't look good. The political appeal of using the IRS to deliver vote-buying cash is apparently too hard for our elected officials to resist.

#4: Influence of the Housing Lobby on the Federal Tax Code

It is well known in tax policy circles that the housing industry is powerful on Capitol Hill. As they have for decades, the lobbies for real estate agents, home builders and mortgage lenders constantly pushed one-sided talking points on Congress and the media about the critical importance of their special-interest tax breaks -- tax breaks that helped fuel a housing boom (turned eventual bubble).

In 2005, experts on President Bush's tax reform panel recommended eliminating the tax deduction for property taxes, as well as converting the mortgage interest deduction into a more equitable credit. But the Realtors, Home Builders, and Fannie Mae and Freddie Mac launched an all-out assault on the reform proposal and effectively dealt the proposal a rapid death blow.

But these lobbyists weren't satisfied with merely preserving housing's favored status in the tax code. As the housing bubble burst (something the National Association of Realtors said would never happen), they lobbied with their cronies in Washington like Georgia Sen. Johnny Isakson (a Realtor himself) for more tax credits for housing. And so now we have a standard deduction for property taxes paid. And now we have had three back-to-back-to-back versions of new tax credits for homebuyers all with the promise of being "temporary."

These lobbies aren't ashamed of what they do. In fact, the National Association of Home Builders in 2008 publicly threatened to withhold contributions to members of Congress unless they expanded the "net operating loss" carryback provision that would benefit their industry. Even President Obama was unable to get his health care reform bill funded in the way he preferred. He wanted to cap high-income tax deductions (including housing deductions) at 28%, but the housing lobby's influence on Congress is so powerful that the idea was "dead on arrival."

Our belated Christmas wish is that for the next decade the general public and members of Congress will turn a deaf ear to a housing lobby that should no longer be trusted as a source for policy recommendation.

#5: Emergence of Environmental Taxation as Key Policy Issue

After narrowly losing the presidency in 2000, Al Gore did not fade away. In the last 10 years he has helped move environmental taxation from the ivory tower to the real-world policy debate. Not every Democrat believes that global warming's destruction of the world is imminent, or that tax policies are the only answer, but the Democratic majorities in Congress have pushed for tax policies that they believe will keep global temperatures lower (Lieberman-Warner and Waxman-Markey). In fact, both presidential candidates in 2008 (McCain and Obama) endorsed cap-and-trade as a carbon-limiting way to prevent global warming.

But even before the 2008 presidential election, the past decade witnessed enactment of myriad new tax laws aimed at getting people and businesses to "go green." Tax credits for hybrid cars and energy-efficient appliances appeared as new lines on the federal form 1040. They were easy to pass because their costs are less visible. The Energy Policy Act of 2005 was passed in response to public disgust over the rapid rise in gasoline prices. Signed into law by President Bush, it included all sorts of tax provisions supporting both clean energy innovation and traditional dirty energy.

In 2008, candidate McCain's support for cap-and-trade didn't stop his Republican colleagues from attacking "cap-and-tax" as the potential ruination of the nation's economy. This opposition has combined with the so-called Climategate email scandal and the difficulty of international negotiation to make passage of a cap-and-trade regime or a carbon tax unlikely in 2010, an election year.

#6: Health Care and Tax Reform

The 2000s saw a lot of talk about reforming health care or health insurance, and the tax code was the favorite vehicle to achieve it. One bad tax provision in particular deserved that special attention, the exclusion from taxable income of employer-provided health insurance. But special-interest advocates and demagogues beat back every sensible attempt to improve the tax code in this area.

Early in the decade, the Bush administration promoted medical savings accounts as a tax idea that would allow people to purchase health care in a more efficient way (high-deductible plans). In 2005, the President's tax reform panel proposed taxing the value of employer-provided health insurance, but that panel faded quickly and quietly (largely due to the housing lobby — see #4).

But health-related tax reform wasn't dead. In 2007, Pres. Bush proposed imposing both payroll tax and income tax on the value of employer-provided health insurance and then allowing a standard deduction for health insurance purchased. This too died quickly, though, ridiculed by Democratic opponents who criticized any proposal from an unpopular Republican president, despite the fact that the proposal would have made the tax system more progressive. Honest policy experts on the left such as those at Brookings and Urban fully supported taxing employer-provided health insurance, and they defended the president's concept, suggesting only that the new standard health insurance deduction be a refundable credit instead.

Sen. McCain essentially endorsed this tax credit proposal as a candidate for president. He was attacked in a politically expedient and often dishonest fashion by then-candidate Obama and the labor unions for wanting to tax health benefits. As president, Obama has been pushing health reform generally, but not any specific proposal. It's somewhat humorous that the Senate health care bill, which Pres. Obama has said he supports, contains a provision that would tax health benefits. Unions want this killed in committee and replaced with other tax sources, preferably taxing millionaires.

And that's where we sit on health care and tax policy at the end of the decade. Two health care bills that have drastically different tax plans are to be mashed together in conference in the first days of 2010.

#7: Growth of Tax Competition (Good and Bad)

The 2000s were a decade of expanding tax competition, both internationally and domestically. Governments across the world, especially those in developing countries, slashed their corporate income tax rates in an effort to lure business to their countries. Other larger nations, except the United States, followed suit in cutting their corporate income tax rate. Attempts to lower the corporate income tax rate in the U.S. were proposed (such as that by Congressman Rangel) but only with replacement taxes on corporations. In 2008, the Treasury released a study highlighting the U.S. falling behind in the area of corporate taxation and suggested various reforms, such as a Business Activities Tax as a replacement to the CIT that would be similar to a VAT—all with the goal of making the U.S. tax system more competitive for business.

Domestically, tax competition between states largely took the form of special deals made between business and state/local governments. Special tax breaks for building a plant in one state (such as Intel in North Carolina) at the expense of another became even more common in the 2000s. This was especially true in the film industry where states sought to become the next Hollywood through the use of film tax credits. Hopefully states will turn the corner in the next decade and stop deal making and start enacting good tax policy. States need to stop asking business: "What special break will it take to get you here?"

#8: Rising Popularity of Nanny Tax Policies

The 2000s saw a surge in legislation designed to punish consumers for buying certain products. Cigarettes led the way among "sinful" products targeted for higher taxes, but many other products are suddenly being considered sinful by legislators who sound more and more like nannies who think their job is to micromanage the citizens.

Serious policymakers like the governor of New York have proposed taxing soft drinks. To hear him describe the motivation, it's all about making people healthier, but cynics will be excused if they suspect that raising revenue is the real reason. Throughout the decade of the 2000s state legislatures have targeted snack foods and candy for extra taxes, invariably accompanied by nannyish rhetoric about helping people become healthier (by paying more taxes). At the federal level, Botox and tanning beds have made the naughty list as part of the new health insurance legislation, and the new head of the CDC is an avowed nanny-taxer.

Without regard to health or even the environment, there are also unadorned moralizers: taxes on strip clubs, pornography and other sex-related taxes.

In every case, it's a revenue raiser wrapped into a paternalistic justification: "This product isn't good for you anyway."

Our wish for the new decade is that elected officials would realize that the people want government, not a governess.

#9: The Tax Gap

The tax gap is not a new issue to the decade of the 2000s, but it has gotten a lot of play, especially from Senate Finance Committee chairman Max Baucus of Montana. The tax gap is the amount of unpaid tax, money people owe but have evaded, some by failing to file a tax return at all but most by filling out their tax returns incorrectly. Since the IRS can't audit everyone, we don't really know how much tax evasion is occurring, but informed estimates are in the 15-to-20 percent range. So for every $100 collected, there's about $20 uncollected that should have been paid.

Experts say that by comparison with other nations, the U.S. does a good job of collecting what's owed. Yet as the government spends more and more each year, it is increasingly intolerant of uncollected tax revenue. This is ironic because the complexity of the tax code is largely responsible for the tax gap, and Congress is directly to blame for that complexity. It has created numberless exemptions, deductions and credits for businesses and individuals, so riddling the tax law with loopholes that even professional tax preparers can't independently calculate a moderately complex tax return and agree on the amount due.

There was a time some decades ago when most individuals, even people with high incomes and complicated finances, filled out their own tax returns at the kitchen table. Congress has made that impossible, and both political parties are to blame. Congressmen seem to see their mission here in Washington as the creation of a tax law that favors some of their voting constituency, ideally bearing the name or hometown of the lawmaker (the Roth IRA or the Hope credit). As a result, the vast majority of taxpayers need professional assistance to fill out their tax returns, assistance which still doesn't bring in all the money it should.

The Obama administration is working hard on one part of the tax gap, money kept in overseas banks by wealthy individuals. Less is being done on the domestic front, perhaps because many prominent administration officials have been caught evading their taxes, notably the Chairman of the Ways and Means Committee, Charles Rangel, and the

Secretary of the Treasury, Timothy Geithner. That's the sort of thing that makes it awkward to rail against people who can't figure out their tax returns.

Congress should see the tax code as a fisherman's net. If they keep putting holes in it, supposedly to benefit certain fish, other fish will manage to wriggle through, and the fisherman will not pull in as many fish as he expected to. The way to close the tax gap is not to badger the IRS but to simplify the tax code.

#10: California's Decade of Fiscal Decay

Even before California raised income and sales taxes in 2009, the state had the sixth highest state-local tax burden in the country, undermining arguments that its fiscal woes are caused by supermajority requirements and Proposition 13, which combine to make raising taxes too difficult.

For many years the state has relied especially heavily on tax revenue from capital gains and other income from high-income individuals. When the state experienced a huge revenue surge during the prosperous economic times in the middle of the decade, lawmakers responded by increasing spending levels to match those revenue surges. While general fund spending ranged between $71 billion and $75 billion in the 1999-2003 period, spending reached $99 billion in 2007, a 31% increase. During the same period inflation increased 12% and the state population grew just 5%. To top it off, each year since 2001, California has avoided fundamental solutions and instead used the full spectrum of gimmicks and one-time revenues: amnesties, temporary tax increases, record borrowing, issuing IOUs, increasing withholding requirements, and shifting expenses into future years. With routine cash shortage and a disintegrating credit rating, the state may go bust before it brings spending in line with revenues.

Legislators are currently considering the views of a recent tax reform panel charged with stopping the state's boom-and-bust budget cycle. The panel majority recommended across-the-board reductions in the individual income tax and sales tax, elimination of the corporate income tax, establishing a tax on business net receipts, and strengthening the state's rainy day fund. The panel minority recommended broadening the sales tax base and requiring that revenues above a certain threshold be used for one-time purposes only.

#11: The FairTax Movement

And another story for good measure. We couldn't discuss the past decade without mentioning the FairTax. A movement that saw its origins in a popular book by the same title and in conservative talk radio became a grassroots tax reform movement full of local precinct captains for virtually every town in America.

The movement is full of followers who believe that most of the U.S. tax troubles can be solved with a mere national retail sales tax that would conveniently eliminate our number one nemesis, the IRS. The FairTax movement even became a player in the 2008 presidential election as former Arkansas Gov. Mike Huckabee became the strongest challenger of Sen. McCain for the Republican nomination, due in large part to the legions of FairTax supporters who believe the reform is simply "amazing."