IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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# THE BUSH TAX PLAN AND THE HOUSE DEMOCRATIC LEADERSHIP ALTERNATIVE

President Bush has proposed a larger-than-expected program of tax relief aimed at hastening the economic recovery and promoting long term growth. The major growth elements of the plan — accelerating scheduled tax rate cuts, ending the double taxation of dividends, expanding expensing for small businesses — would indeed push the economy's "growth buttons". They would provide the sort of incentives that promote economic expansion and would increase investment, productivity, jobs, and wages both in the short run and for the longer term. They would also be consistent with fundamental tax reform, which means reducing the biases against saving and investment found in the current "broad-based income tax" system.

Other features of the Bush plan, more minor in cost and economic effect, address social issues (the marriage penalty) or "spread the wealth" of the tax cut to people with limited tax liabilities, or assist the unemployed. These latter proposals may be necessary to help ensure passage of the program, and to ease hardship among the unemployed. However, these provisions would not, by themselves, provide incentives to increase economic activity or jobs. Any "pump-priming" which old-style analysis might attribute to these provisions is a mirage.

The smaller Democratic tax cut alternative introduced on January 6 by the House Democratic leadership consists mainly of one-time refundable tax rebates, extended unemployment assistance, and aid to the states. The plan is mostly aimed at generating a quick boost in consumer and state spending in 2003, and is the old, ineffective "pump-priming" approach at work. The Democratic plan contains virtually none of the incentives that would actually succeed in expanding economic activity.

**Cost is not the measure of effectiveness.**

The Bush plan would cost $674 billion over ten years (not counting the revenue effect of additional growth.) The Democratic alternative would cost $136 billion over ten years, all up front. *The dollar amounts of the plans are less important than how they are structured to affect incentives. The Bush plan is not only larger than the Democratic alternative; it is far better structured to promote economic growth and employment.*

**The President's plan:**

• Speed up the 2001 tax reductions that have not yet taken effect.

> • The marginal tax rate reductions due in 2004 and 2006 would become effective, retroactively, on January 1, 2003. The top tax brackets would fall to 25%, 28%, 33%, and 35%.
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> • Marriage penalty relief scheduled to phase in through 2009 would become effective in 2003. (It would accelerate the scheduled expansion of the 10% bracket for all filers and the scheduled widening of the 15% bracket and standard deduction for married couples to twice the amounts allowed for single filers.)
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> • The child credit would jump from $600 to $1,000 per child this year instead of in 2010.

• End double taxation of dividends by excluding them from tax at the shareholder level.

• Allow small businesses to expense (write off immediately) $75,000 a year of investment in equipment in 2003, up from the current $25,000, and index that increased amount for inflation thereafter.

• Extend the expanded unemployment benefits that expired last year, and give money to the states to create new employment accounts to help and encourage displaced workers to get new jobs.

**The Democratic plan:**

• Give refundable rebates of up to $300 for single filers and $600 for married couples with income from labor for 2003.

• Extend the expanded unemployment benefits that expired last year and give $31 billion in aid to the states for various programs.

• Boost expensing limits for small business to $50,000, but only for 2003. It would also boost the current temporary 30% expensing allowance for equipment spending (part of the President's 2002 stimulus tax bill, effective for 2002-2004) to 50% for 2003, but drop it to 10% for 2004.

**How to judge the plans:**

Tax cuts do not work by giving people money to spend. The Bush proposals and the Democratic alternative should not be viewed as pumping up consumer spending, even though this objective was mentioned in the Administration's list of things that its tax cuts would accomplish and touted as the chief "advantage" of the items in the Democratic proposal.

Tax cuts do not work by giving people money to spend because the government must borrow that same amount back unless it cuts spending to match. There is no added "demand" injected into the economy. If the Federal Reserve steps in to buy the added debt, which expands the money supply, there is an increase in nominal demand. That, however, is the result of the change in monetary policy, not the tax cut per se, and the Fed has already been boosting the money supply as much as it thinks prudent.

Tax cuts only expand the economy if they make it more rewarding, after taxes, to work an extra hour, save an extra dollar, or add an additional machine or building to the stock of capital. That means reducing the tax take on pay received for additional hours worked, on dividends, interest or capital gains received on additional saving, or on profits from additional investment in plant and equipment.

The Bush plan has elements — marginal tax rate cuts, dividend relief, added expensing for small businesses — that would boost incentives to increase economic output. The Democratic alternative — mainly one-time tax rebates — mostly does not. Its hand-outs would largely be saved, not spent, as were the 2001 rebates, and there is nothing in the rebates that would reward people for additional work, saving, or investment.

**The Bush plan's dividend relief.**

Over half of American households now own stock, particularly households of seniors and people of middle age. They will benefit from dividend tax relief. Millions of younger Americans who have not yet begun to save, and do not yet get dividends, will benefit in the future when they, in turn, own stock. But the primary beneficiaries of dividend relief will be workers and consumers. Dividend relief will reduce the cost of capital, raise the capital stock, boost productivity, wages, and employment, and reduce rents and the cost of goods and services for everyone. That is the right way to view dividend relief. Any other considerations are insignificant by comparison.

Relief from the double taxation of dividends should not be looked at as giving money to shareholders to spend. Many critics of the policy focus on who gets the money, and what their income levels are. That has nothing to do with the economic benefits of the tax relief, nor is the "distribution" of the relief "unfair", since this is double taxation to begin with.

Nor should tax relief for dividends be judged by how much any resulting increase in the stock market might boost consumer spending. Critics ask how dividend relief will boost spending by shareholders, since the rise in the stock market a few years ago appears to have done little to boost consumer spending, and the recent fall did little to curtail it. The provision is not aimed at spurring consumer spending, it is aimed at encouraging capital formation, which it will do.

Tax relief for dividends should be looked at as reducing the combined tax burden on the returns to saving and investment. More precisely, it should be viewed as raising the after-tax returns to capital by enough to make hundreds of billions of dollars of additional investment sufficiently profitable after tax to be undertaken. The main beneficiaries will be the workers who are employed to use the added capital, and the consumers who get to enjoy the additional and cheaper products and services it makes possible.

Today, when a corporate business earns a dollar, it pays \$0.35 in tax. If it pays out its after-tax income of \$0.65 as a dividend, the shareholder may have to pay as much as \$0.25 in additional federal income tax. The combined federal tax on the \$1 of corporate income is \$0.60 (ignoring additional state income taxes). If shareholders require an expected return of 3% after taxes to induce them to finance corporate investment, the pre-tax return on the company's assets must be at least 7.5%. If the extra layer of shareholder tax is eliminated, the required pre-tax return on the company's assets falls to 4.6% to deliver the same after-tax return to the shareholders.

Plant, equipment, commercial and residential buildings that could earn more than 4.6% but less than 7.5% suddenly become possible. The reduction in the tax on dividends will immediately boost the value of corporate shares. Corporations will be able to raise money to finance the desired expansion of the capital stock more easily. The capital stock will grow. Rents and costs of production will drop. Productivity will rise, making labor more valuable and increasing employment and wages. As additional capital reduces the pre-tax returns, the benefits to capital will be competed away, and the primary beneficiaries will be workers, consumers, and the government (which will get some additional tax revenue from the added wage growth).

Some corporate managers fear that shareholders will demand higher dividend payouts as a result of the lower tax on dividends, and in the past some business leaders have argued against dividend relief at the shareholder level. The managers would prefer to retain earnings for reinvestment without having to increase borrowing or issue new shares under the discipline of the financial markets. But such discipline is highly salubrious. To pay a cash dividend, a firm must have real cash earnings, rather than just accounting earnings that have, in some recent cases, been doctored to drive up share prices.

In fact, cutting the tax on dividends would raise share prices up front by many times the amount of additional annual dividend payments. Indeed, the more real earnings the company has and the more willing the managers are to pay dividends, the higher the share prices will rise. Higher share prices make it easier for a corporation to finance its growth by issuing new shares instead of taking on more debt. Substituting equity for debt greatly reduces the risks involved in expanding the business. The beneficial treatment of equity finance will more than compensate corporate managers for any reduction in retained earnings.

Firms that do not currently pay dividends will not be harmed by dividend relief. The share price of companies currently paying dividends will rise the most, but there will be some increase even in the shares of firms that may be expected to pay dividends in the future, even growth companies that are currently reinvesting all that they earn.

State and local officials may fret that dividend paying stocks will become as attractive as tax-exempt bonds, and reduce the demand for such bonds, forcing up interest costs for government borrowers. This is not a valid concern. Savers have a desired after-tax return, and already set prices in the market to produce equal after-tax returns among taxable bonds, non-taxable bonds, and stocks. If the tax treatment of dividends improves, there will be a quick rise in stock prices to maintain the same after-tax yield. It is the stock prices that will adjust, not the prices of other securities whose tax treatment has not changed.

There are many economic pluses in the Bush tax plan. The relief from the double taxation of dividends is at the head of the list.

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President and Executive Director

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*Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.*