How the tax cut debate affects you

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By Tim Sloan, AFP/Getty Images

President Obama urged a crowd today to stick with his economic policies as the nation slowly recovers from an economic crisis more than a decade in the making.

WASHINGTON — In 2001, George W. Bush signed one of the biggest tax cuts in U.S. history. He heralded it as an elixir for a struggling economy. But it also contributed to a growing deficit.

Congress set the tax cuts and others enacted in 2003 to expire in 2011 so the costs would not explode in the coming decade.

TRACKER: Where are your tax dollars

TAX CALCULATOR: See how you would be affected

Now, Democrats in Congress, at the urging of President Obama, are poised to make at least 80% of those tax cuts permanent, at a cost of $3 trillion over the next decade. Up for debate is another $700 billion in tax cuts for the 2% of taxpayers with taxable income above $200,000 for individuals and $250,000 for couples. Obama wants to raise taxes on income above those levels.

As Congress takes up the issue, here is what's driving the debate:

Q: What taxes are at stake?

A: Income tax rates are at the center of the debate. The Bush plan reduced rates by about 3 percentage points in each tax bracket and created a new, lower 10% tax bracket.

For the poor, the plan expanded the earned income credit. For the middle class, it doubled the child credit to $1,000 and eliminated the "marriage penalty." For wealthier taxpayers, it lifted limits on itemized deductions, gradually eliminated the phaseout of personal exemptions, and slashed rates on dividends and long-term capital gains.

The tax rate on estates was cut from 55% to 45% and the exemption raised from $1 million to $3.5 million; this year, the tax was eliminated, but returns at 55% unless Congress acts.

Q: Why does Obama want to continue most of the tax cuts?

A: During his presidential campaign, Obama vowed not to raise income taxes on families with annual income below $250,000. His pledge was coupled with his plan to raise taxes on wealthier Americans who benefited the most from the Bush tax cuts. That plan is at the center of today's debate.

"In order to save our children from a future of debt, we will ... end the tax breaks for the wealthiest 2% of Americans," Obama told a joint session of Congress last year. "If your family earns less than $250,000 a year, you will not see your taxes increased a single dime."

Q: Who stands to benefit most if the tax cuts are extended for everyone?

A: The wealthiest would get the largest breaks. Those near the bottom of the income scale would get an average cut of about $70 in 2012. A family of four with taxable income of $1 million would save more than $50,000.

The tax cuts are particularly important to families with children because they double the child tax credit. Married couples also benefit greatly from a more generous standard deduction and favorable tax rates that eliminate the "marriage penalty."

"These are the people with the most at stake," says Clint Stretch of Deloitte Tax.

Q: What will be the impact on the economy?

A: Businesses have been sitting on cash because of uncertainty about future policies. Extending the tax cuts would eliminate some of that uncertainty. Consumers who are just beginning to spend more freely would have reason to continue doing so.

If the cuts are not extended at least temporarily for wealthier people, the economy could slow further, some economists say. "I think it's a gamble to raise taxes on upper-income households in 2011," says Mark Zandi, chief economist at Moody's Analytics.

Q: What's the impact on the federal deficit and debt?

A: Extending all the tax cuts would cost nearly $3.7 trillion over 10 years, according to the Treasury Department. Obama's plan to let tax rates rise only on upper-income groups would reduce the cost by nearly $700 billion. That won't do much to a national debt that's at $13.4 trillion .

"I think it will be a disaster (for the deficit) to make any of the tax cuts permanent," says Syracuse University professor Len Burman, former co-director of the Tax Policy Center in Washington.

Q: Should tax cuts be extended for wealthier people?

A: Obama says they don't need more tax cuts and won't spend the money as readily as the middle class would. Others counter that people with the most money to invest should be able to keep more of it. "Capital formation is the key to long-term growth," says Dan Mitchell of the conservative Cato Foundation.

Obama's plan would restore the 36% and 39.6% top tax rates, up from 35%. Long-term capital gains and dividends would be taxed at 20%, up from 15%. Personal exemptions would be phased out and itemized deductions limited.

Obama says only 3% of small businesses would pay more taxes. Republicans such as Rep. Paul Ryan, R-Wis., say those businesses represent half of all small-business income. Both are correct: About 900,000 small businesses would pay higher rates; they earn about $400 billion, or 44% of small business income.