IRET *Congressional Advisory*

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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December 10, 2002 **Advisory No. 143**

STIMULUS OR INCENTIVES?
WHAT WOULD GOOD TAX RELIEF LOOK LIKE?

The White House is working on a new set of tax proposals to spur the economic recovery. A number of ideas are being mentioned in the press, including moving forward scheduled marginal rate cuts, relief from the double taxation of dividends, allowing people to deduct more of their capital losses, additional "bonus" depreciation, further enhancement of retirement saving accounts, and making estate tax repeal permanent. Meanwhile, the Business Roundtable has floated three specific steps it would like to see taken (discussed below). How should we judge these proposals by the Roundtable and whatever specific ideas the White House eventually releases? What are the characteristics of a good tax package?

First, let us get the analysis right. It is time to lay to rest obsolete notions of how tax cuts work. Tax cuts do not work by giving people money to spend. When the government cuts taxes without cutting spending, it immediately borrows the money back. There is no increase in aggregate consumer purchasing power, and no immediate boost to consumer spending from a tax cut. (The only exception is if the Federal Reserve steps in to buy up the new government debt, in which case the additional spending comes from a shift in monetary policy, not from the tax cut. Monetarist economists like Milton Friedman and neo-classical economists like Norman Ture have pointed this out forcefully and repeatedly since the 1960s, and the evidence backs them up.)

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Tax cuts boost the economy, if they work at all, by increasing incentives ***at the margin*** to produce more. That is, they encourage ***additional*** hours of work and ***additional*** hiring, ***additional*** saving and ***additional*** investment in plant, equipment, and buildings. The added supplies of labor and capital combine to produce added output, for which the suppliers get paid. Only after the tax changes lead people to offer more of their services and increase their output is there an increase in national income, and only then do people have more income to spend. Demand then rises with supply. Without added supply, demand and income don't increase.

The only tax cuts that have these beneficial effects are those that impact ***incremental*** income and cost calculations. These include: faster write-off of investment, lower ***marginal*** tax rates on earning ***additional*** wages, dividends, interest and capital gains, reduced double taxation of corporate income, and reductions in the add-on tax on the savings that constitute estates.

The Business Roundtable has proposed three tax reductions (BRT press release, November 21, 2002) and has declared that all of them would be of benefit because [it thinks] they would give consumers and savers more money to spend. The three Business Roundtable proposals are:

1) Eliminate for a year the Social Security payroll tax (excluding medicare) on employers and

employees (6.2% of payroll each) on the first $10,000 of wages. The Roundtable press release claims that this would "put money into workers' pockets immediately: each worker would receive up to $620. Self-employed workers would get up to $1240."

2) Accelerate the marginal income tax rate reductions passed in 2001 "in order to add to the purchasing power of individuals in 2003, 2004, and 2005. Wage earners would see less income tax withheld from their paychecks, giving them more to spend."

3) Eliminate the double taxation of dividends for individuals "which would provide a near-term stimulus by reducing taxes, providing an immediate increase in disposable income, and encouraging investment in equities."

> ***[T]ax cuts that have these beneficial effects ... include: faster write-off of investment, lower marginal tax rates on earning additional wages, dividends, interest, and capital gains, reduced double taxation of corporate income, and reductions in the add-on tax on the savings that constitute estates.***

The first of these proposals would do nothing for growth, and is political window dressing. The other two proposals would indeed help the economy, although the analysis and rationale are almost entirely faulty.

1) Suspend the payroll tax. The payroll tax holiday would resemble the ill-fated 2001 $600 tax "rebate", which caused a minor pop-up in the personal saving rate and did nothing for economic growth. It would not be "at the margin" for anyone earning more than $10,000, which is to say, anyone earning the minimum wage in a full time job.

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The best that can be said for this non-marginal "tax rebate" is that it might lower the cost of part time workers or help to pay for the training of new hires. Other than that, it would offer no incentive for permanent employment or hiring. It is an expensive give-away with little effect on marginal incentives. Its chief value is political, offering a way to make the tax distribution tables look prettier by giving more of the tax cut to lower income workers.

If payroll tax relief is to be part of the package, cutting the payroll tax rate by a percentage point would offer more relief "at the margin" to many more workers (anyone with wages below $84,900, the current wage ceiling at which the old-age and disability tax is capped). Payroll tax relief is best left for a Social Security reform package that will address the long term insolvency of the system.

2) Move forward the scheduled marginal rate cuts. Accelerating the next two steps in the marginal tax rate reductions (set for 2004 and 2006) to 2003 (or to 2003 and 2004) would hasten the effective date of their incentive effects. Indeed, the delay in reducing these rates is one reason that the 2001 tax bill, as enacted, had such limited impact in its first two years.

The rate cuts would be "at the margin" for people in the four top brackets who generate a large amount of the nation's taxable wages and capital income. The rate cuts would boost employment by lowering the cost of labor to the employer while simultaneously increasing the after-tax reward to the worker. Savers would have more incentive to save because of the increase in after-tax interest and dividends. Owners of businesses would have more incentive to expand their operations because the tax on an added dollar of profit would be reduced. This is a useful step for improving the pace of the recovery, and it would carry a low "revenue cost" in the federal budget "score" because it would move forward by only a short time two rate cuts that are already scheduled to occur.

3) Reduce double taxation of dividends. Tax relief for dividends is another pro-growth, incentive-enhancing policy step. Excluding some percentage of dividends from the personal income tax (or alternatively, allowing a deduction to the corporation for some portion of dividends paid) would be a reduction in the tax bias against the corporate form. It would bring the tax treatment of dividends more in line with the tax rate on capital gains, and reduce the current tax incentive for management to retain earnings (even if they have no great investment opportunities) instead of sending them to the shareholders. Dividend relief will only provide tax relief "at the margin" if it takes the form of a percentage exclusion without a dollar cap. A $200 or $400 exclusion would not give any incentive to increase share ownership for anyone already receiving more than those amounts of dividends.

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The effectiveness of this proposal would not come from giving shareholders more income to spend. It would come from reducing at the margin the several layers of tax imposed on saving used to buy shares, and by making shareholding more attractive (the only incentive mentioned in the press release). It would reduce the cost of raising funds for new investment by selling shares, boosting capital formation. It would lift the stock market, and would reduce capital losses and increase tax receipts from capital gains.

> ***Any tax provision that is offered solely with an eye to the distribution tables should be clearly labeled as such so it can be kept to a reasonable size and be prevented from crowding out the parts of the package that actually aid job creation and capital formation.***

A key omission: accelerated depreciation. Omitted from the Roundtable list is any increase or extension of the bonus depreciation provision contained in the spring 2002 stimulus package. That is too bad, as enhanced expensing is the sort of provision most likely to increase investment spending, which is the weakest sector of the economy. It would be nice to see it in the proposal the Administration is preparing. Ideally, the Administration would recommend raising the amount of equipment investment that can be written off at once (expensed) from the 30% contained in the last stimulus bill to 50%, 60%, or 100%. The current provision applies to eligible assets ordered before September 11, 2004 and placed in service by the end of 2004. These dates should be extended a year or more (especially the placed in service deadline). Since the added write-offs are merely being brought forward from later years, a one-year extension would have little impact on the ten-year budget totals that play such a large role in the federal budget process. The corporate and individual AMTs should be amended to allow all businesses full use of the bonus depreciation provision. It would also be a good idea, if a net tax cut is in order, to reduce the write-off period for structures (plants and office, commercial, farm, and residential buildings) not covered under the bonus depreciation provision.

This omission of business tax relief in the Business Roundtable proposal may seem like a selfless approach to tax reduction by this segment of the business community, but it is based on faulty analysis. The Roundtable thinks that there is currently excess capacity and inventory, so it is futile to try to spur investment, and it thinks that tax cuts can give consumers money to spend on manufactured goods, drawing down inventory and boosting demand for new output.

The reasoning is flawed on both counts. First, the over-investment in the telecommunications and tech sectors is not a general phenomenon. There are many areas in the manufacturing, mining and transportation sectors, and even in many high tech sectors, where additional investment in upgrading

and expanding capacity could be usefully undertaken if the tax treatment were not so severe. Second, tax reductions do not, by themselves, give people more money to spend, because of the government budget constraint, as described above.

Using the wrong rationale for a tax proposal is dangerous. It can lead to the design of an ineffective tax package. It can provide an opportunity for those who are chiefly interested in income redistribution to substitute more of that sort of tax change for ones that would do some real economic good. The country could certainly use a package of pro-growth tax changes that would both meet current needs and fit in well with long term tax reform. Any growth proposals should be analyzed in those terms. Any tax provision that is offered solely with an eye to the distribution tables should be clearly labeled as such so it can be kept to a reasonable size and be prevented from crowding out the parts of the package that actually aid job creation and capital formation.

Stephen J. Entin
President and Executive Director

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