IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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THE FINAL TAX COMPROMISE: A GOOD OUTCOME, DESPITE THE LIMITED BUDGET AND POLITICAL CONSTRAINTS

The Jobs and Growth Tax Relief Reconciliation Act of 2003 was hammered together after an unusually chaotic legislative struggle. Was the resulting tax and fiscal policy outcome a hit or a miss? Should we expect the new tax law to improve the economy, do nothing, or hurt the recovery? Does it improve the tax system or muddle it further?

The 2003 tax cut contains several significant provisions that reduce tax impediments to hiring and capital formation. These steps will help the economic recovery. They are temporary, however, and will have to be extended if they are to achieve their maximum economic impact. The particular structure of these growth-related and jobs-related tax changes, after vacillating among several competing options of differing quality, turned out to be a fairly good choice that establishes a sound basis for moving on to fundamental tax reform.

While it was disappointing that the full elimination of the double taxation of dividends and retained earnings that the President requested was not achieved, the reduced rates of tax on that income provided in the final bill provide a good jumping off point for further steps toward fundamental tax reform.

Other provisions of the Act, those relating mainly to relief for families and those described as "stimulating demand", may serve a social purpose, but they will not boost the economy. The social provisions may have been intended in part to grease the skids for the growth elements, but the social elements took up so much of the revenues available for the tax cut that they reduced the growth incentive portion of the package. As a result, the Act will not be as beneficial for the working poor as it might have been if the productivity, wage, and employment-enhancing features of the bill had been made larger and more permanent.

While it was disappointing that the full elimination of the double taxation of dividends and retained earnings that the President requested was not achieved, the reduced rates of tax on that income provided in the final bill provide a good jumping off point for further steps toward fundamental tax reform. In fact, the approach taken in the 2003 Act allows an easy transition to either a saving deferred income tax (a "consumed income" tax) in which individuals deduct saving and pay tax on the returns, with no added business tax, or a returns exempt tax, such as the personal side of the "Flat Tax", in which individuals get no deduction for saving and pay no tax on the returns, which (after expensing capital outlays) are taxed at the business level. Both options remain open until a consensus is reached as to which is preferred.

How tax cuts do and don't work.

Tax cuts can work to increase the GDP by raising incentives at the margin to work, save, and invest more than before. That is, they can

encourage an expansion of the labor force and the stock of plant, equipment, and structures, which means an increase in the supply of productive inputs. More input equals more output, and more output means more national and personal income.

Tax cuts do not work by "giving people money to spend". In the absence of additional money creation by the Federal Reserve, the government must finance the tax cut by raising other taxes, by borrowing the tax cut back from the public, or by cutting government spending to match. These offsets negate any tendency of the tax cut to "pump up demand". Put another way, if the government cuts taxes without cutting spending, it issues added debt, and therefore the public must save an amount of money equal to the tax cut to buy the added Federal bonds. If, however, the Federal Reserve buys the added government debt, the exercise adds to the money supply, but that is due to the change in monetary policy, not the tax cut per se. (The same analysis applies to increases in government spending. They do not boost "demand" either, because they have to be paid for. They do divert labor and capital resources from private to government use. They do not raise total GDP, and, if used inefficiently, may reduce it.)

The incentive provisions in the tax cut that will lower barriers to production and employment.

Individual tax rates. The bill brings forward to 2003 the marginal tax rate reductions scheduled for 2004 and 2006 under the 2001 Act. This step will add to employment and GDP in 2003 - 2005. The lower marginal rates will raise the reward to workers and reduce the cost of hiring. The lower rates will encourage entrepreneurs and the self-employed to greater effort. The immediate rate cuts will eliminate any tendency to defer income until the rate cuts were to have been phased in.

Enhanced depreciation. The enhanced depreciation provision enacted in the 2002 growth package is expanded and slightly extended. The 2002 provision allowed businesses to expense 30% of the cost of equipment and depreciate the rest, for equipment acquired by September 11, 2004 and

2003 Tax Cut, Major Provisions

Economic growth provisions:

- Marginal tax rate cuts scheduled for 2004 and 2006 brought forward to 2003.
- Reduced tax rates of 15% for dividends and capital gains through 2008 (5% for taxpayers in lowest two brackets through 2007, zero in 2008).
- Small business expensing (Section 179) increased to first $100,000 in equipment outlays through 2005. Phase-out begins for businesses when spending exceeds $400,000.
- Enhanced special depreciation for all businesses — expensing of 50% of equipment outlays for items placed in service by the end of 2004.

Social and distributional provisions:

- Accelerated increase in child credit to $1,000 through 2004 (reverting to 2001 law thereafter).
- Accelerated marriage penalty relief — increases standard deduction and 15% bracket for joint filers to twice those for single filers through 2004 (reverting to 2001 law thereafter).
- Accelerated widening of 10% bracket through 2004 (reverting to 2001 law thereafter).
- Increased exempt amounts for AMT through 2004 (reverting to 2001 law thereafter).

placed in service by Dec. 31, 2004. The tax bill will raise the 30% expensing to 50% and extend the provision to all equipment acquired and put in service by Dec. 31, 2004. That should give an important lift to investment, the slump in which is the chief source of the sluggish economy.

The original House provision would have allowed the additional write-off through 2005, but the low $350 billion cap forced a shorter time frame. This provision should be extended by the fall of 2004 to avoid a drop off in investment spending in 2005 and beyond. If the enhanced depreciation provision is made permanent, or becomes one of the many perennial "extenders" (such as the R&D tax credit) that are renewed over and over again, it could provide a powerful incentive to build up the U.S. capital stock.

> ***Tax cuts can work to increase the GDP by raising incentives at the margin to work, save, and invest more than before... Tax cuts do not work by "giving people money to spend".***

Some tax analysts have suggested that the shorter time frame for the 50% bonus depreciation is actually a good thing, because it will push firms to increase their investment sooner, rather than wait until 2005. That is poor thinking and bad policy. Capital goods are generally made to order, not bought off the shelf out of a supplier's inventory. They must be ordered months in advance. If the provision applies only to equipment acquired and put in service by December 31, 2004, orders for new equipment will start to dry up in the second half of 2004, and investment goods output could start to slump before year end. A provision lasting through 2005 might do more for investment in 2004 than one that expires in 2004, and would certainly improve the outlook for 2005.

Extending the provision through 2005 would also have sent a signal that the provision is not just an election year gimmick, that it is intended to become an annual "extender" and be as permanent as the perennially renewed R&D credit. Making the provision more likely to become permanent would further encourage investment. Many projects involve assets that must be replaced several times over the life of the effort. Consider the decision to build a factory to house an additional assembly line. The machinery may be replaced every five or seven years inside a building that lasts for half a century. Cutting the tax on just the first set of machines, and not on the future replacements, limits the incentive to expand the business.

Small business expensing. The amount of equipment investment that small businesses may expense (write off immediately) will jump from the previous $25,000 a year to $100,000 through 2005. The allowance will be phased out for businesses with over $400,000 in annual equipment spending, up from $200,000 under old law, through 2005. Though the incentive is still capped, many additional businesses will be eligible for the allowance, and it will be "at the margin" for much more investment spending than the old provision. It should give a boost to investment and GDP.

Tax treatment of dividends and capital gains. The big question during the debate over the bill was what to do about the tax treatment of dividends and capital gains.

Two biases that need fixing. Two different tax biases that have been somewhat confused in the recent debate are: the basic income tax bias that favors consumption over saving, and the added bias imposed by the corporate income tax. (A third bias, created by the estate and gift tax, was addressed, temporarily, by the 2001 Tax Act, and would be eliminated for bequests only, not for gifts.)

The basic bias of the income tax against saving in favor of consumption comes from taxing both income that is saved and the returns on that income. Income is taxed when earned, and except for a few federal excise taxes there is no added federal tax on general consumption. One can buy and eat a pizza

or buy a TV and watch a stream of programming (or both together!) with no further federal tax. If, however, one uses that same after-tax income to buy a bond or a stock, the streams of earnings on the saving are taxed again. That is the basic income tax bias against saving, which stems from taxing both the saving and the returns on the saving. It is offset in part under current law by means of pension plans and deductible IRAs (which permit the earner to defer tax on saving and pay on withdrawal) and by Roth IRAs and tax-exempt bonds (which levy tax when the saving is first earned but exempt the returns). Both methods put saving on an equal footing with consumption. They either defer tax on the saving and tax the returns of principal and earnings, or tax the income used for the saving and exempt the returns from tax.

The other major anti-saving distortion in the tax system is the added layer of tax that is imposed on savers' income by the corporate income tax, a bias which is over and above the individual income tax bias against saving. Dividends paid out of after-tax corporate earnings are taxed again at the shareholder level. This is the so-called "double taxation of dividends". If a corporation retains its after-tax income for reinvestment, it raises the value of the business, which will subject the shareholder to a capital gains tax when he or she sells the shares. The capital gains tax is thereby actually "double taxation of retained earnings". Even if a shareholder is a tax-exempt institution, or an individual who has received pension treatment of the initial saving, the corporate tax still applies to the shareholder's corporate income before the shareholder receives it.

(More fundamentally, the capital gains tax is always double taxation regardless of the type of business or the source of funds. Even gains occurring due to new discoveries or products financed with new share issues, borrowing, or other revenues are "double taxed". Share prices are the present value placed on the business's expected future after-tax earnings. Those earnings rise when there is an increase in people's expectations of the business's future earnings. If the expected jump in earnings occur, they will be subject to corporate tax. To tax the rise in the present value of those same earnings is to double tax the future earnings.)

If the enhanced depreciation provision is made permanent, or becomes one of the many perennial "extenders" (such as the R&D tax credit) that are renewed over and over again, it could provide a powerful incentive to build up the U.S. capital stock.

Which bias did the President address? President Bush described his original proposal for excluding dividends from tax as eliminating the double taxation of dividends ***where they were being taxed at both the corporate and shareholder levels***. To make that strictly true, the Bush plan would have excluded from tax only those dividends that were paid out of current (actually, prior year) corporate income that had been subject to corporate tax (either here or abroad — correctly treating the foreign tax credit as a record of foreign tax paid), and would have given a basis adjustment equal to already taxed retained earnings so they would not be taxed again when the shareholder sold the shares. Furthermore, the relief would have applied only to dividends and gains received by ordinary savers; there would have been no added benefits to tax-exempt entities or for assets held in pension arrangements.

In fact, another way to describe the President's proposal is that it would have effectively extended Roth IRA treatment to ordinary shareholders on dividends they earned outside of pension arrangements, and to their capital gains on retained earnings. One could just as easily have called his proposal an extension of relief against the basic individual income tax bias against saving, while leaving the added layer of corporate tax in place.

Keeping the system neutral between dividends and capital gains. Old law favored retained earnings over dividends, because the tax rate on capital gains was less than that on dividends. Both

the final tax bill and the President's plan treated capital gains and dividends equally. The Senate plan would have stood the current law bias in favor of capital gains on its head, and substituted a bias in favor of dividends. That would have been bad policy.

The President's proposal to eliminate the shareholders' tax on already taxed dividends and give a basis adjustment for already taxed retained earnings (to eliminate the capital gains tax on those amounts) had the virtue of making the tax treatment of dividends and retained earnings equal — no double taxation of either. The House approach, the basis for the final bill, also treated capital gains and dividends equally, but with a rate of 15% on both (5% for low income savers). By contrast, the Senate dividend relief plan omitted the President's capital gains basis adjustment for retained earnings. It therefore would have moved from a system that favored retained earnings over dividends to one that favored dividends over retained earnings.

> ***[T]here is as yet no consensus as to the best route to fundamental tax reform. The current Act is a good jumping off point for moving either to a saving deferred tax (in which individuals get a deferral of income that is saved, and pay tax on the returns as they are withdrawn for consumption) or a returns exempt tax (in which individuals get no deduction for saving and pay no tax on the returns, including interest as well as dividends and capital gains).***

Other features of the Senate approach. In addition, the Senate's dividend exclusion was not restricted to amounts of current corporate income that had been subject to the corporate tax. Thus, it was in a sense more of a reduction in the corporate tax than a reduction in the double taxation of dividends per se. This is not necessarily a bad thing, because the corporate tax is a very bad tax, but it is not the cleanest way of dealing with it.

Opposition to the Senate plan. One reason for the Senate's rejection of the limitation of the relief to income previously taxed was opposition from several industry groups that were concerned that tax credits or other tax advantages would lose value if they rendered some corporate income ineligible for paying excludable dividends. Users of the R&D credit and purveyors of the low-income housing credits were concerned that their businesses would be harmed. Congress could have excluded these credits from counting against the excludable dividends if it wished to maintain a certain amount of subsidy to encourage the desired activity. No business, however, has the right to stand in the way of a general improvement in the tax system and the economy simply to provide itself with a relative advantage vis-a-vis other companies.

The second powerful group in opposition to the President's approach consisted of state and local governments and dealers in their bonds. One concern was that ending or reducing the taxation of dividends and capital gains would make shares too competitive with tax-exempt bonds, and drive up states' borrowing costs. This fear was groundless. Tax-exempt bonds enjoy a lower interest rate than taxable bonds, and a lower total return than stocks, reflecting the different tax treatments. On an after-tax (and risk adjusted) basis, these assets' yields are already made equal by the market. The tax-exempt bonds have no "advantage" to current savers; they are equal at the margin. If the tax on stock earnings is reduced, the price of stocks will rise and their after-tax rates of return will be unchanged. Prices and yields of other assets, including tax-exempt bonds, will not change, because their tax treatment will not change. None of the options, including the final version of the bill, will harm state and local securities on this score.

Another concern of state and local governments involved the impact of the Bush plan on the tax-exempt bond holdings of corporations. Tax-exempt interest would reduce the amount of company earnings eligible for the President's proposed dividend exclusion and basis adjustment, and firms

might exchange tax-exempt bonds for other assets (and there would be a matching swap by other savers out of other assets into tax-exempt bonds). Corporate holdings of tax-exempt securities, however, are not large enough to move the prices or interest rates in the huge tax-exempt bond market by any noticeable amount. Certainly, the added capital formation, income, and job growth generated by the tax reduction would cause a rise in tax revenue to the states that would dwarf any such effect.

The social provisions in the tax cut.

The child credit rose under the 2001 tax cut to $600 in 2003, and was due to rise in stages to $1,000 in 2010. The new bill boosts the credit to $1,000 for 2003 and 2004. It will drop back to its previously scheduled phase-in path in 2005 if not extended. The $400 jump in the child credit is a social policy, and will have no noticeable impact on growth or jobs. It will not boost the economy by "putting money in people's pockets", because the government will have to borrow the same amount back. As was the case with the $300/$600 tax "rebate" in the summer of 2001, these lump sum checks will probably cause a jump in personal saving (consisting either of additions to saving or the repayment of debt).

Much the same analysis would apply to the temporary acceleration of scheduled marriage penalty relief, making the standard deduction and 15 percent bracket twice as large for joint returns as for single filers for 2003 and 2004.

The accelerated enlargement of the 10 percent tax bracket scheduled under the 2001 Act is primarily an effort to give additional tax relief to low income workers. It will have a small incentive effect at the margin, but only for a very few individuals with low incomes who produce only about two percent of the GDP. It will have minimal growth effects.

The $20 billion in additional Federal aid to the states will have no economic growth effect, unless it prevents the states from raising their own marginal income tax rates, which would be anti-growth. The state spending that the aid preserves would have to be matched by added federal borrowing. The states were foolish in the extreme to think that the rising capital gains and other revenues they experienced during the stock market boom would continue to soar ever higher, and they boosted their hiring and spending as if the good times would never end. The additional Federal aid will just delay the retrenchments that will have to be made at the state and local level to conform to reality.

Which reform plan should be adopted is a question deserving of debate, decision, and action in the near future.

Where do we go from here?

The ultimate objective of tax policy should be a fundamentally reformed, neutral tax system that completely eliminates the tax biases against saving and investment. As alluded to above, there is as yet no consensus as to the best route to fundamental tax reform. The current Act is a good jumping off point for moving either to a saving deferred tax (in which individuals get a deferral of income that is saved, and pay tax on the returns as they are withdrawn for consumption) or a returns exempt tax (in which individuals get no deduction for saving and pay no tax on the returns, including interest as well as dividends and capital gains). Either system puts income saved on a par with income used for consumption. Which reform plan should be adopted is a question deserving of debate, decision, and action in the near future.

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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.