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July 24, 2010

Next Big Battle in Washington: Bush's Tax Cuts

By DAVID M. HERSZENHORN

WASHINGTON — An epic fight is brewing over what Congress and [President Obama](#) should do about the expiring Bush tax cuts, with such substantial economic and political consequences that it could shape the fall elections and fiscal policy for years to come.

Democratic leaders, including Mr. Obama, say they are intent on letting the tax cuts for the wealthy expire as scheduled at the end of this year. But they have pledged to continue the lower tax rates for individuals earning less than \$200,000 and families earning less than \$250,000 — what Democrats call the middle class.

Most Republicans want to extend the tax cuts for everyone, and some Democrats agree, saying it would be unwise to raise taxes on anyone while the economy remains weak. If no action is taken, taxes on income, dividends, capital gains and estates would all rise.

The issue has generated little public attention this year as Congress grappled with health care, [financial regulation](#), energy, a [Supreme Court](#) nomination and other divisive topics. But it will move to the top of the agenda when lawmakers return to Washington in September from their summer recess, just as the midterm campaign gets under way in earnest. In recent days, intense discussions have begun at the

Capitol.

Beyond the implications for family checkbooks, the tax fight will serve as a proxy for the bigger political clashes of the year, including the size of government and the best way of handling the tepid economic recovery.

“It has enormous ramifications for the fall and clearly will be one of the dominant issues,” said Senator [Ron Wyden](#), Democrat of Oregon. “This is code for the role of the federal government, the debate over the size of government and the priorities of the nation.”

At a closed-door meeting of the Senate Finance Committee on Thursday, participants said Democrats were clearly divided while Republicans wanted assurances that any bill would be developed openly, allowing them to propose amendments. In a sign of how combustible the issue could be, Senator [Max Baucus](#), a Montana Democrat and the committee’s chairman, has so far refused to make that commitment.

Both parties are still charting strategy, but some lawmakers, Congressional aides and administration officials said Democrats must try to pass a bill before the election and not wait for a lame-duck session. “You can’t play chicken with this much of the tax system,” said a senior Republican Senate aide, who spoke on the condition of anonymity given the sensitivity of even the timing of the debate.

If no tax legislation is passed, all the major tax reductions passed under President [George W. Bush](#) in 2001 and 2003 will expire, with rates reverting overnight on Dec. 31. The top marginal income tax rate, for example, would go back to 39.6 percent from 35 percent now, with corresponding increases in rates for lower income brackets.

Given the partisan gridlock of recent months, there is a chance that the battle could go down to the last minute, or even — in the face of a stalemate — that the tax cuts could be allowed to expire completely, a development that Republicans are already heralding ominously as the largest tax increase in history and that lawmakers in both parties say could be the worst outcome.

From both political and policy perspectives, the tax issue is dizzyingly complex, and even some of Washington's most grizzled legislative operatives say they cannot predict the outcome.

Some liberals want Mr. Obama to keep his promise to raise taxes on the rich, and the White House's budget forecasts rely heavily on rolling the top income tax rates back to their pre-2001 levels. Some fiscal hawks warn that extending the tax cuts would add more than \$2 trillion to the **federal budget** deficits at a time when the national debt is becoming an economic concern and a political issue.

Political economists are fiercely divided.

So are Democrats. In recent days, fiscal conservatives like Senators **Kent Conrad** of North Dakota and **Evan Bayh** of Indiana expressed support for extending the tax cuts at all income levels, at least temporarily.

Senior administration officials said there was no interest in such a plan at the White House, which intends to have **Treasury Secretary Timothy F. Geithner** lead an effort to make the case that continuing tax breaks for the rich will not help lift the economy, but eliminating them will help reduce the deficit.

"We do not buy into the theory that because the economy is still recovering, extending tax cuts for the highest earners is a necessary or effective policy response," said **Gene Sperling**, counselor to Mr. Geithner.

"While we are supporting measures like small-business lending and tax cuts to spark growth," Mr. Sperling added, "it is also important to show the world that we are following through on our commitment to long-term fiscal discipline."

But the questions go far beyond the basic issue of whether to allow the top two marginal income tax rates to rise.

Congress must also wrestle with the **estate tax**, which lapsed last year but will automatically be reinstated effectively at a 55 percent rate on Jan. 1 for estates larger than \$1 million. Lawmakers must

also deal with an array of other provisions, including tax rates on dividends and capital gains, and the **Alternative Minimum Tax**, which has been adjusted annually to prevent millions of middle-class families from paying higher tax bills. The child tax credit would also be reduced.

There are many permutations of permanent or short-term extensions of various provisions.

Negotiations are expected to start in the Senate, where it is hardest for Democrats to advance legislation because of Republican **filibusters**. But some Democrats say a fallback plan would be to have their larger majority in the House approve a continuation of the lower rates just for the middle class right before the election, almost daring Republicans to oppose them.

In that case, Democrats say, Republicans who opposed the bill would be blocking a tax cut for more than 95 percent of Americans to defend tax cuts for a relatively few wealthy households. Republicans are readying an arsenal of economic data to portray the Democrats as endangering the precarious recovery and harming small-business owners, some of whom are taxed at the top personal income tax rates.

In the weekly Republican radio address on Saturday, Representative **Mike Pence** of Indiana promised an all-out push to extend the tax cuts for everyone. “House Republicans will oppose this tax increase with everything we’ve got,” he said.

The issue is further complicated by the rising concern among voters about the federal deficit, which would be increased by roughly \$1.5 trillion over 10 years just by continuing the tax breaks for the middle class. Many economists say the nation’s debt load is already headed to risky levels.

A decision on the tax issue could come just as Mr. Obama’s National Commission on Fiscal Responsibility and Reform reaches a Dec. 1 deadline to propose remedies for addressing the long-term debt problems. “The big questions before us now are whether we should make some of these tax cuts permanent, and if so, which ones,” Mr. Baucus said at a recent public hearing. “But that’s not the only challenge. There’s another elephant in the room — the budget deficit. And that elephant is growing.”

At Thursday's closed committee meeting, in a testy exchange described by several witnesses, Senator [Orrin G. Hatch](#), Republican of Utah, pushed for developing the bill openly in committee rather than having Democrats bring it straight to the floor.

In a statement, Mr. Hatch lambasted Democrats. "They can talk about the wealthy all they want, but this is about stopping a job-killing tax hike on small businesses during tough economic times," he said.

But some lawmakers, including Mr. Wyden, say the deficit concerns and the attention on the debt commission could help forge a deal: a short-term continuation of the tax cuts for the middle class, and perhaps some new tax breaks for businesses, that would buy lawmakers time to undertake a broad overhaul of the tax code in the next Congress.



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