IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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PRESIDENT BUSH'S SAVING PROPOSALS AND THE STATES

Many state governments are confronting a difficult budget situation. According to the National Association of State Budget Officers, "States are facing a perfect storm: deteriorating tax bases, an explosion in health care costs, and a virtual collapse of capital gains and corporate profits tax revenues. Currently, states face budget shortfalls of $29 billion in fiscal 2003 and $82 billion in fiscal 2004." (NASBO web site, www.nasbo.org.)

Because of their financial difficulties, state and local officials are nervous about President Bush's proposals to eliminate double taxation of dividends at the shareholder level and to reduce the capital gains tax on retained earnings. They also fear his plans to create Lifetime Saving Accounts, Retirement Saving Accounts, and Employer Retirement Saving Accounts with expanded contribution limits and simplified eligibility rules.

The President's saving proposals would give most saving invested in stocks, corporate bonds, and government bonds the same federal tax treatment as is now accorded to tax exempt bonds issued by state and local governments. Many state and local officials are worried that if their bonds lost their current tax advantage relative to other (non-pension) assets, state and local governments would have to pay a higher rate of interest when they borrow.

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State and local officials are also upset that removing dividends and a portion of capital gains from the federal definition of taxable income would cut into state and local income tax revenues, because many states use the federal definition of taxable income as the basis for their state income taxes.

These concerns are unfounded. The President's tax proposals would be good for state and local governments. In particular, they would help to remedy the specific revenue losses the states have suffered from the reduction in corporate profits and the slump in the stock market.

The President's saving initiatives would not make tax exempt bonds less attractive.

Savers base their decisions about what assets to buy by looking at the expected ***real, after-tax*** returns. They begin with that, and then factor in risk differentials, expected inflation, and the tax treatment of the interest or dividends, and demand a high enough gross nominal return to give them the inflation and risk adjusted after-tax reward they seek. After-tax returns are made equal by the market. Taxable and non-taxable assets are priced to yield the same returns to the holders.

Consider the situation today in which a tax exempt state bond might pay a 5% interest rate, while a taxable corporate bond might pay 7.5%. Most bondholders are in tax brackets where they must give about a third of any additional income to the federal government. For them, the two bonds are equivalent on an after-tax basis. Of the 7.5% interest on the corporate bond, the IRS takes about 2.5%, leaving the saver with 5%, the same as he would earn from the tax exempt bond. The market has set these interest rates to make these bonds equally attractive to potential buyers.

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If the federal tax rate on corporate bond interest went to zero, the interest rate on those bonds would fall by the tax component built into them. The after-tax corporate bond yield would be unchanged. New corporate bonds would only need to offer a 5% yield to provide a 5% after-tax return. Old corporate bonds paying $7.50 per $100 of face value would rise in price until their returns to maturity dropped to 5%. There would be no tax-induced change in the interest rate on the state bonds, because the tax treatment of those bonds was not altered. The relative attractiveness of tax exempt bonds and taxable bonds would not be affected. Their after-tax yields would remain equal to one another, with the adjustment in gross returns coming on the taxable bond side. (This abstracts from state taxes; double tax exempt state bonds have an added edge in that they are not subject to state income tax for own-state holders. The market has already adjusted the rates accordingly. It also abstracts from market-wide changes in rates of return due to tax effects on the cost of capital and the rate of growth, discussed below.)

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The same analysis would apply to a share of stock. Given the riskiness of stocks, investors may require an 8% after-tax return (versus 5% on bonds). Suppose a corporation earns 11.5% after the corporate tax, and pays a 3.5% dividend, retaining 8% for reinvestment. If the income and capital gains taxes on the dividend and retained earnings average about 30%, then the 11.5% return to the shareholder before personal taxes is about 8% after personal taxes. Suppose these taxes were removed. Then the share would only need to yield 8% (after the corporate tax), and share prices would be bid up until the rate of return provided by the (unchanged) corporate earnings flow fell to that level.

The price increases in corporate bonds and stocks might not be quite as large as depicted here, because some holders of these bonds are foreigners, tax exempt institutions, and tax deferred pension holders, and because some capital gains are held until death and receive "stepped-up" basis. But the point is, the prices of the currently taxable assets would rise (and their gross yields would fall). The prices and yields of tax exempt state and local bonds would remain largely unaffected by the relative shift in tax treatment. There would be a significant increase in the stock market, and state revenues would benefit from higher capital gains and corporate income tax revenues.

State officials are making a mistake in their analysis of how the tax change would affect savers and the credit markets. They are thinking in terms of "flows of funds" instead of in terms of a revaluation of assets. Suppose a drug company announces, after the stock market closes for the day,

that the company's researchers have discovered a cure for cancer. Think of what would happen at the opening of trading the next morning. Everyone who owned the stock, and everyone who wanted to buy it, would realize that it was worth a lot more than they had thought the day before. The stock might have closed at $50 a share the day before, a price at which bids and offers were just in balance. The next morning, the bids and offers might have all jumped by $100, and the stock might open the next morning at $150. The jump in the bid and offer prices would have occurred even before a single trade was made. Not one cent of money has to "move" out of some other security or bank account to bring about this revaluation of the drug company stock. All it takes is an awareness of the new information and a change in opinion.

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In the event of a tax change such as the President has proposed, the market would be dealing with price changes, not money flows. The state officials think that "money would flow" away from tax exempt bonds into corporate bonds or stock. They envision a limited pool of saving, and fear that people would sell tax exempt bonds to get the money to buy the other securities, depressing the price of the tax exempt securities and raising the interest rate that new tax exempt securities would have to offer. First, in reality, the saving pool is not fixed. Domestic savers can choose to save more or buy domestic versus foreign assets. Also, saving can flow in from abroad. Second, money does not have to flow, and people do not have to trade securities, in order to change the asset prices to reduce the interest rate or rate of return on the formerly taxable assets.

The historical record does not give the states any reason for concern.

From early 1986, when President Reagan's budget proposed to reduce income tax rates, which were then cut as part of the Tax Reform Act of 1986, to January 1987, when the first stages of the rate reduction became effective, tax exempt bond yields (Bond Buyers Index) fell 1.42 percentage points and corporate bond yields (Moody's Aaa) fell by 1.69 percentage points. The spread between them fell a small amount, from 1.97 to 1.70 percentage points. Although the spread narrowed, both interest rates went down. A year later, as the full tax cut took hold, rates had crept part way back. In January 1988, the tax exempt rate was 0.39 percentage point below its January 1986 level, while the corporate rate was 0.17 percentage point below its January 1986 level. The spread was actually wider than before the tax cut. There was no surge in state and local borrowing costs.

After winning the November 1994 Congressional elections, the Republicans took over the House in January 1995, and there was a flurry of excitement over the Armey Flat Tax. That tax system, too, would have ended the tax differential between state and local government bonds and other forms of saving. From October 1994, to December 1996, tax exempt bond yields fell about 1.07 percentage points, while taxable corporate Aaa bond yields fell about 1.75 percentage points. The spread narrowed from 2.05 to 1.37 percentage points, but both rates went down.

Since President Bush announced last fall that he would seek to eliminate the double taxation of dividends, and has proposed giving most ordinary saving the same Roth-style treatment as tax exempt bonds, the tax exempt bond rate has hardly moved, and the corporate bond rate has fallen by an insignificant fraction. The stock market rose briefly before falling back.

There is no sign in any of these historical data that improving, or threatening to improve, the tax treatment of other assets puts undue pressure on tax favored state and local securities. The concern over

the effect of the President's proposals on the competitive status of tax exempt bonds and the resulting state and local interest costs is unfounded.

States' concerns over removing dividends from the income tax base is also unfounded.

The concern over dropping dividends from federal taxable income is also unreasonable. Not all states have income taxes. Not all states that have income taxes use federal AGI as the basis for their income taxes. Those states that currently use the federal definition of taxable income can always vote to keep dividends taxable under their own income taxes.

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The dividend exclusion and small business expensing proposals would cost the federal government about $24 billion in 2004. It would cost the states far less. States that have income taxes have tax rates far below the top federal rates. The Council of Economic Advisors estimates that the direct effect of the dividend and expensing proposals would cost the states $3.577 billion in 2003 and $3.829 billion in 2003 and 2004. This compares to total state tax receipts of about $1 trillion, and total state revenue, including federal grants, of about $1.3 trillion. The loss would be about three-tenths of a percent of the states' total revenues (a bit higher in states with the heaviest reliance on income taxes).

> ***The states could ... alter their tax rules to keep dividends ... taxable under state income taxes. They may not want the political heat for doing so, but that is no reason for them to oppose federal efforts to grow the economy.***

Note, too, that those figures are "static", ignoring any economic impact. The Administration predicts that its tax proposals would boost GDP and national income by about a percent in 2003 and another 0.8 percent in 2004. They predict the creation of an additional 1.4 million jobs within eighteen months. Wages per worker would rise as well. The 1.8 percent increase in incomes would more than make up for the one-third of one percent reduction in state tax bases due to the dividend and expensing proposals. The CEA estimates that the added growth would increase state revenues by $4.85 billion in 2003 and $8.381 billion in 2004.

Our estimates would put a bit more of the growth in 2004, and a bit less in 2003, but the Administration's two year totals appear reasonable given the strong reduction in the cost of capital from the dividend and expensing proposals, and the added work incentives from the accelerated marginal tax rate cuts. We do not assign any growth effects to the non-marginal elements of the tax package. Nonetheless, we agree that the states would actually gain revenue from the President's proposals, and fairly soon, due to the stronger economy.

There would also be a several percent rise in the stock market, offsetting a portion of the reduction in capital gains revenue due to the 2000-2002 stock market decline. Previous reductions in the taxation of capital gains have led to a higher stock market and greater willingness by shareholders to realize gains. Similarly, expanded saving incentives have encouraged capital formation and boosted stock values. Conversely, the big capital gains tax rate increase in the Tax Reform Act of 1986 led to a collapse in capital gains realizations and revenues for federal and state governments. The positive effects of the President's plan on state capital gains receipts were not factored into the CEA estimates of state revenue gains.

The static losses also assume, of course, that the states go along with the federal change in the definition of taxable income. The states could, instead, alter their tax rules to keep dividends and the proposed capital gains basis adjustments for

retained earnings taxable under state income taxes. They may not want the political heat for doing so, but that is no reason for them to oppose federal efforts to grow the economy. Of course, states that opt out of the tax cut might lose some residents, particularly retirees, who might move to states that went along with the saving-friendly federal changes. That is a positive outcome (for the citizens) of beneficial tax competition.

States would have more of an adjustment to make if the President's whole saving agenda were adopted, including extending either Roth IRA or saving deferred treatment to most saving via his proposed LMAs, RSAs, and ERSAs. However, these extended saving reforms would add even more growth of jobs and incomes to the economy, and further cushion the states' tax bases.

Market-wide rates of return would rise in an expansion, but so would state revenues.

All this is not to say that there would be absolutely no increase in interest rates if the President's proposals were to pass, just that state and local bonds would not face any raise in yields ***relative to other securities***. In fact, one should expect at least some rise in rates of return throughout the economy, including on financial instruments of all types, if the proposals went forward.

The recent recession was triggered by a drop in investment spending, which was in turn induced by a drop in the rate of return, after taxes, on physical capital. That was accompanied by a drop in returns on all assets, including a sharp drop in interest rates on bonds, money market funds, and bank accounts. There will be little hope for a strong recovery in GDP, incomes, the stock market, and corporate profits unless the rate of return on investment improves. If the rate of return on investment in plant, equipment, and buildings is improved by a tax reduction, there would be some corresponding rise in the rate of return on stocks and bonds, at least until the additional amount of capital made profitable by the tax change is put into service, because the supply of saving is not perfectly elastic. The higher returns on capital would raise required returns on all financial instruments, because all assets are to some extent substitutes and have to be competitive in the market.

However, the after-tax returns on stocks and the interest rates on taxable corporate bonds would likely rise by more than those on state and local bonds, because the assets are not perfect substitutes. Indeed, corporate bond rates have fallen more in the recession than have tax exempt bond rates, and the reverse should be true in the expansion. The current very low level of interest rates is clearly abnormal, and there will be some increase in rates as the economy recovers. A stronger recovery in the economy would generate a far greater increase in tax revenue for state and local governments than the associated interest rate increase would cost them.

This increase in rates of return to savers and investors (and in state and local borrowing costs) would only occur if the tax change actually succeeds in raising returns to capital

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It is ironic that the states are complaining about the very features of the President's tax proposals that are best designed to reverse the specific causes of their revenue shortfalls, what the NASBO calls "the virtual collapse of capital gains and corporate profits tax revenue."... States need to bring their spending under control, not rail against federal tax changes that could get the economy, and the states' revenue bases, growing again.

investment and boosting economic growth and the stock market. The associated growth of corporate profits would boost state corporate tax receipts. Less punitive treatment of dividends and capital gains, and higher stock prices, would increase dividend payments and capital gains realizations, boosting state income tax receipts. It is ironic that the states are complaining about the very features of the President's tax proposals that are best designed to reverse the specific causes of their revenue shortfalls, what the NASBO calls "the virtual collapse of capital gains and corporate profits tax revenue." State taxes from wage income and sales tax receipts would rise as well.

It is important to understand, too, that the states' financial woes are due only in part to the economic situation and slower growth of revenue. Most of the states have been increasing their taxes and outlays at rates well above the growth of the economy for more than a decade. (For example, the Tax Foundation reports that only eight of the 50 states held the growth of taxes to less than the growth of the personal income of their residents between 1990 and 2000.)

State and local revenues rose strongly in the late 1990s and 2000 as unemployment rates fell and the stock market rose, spinning off rapidly rising revenues from capital gains realizations and, in California especially, the exercise of profitable stock options. Most states spent every penny of the rising revenues, not thinking ahead to a day when the market might sag or the economy might hit a soft spot. These outlay increases were not just on discrete, annually funded projects, such as road expansion and bridge repairs. Rather, many states increased permanent programs, such as open-ended entitlements (some mandated by the federal government), and hired additional state workers. These steps are harder to reverse when revenues fall. States need to bring their spending under control, not rail against federal tax changes that could get the economy, and the states' revenue bases, growing again.

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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.