# IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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**October 28, 2004** **Advisory No. 180**


# A PRINCIPLED ANALYSIS OF PRESIDENT BUSH'S TAX PROPOSALS

## Introduction and Summary

President Bush has proposed a tax and economic program of four main parts: permanent extension of the most recent tax cuts, enhancement of tax-friendly saving arrangements, enactment of fundamental tax reform, and fundamental reform of Social Security to permit personal accounts with real saving. The plan has two main objectives, the promotion of certain social goals and the promotion of long term growth.

Some of the features of the original Bush tax reductions and their proposed extension address social issues, or were designed to "spread the wealth" of the tax cuts to people with limited tax liabilities, or to assist the unemployed. These provisions include making permanent the larger child credit, the marriage penalty relief, and the 10 percent tax bracket. These provisions are not focused primarily on expanding incentives to increase economic activity or jobs, although some married couples will find themselves in a lower tax bracket as a result of the policy change. Any "pump-priming" which old-style analysis might attribute to these provisions is a mirage.

The major growth elements of the tax cut extension plan include making permanent the recently enacted cuts in marginal tax rates, the 15 percent tax rate caps on capital gains and dividends, and the repeal of the estate tax beyond 2010. These provisions have helped to produce the healthy 4% to 5% growth rates the economy has turned out over the last several quarters.

Allowing these provisions to expire in 2010 would result in a significant tax increase and a significant reduction in incentives to work, save, and invest, and would slow economic growth. Making them permanent would reinforce the pro-growth impact they have had in recent quarters. They would be generally consistent with fundamental tax reform, which means reducing the biases against saving and investment found in the current "broad-based income tax" system.

The Bush saving proposals move in the direction of eliminating the biases in the income tax against saving. They expand "Roth IRA" treatment of saving and broaden pension availability. The dividend and capital gains relief proposal reduces the double taxation of corporate income. The corporate income tax still needs to be phased out or fully integrated with personal taxes.

The President proposes to move forward on fundamental tax reform and Social Security reform. Tax reform should be understood to mean eliminating tax biases against saving and investment, and keeping tax rates low to encourage effort. Social Security reform should mean the creation of personal accounts that would involve real saving, unlike the current tax-transfer system. If done correctly, these major reforms would boost employment, output and living standards by more than ten percent, or between $4,000 and $5,000 a year, for a middle income family.

All these proposals and reforms would be easier to enact in the context of a net tax reduction. That outcome would be facilitated by limiting the rate of growth of federal spending to less than the rate of growth of GDP, which would be a sharp departure from the spending increases of the last four years.

**Principles of sound taxation: a standard against which to judge a tax plan.**

Taxation serves two key purposes. One is to collect revenue to pay for government goods and services. The other is to let taxpayer/voters know the cost of government so they can make informed decisions as to how much government they wish to support. In carrying out these tasks, taxes should be designed so that they do not cause unnecessary damage to individuals and the economy. A well designed tax will have several attributes.

***Neutrality.*** A neutral tax would distort economic incentives as little as possible. The income tax distorts the labor/leisure choice, because using time to earn income to buy goods and services is taxed, while using time for leisure is not. Marginal tax rates should be kept low to minimize this distortion.

The income tax system also distorts the saving/consumption choice. The income tax falls more heavily on income used for saving than on income used for consumption, by taxing the income used for saving when it is earned and then taxing the returns on the saving. By contrast, if the income is used for consumption, there is usually no additional federal tax, except for a few excises.

To end this basic tax bias against saving, all saving should be eligible for the treatment accorded pensions and IRAs: either allow a deferral for saving and tax the returns, as in a pension or ordinary deductible IRA; or tax the income saved up front but exempt the returns from tax, as in a Roth IRA or tax-exempt bond. Neutral treatment of direct investment in plant, equipment, and structures would be provided by immediate expensing in lieu of depreciation. These steps would create a "consumed income" tax in lieu of the current "broad-based" income tax.

In addition, the income tax is imposed a second time on corporate earnings before they are distributed to shareholders. To make the tax system neutral, the corporate tax should either be eliminated or "integrated" with the personal income tax, to tax the income at one level or the other but not both.

The estate and gift tax adds another layer of tax to saving that has already been taxed repeatedly. The estate and gift tax should be eliminated.

***Simplicity.*** Compliance and enforcement costs should be kept low. The tax base should be clear and easy to calculate to minimize the effort required and to avoid disputes between the taxpayer and the IRS. Neutral taxes, which avoid multiple layers of tax on capital income, acknowledge business costs in the year they are incurred, and require far less record keeping, are inherently simpler than non-neutral income taxes.

***Fairness.*** Reasonable people can disagree strongly about what is fair. However, the perception of what is fair should be based on the realization that income is earned, and that it belongs in the first instance to whoever earned it. Income is the reward for producing goods and services that others wish to buy. Except in rare instances, income reflects the value of one's contribution to economic output. This strongly suggests that a proportional or flat rate tax is about as fair an imposition of the tax burden as one can find, with due relief for those who truly cannot afford to pay.

***Visibility.*** Taxes should be highly visible so that citizen/voters can see the cost of government services. Transparency helps citizen/voters make better informed decisions about what level of government and which government services are worth the money. Hence, taxes should be collected directly from the people.

In reality, only people pay taxes. All taxes collected at the business level are ultimately paid by people as owners, employees, or customers, but business-level taxes, especially complicated ones, have the political attraction that many people falsely think the taxes are on someone else. Hidden taxes are popular with politicians but are bad public policy.

It is also desirable that ***all citizen/voters pay taxes except the very poor***. Exempting large numbers of voters from taxes will tend to result in an inefficiently large government. Voters who do not pay tax will favor government programs even if the programs' benefits are small relative to the costs. In the last 15 years, both major political parties have ignored this principle and strongly endorsed tax changes that have removed a significant share of voters from the income tax rolls.

**How to judge the growth and efficiency of a tax plan: Marginal tax rates matter.**

Tax cuts do not work by giving people money to spend. They should not be viewed as pumping up consumer spending, even though this objective is often mentioned by candidates, including the President.

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.

Changes are sometimes proposed that would affect the tax on the initial units of the taxed activity but have no effect on the tax bite at the margin (examples are tax rebates and some tax credits). Because such changes do not alter tax biases when a taxpayer is considering whether to undertake more or less of the taxed activity, they have little impact on taxpayer behavior.

**The economic consequences of a tax affect who bears the burden.**

The person who pays a tax, either at the individual or business level, is often not the person who ultimately bears the burden of the tax. Taxes are shifted by tax-induced changes in supply and demand. For example, taxes on capital are largely shifted to labor. A capital tax reduces investment, which is very sensitive to its after-tax real return. As the capital stock falls, the value in production of each remaining unit increases, which raises the before-tax real return on capital and partially offsets the tax for capital owners. On the other hand, the tax-driven fall in the capital stock reduces labor productivity because labor has less capital with which to work. Because real wages are largely based on productivity (an employer cannot stay in business if it pays workers more than they add to the value of output), the end result is that real wages fall, and much of the burden of the tax is thereby shifted to labor.

Discussions of tax fairness often ignore tax shifting and naively assume that the person from whom a tax is collected is the same person who ultimately bears the tax burden. A recognition of real-world tax shifting can have a dramatic impact on whether a proposed tax change is perceived to be fair or not.

**The President's four part tax agenda:**

Make permanent most of the tax reductions enacted in 2001 and 2003.

Enact three new saving plans that would simplify, consolidate, and expand upon the saving arrangements in current law.

Develop a plan for fundamental tax reform.

Create an option for personal accounts for Social Security, as part of a reform that would make the System financially sound on a permanent basis.

**Making recent tax cuts permanent.**

The Bush plan would make permanent most of the tax reductions enacted in 2001 and 2003.

• The reduction in the top tax brackets to 25%, 28%, 33%, and 35% would be made permanent; the rates would revert otherwise to 28%, 31%, 36%, and 39.6%.

• The repeal of the phase-outs of the personal exemption and itemized deductions for upper income taxpayers would be made permanent.

• The marriage penalty relief, which makes the standard deduction and the width of the 10% and 15% tax brackets for couple twice that for single filers.

• The new 10% bracket, which would revert otherwise to the 15% rate for all filers.

• The enlargement of the child credit to $1,000 per child from the previous $600.

• The partial relief from the double taxation of corporate income would be made permanent. The 2003 Tax Act capped the tax rate on dividends previously taxed at the corporate level, and on capital gains (which reflect the value of retained after-tax corporate earnings) at 15%. The tax on dividends would otherwise revert to ordinary income tax rates, and the tax on long term capital gains would revert to 20%.

• The increase in the amount of investment in equipment that small businesses may expense (write off immediately) to $100,000 a year, up from $25,000, and the indexing of that increased amount for inflation thereafter.

• The elimination of the estate tax in 2010 would be made permanent.

The recent tax reductions have ameliorated the tax biases in the income tax by lowering marginal rates, by expanding pension and IRA treatment of saving, by relieving the double taxation of dividends and the capital gains that arise due to retained after-tax corporate earnings, and by moving toward immediate expensing of investment outlays. Steps to extend or expand such provisions move toward tax neutrality. Allowing such provisions to expire would increase tax distortions.

**A key omission.**

One glaring omission from the President's extension list is the 50% expensing provision enacted in 2003. That provision allowed businesses to deduct immediately half of their outlays on equipment placed in service by the end of this year, while depreciating the rest under the usual schedules. The recession was caused in large part by a slump in investment. The expensing provision was billed as a temporary measure to boost investment to spur the economic recovery. It reduced the cost of investment, and was very successful in turning the investment decline into an investment increase, at double digit annual rates. The factors reducing investment below optimal levels were not temporary, however, and the expiration of this provision may come back to haunt the economy early next year. Expensing should be extended, and full expensing should be part of any fundamental tax reform. It is the optimal tax treatment.

**The Bush plan's dividend and capital gains relief.**

Over half of American households now own stock, particularly households of seniors and people of middle age. They will benefit from continued dividend tax relief. Millions of younger Americans who have not yet begun to save, and do not yet get dividends or realize capital gains, will benefit in the future when they, in turn, own stock, if the provision is made permanent. But the primary beneficiaries of dividend and capital gains relief will be workers and consumers. Extending the dividend and capital gains 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.

Relief from the double taxation of dividends and the taxation of capital gains 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 shareholders be judged by how much any resulting increase in the stock market might boost consumer spending. Critics ask how dividend and capital gains 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.

This tax relief 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.

When a corporate business earns a dollar, it pays $0.35 in tax. Before the Bush tax cut, if it paid out its after-tax income of $0.65 as a dividend, the shareholder may have had to pay as much as $0.2574 in additional federal income tax (at the top rate of 39.6%). The combined federal tax rate on the $1 of corporate income was 60.74% (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 needed to be at least 7.64%. After the Bush tax cuts, the top tax rate on dividends fell to 15%, the shareholder's tax on the $0.65 dividend fell to $0.0975, and the combined tax rate on the $1 of corporate income fell to 44.75%. The required pre-tax return on the company's assets fell to 5.43% to deliver the same 3% after-tax return to the shareholders.

Plant, equipment, commercial and residential buildings that could earn more than 5.43% but less than 7.64% suddenly became possible. The reduction in the tax on dividends boosted the value of corporate shares. Corporations are able to raise money to finance the desired expansion of the capital stock more easily. The capital stock will grow. 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).

A similar analysis can be done for retained earnings. These are corporate earnings that are taxed and then used for investment without first being paid out to shareholders. The retained earnings add to the value of the company, which increases the capital gains that shareholders receive when they sell the stock. That gain is taxed at ordinary tax rates if the shares were held for less than a year, or, under old law, at a top rate of 20% for longer term gains. The 2003 Act lowered the tax rate on long term gains to 15%, to match the lowered tax rate on dividends. The reduced long term capital gains rate also lowered the cost of capital and promoted investment.

**Estate tax elimination.**

Estates are built out of saving. The income that was saved was generally taxed when earned. After being saved, the earnings on the saving were then subject to additional taxes, including the double tax on corporate income if invested in corporate equity. Even that portion of an estate that consists of an IRA or other saving deferred plan is subject to the income tax, because the heir or beneficiary must include the proceeds of such plans in his or her taxable income over a specified period of time after inheriting them. Therefore, the estate tax is always an additional layer of tax on saving, and a violation of neutrality.

Estate tax rates can be very high, up to 55% on an ordinary estate before the recent cuts, with compounded rates of nearly 80% on a generation skipping trust. These rates are imposed on top of the income taxes already levied on the earnings of the saving and on the labor income of the initial savers. Combined rates in excess of 88% or 90% are possible.

By discouraging work by the initial savers, and by retarding capital formation, the estate tax harms workers as well as heirs. The estate tax probably costs the government more revenue from other sources than it brings in. It reduces investment, GDP, employment, and wages, and the taxes that would have been collected on the lost income. It also induces people to transfer assets to heirs and beneficiaries earlier than otherwise. When people in their peak earning years, who are in the highest tax brackets, give assets to children who are in lower tax brackets and to tax exempt charities, the government collects less income tax on the subsequent earnings of the assets.

The estate tax is based on envy and greed — not that of the savers and their heirs, but of people who feel free to punish the frugality and success of others.

**Saving proposals.**

President Bush has re-proposed three vehicles to promote saving which were in his budget for FY 2003. They would replace a wide variety of existing personal saving plans and defined contribution pension arrangements offered by employers. More saving would be eligible for the treatments than under current law. The tests and restrictions required for such plans under current law would be greatly simplified and relaxed, reducing legal and compliance costs to enable more companies to offer such plans to their employees.

These proposed saving plans are good tax policy, in that they would remove one of the layers of tax bias that the income tax imposes against saving relative to consumption. Reducing the tax bias against saving would in turn increase investment, productivity, employment, wages, and income across the board. They would constitute a significant step toward fundamental tax reform.

Assuming that these plans are to be similar to those in the Presidents earlier budget submissions, they would work as follows:

• ***Lifetime Savings Accounts (LSAs)*** would allow each person to set aside after-tax money each year, from any source and in addition to any other saving plans. There would be no income limits on participation, no minimum holding period, and no restrictions on what the money could be used for. Because the initial contributions would be made out of already-taxed income, the subsequent earnings and withdrawals would be tax free. LSAs would have a great advantage for low and middle income savers who cannot afford to save separately for retirement and emergencies, such as being laid off, and who are therefore afraid to use ordinary IRAs because of their penalties for early withdrawal.

• ***Retirement Saving Accounts (RSAs)*** would resemble current Roth IRAs, but would have a higher contribution limit, and no income limits on participation. Withdrawals could be made penalty-free and tax-free after age 58. For future contributions and new accounts, RSAs would replace deductible, non-deductible, and current Roth IRAs.

• ***Employer Retirement Savings Accounts (ERSAs)*** would enormously simplify defined contribution plans. They would replace 401(k), 403(b), and government 457 plans, SARSEPs and SIMPLE IRAs. Top-heavy and non-discrimination rules and tests would be simplified and eased to reduce complexity and compliance costs and to enable more firms to offer the plans to more workers. Defined benefit plans would not be affected.

**Fundamental tax reform.**

For years, the tax literature has debated the merits of taxing income or taxing "consumed income" (revenue less net saving). The income tax treats income used for saving more harshly than income used for consumption, and is therefore not "saving-consumption neutral."

As mentioned earlier, there is one layer of federal tax on most consumption, but up to four layers on income that is saved. 1) Income is taxed when earned. If used for consumption, it is generally not subject to additional federal tax (except a few excises). 2) If saved, however, the interest, dividends and capital gain produced by the assets are taxed again. Thus, one can buy a loaf of bread and eat it or buy a television and watch a stream of programming with no further federal tax, but if one buys a bond or stock the government taxes the stream of interest or dividends. This is the basic income tax bias against saving. 3) If the saver buys corporate stock, there is the additional corporate tax on the income before it is paid out as a dividend, or reinvested, which leads later to a capital gains tax. And 4), if one has saved a great deal, the saving may be subject to the transfer (estate and gift) taxes.

The many variants of fundamental tax reform all have the following in common: They eliminate the transfer taxes. They end the double taxation of corporate income by fully taxing the returns either at the individual or corporate level, but not both (or collect a tax at half the normal rate in each spot). They eliminate the basic income tax bias against saving either by allowing a deferral of tax on all income that is saved and taxing all the returns upon withdrawal (as in a deductible IRA or pension), or they tax the amounts saved up front and exclude the returns from further tax (as with a Roth IRA). In a similar vein, businesses are allowed to expense (deduct immediately) their investment spending instead of depreciating it over time.

There are many alternative systems that meet these objectives of restoring neutral tax treatment of saving and consumption. They include the national retail sales tax, the VAT, the Armey Flat Tax or revised USA Tax (introduced by Congressman Phil English), or the saving-deferred income tax (the original graduated Nunn-Domenici USA Tax or IRET's flat rate Inflow-Outflow Tax, which is described in a paper available on our web site, www.iret.org).

A complete reform of the tax system to make it saving/consumption neutral would dramatically reduce the cost of capital and expand the capital stock. The labor force would be made far more productive. Wages and family incomes would rise over time. The potential improvement could exceed ten percent. For middle income families, in today's terms, that would mean an increase in family income of between $4,000 and $5,000 a year.

In recent years the country has taken a number of steps toward fundamental tax reform, including the 1997 capital gains cut and the 2001 IRA expansion, marginal tax rate reductions, and estate tax phase-out. The new proposals by President Bush would move us further down that road. At the end of the journey, we would arrive at a far simpler tax code, a far larger capital stock, and greater productivity, higher wages, and higher incomes across the board.

**Social Security reform.**

The current pay-as-you-go Social Security Old Age and Survivors Insurance and Disability Insurance programs take taxes from current workers and give the money to current retirees or to those currently disabled. Unlike a real pension or insurance system, they involve no saving for the future, do not add to the stock of productive assets, and do not increase economic output. Indeed, by substituting for real retirement saving and real insurance, they lower national output and make it harder for the nation to care for retirees.

The System faces large deficits as the baby boom retires, amounting to more than $10 trillion over the next 75 years. Current annual Social Security surpluses are being taken by the government to fund current outlays, and will not be available to pay future benefits, even though they are recorded as being put into a "trust fund." In later decades, the System (retirement and disability) will run annual deficits rising to 6 percent of taxable payroll. It would take a 6 percentage point increase in the payroll tax to bail out the retirement and disability programs. Fixing Medicare would require an even larger hike of nearly 10 percentage points more. Closing the gap would mean raising the total payroll tax rate to roughly 31.3% (or more, if one were to adjust for the decline in employment and wages that would surely result).

Change is inevitable. Simply raising the payroll tax to more than 30 percent of payroll is not a viable option. It would saddle American workers and employers with social insurance tax rates approaching levels common in much of Western Europe, where unemployment rates are nearly twice that in the United States, and growth rates are less than half U.S. levels.

President Bush proposes reforming the retirement portion of Social Security (but not the disability portion) by converting it, on an optional basis, to a real saving program. Younger workers could divert a portion of their payroll tax to their own personal retirement accounts, in exchange for a portion of their promised future benefits. The earnings generated by such real saving would more than make up for the reduction in government benefits, leaving them with a larger retirement income.

Several options were outlined by the President's bipartisan Social Security Reform Commission, and others have been introduced by Members of Congress. They will serve the country best if they allow 5 or 6 percentage points of the payroll tax to go into the personal accounts, as envisioned in some of the Congressional proposals. The 2 percent diversions allowed in some of the plans put forward by the bipartisan Commission and some Members of Congress would not provide adequate retirement income from the private accounts alone, without continued Social Security transfers from future generations.

Personal accounts would transform the payroll tax from a tax on effort to a form of deferred compensation that rewarded effort. The accounts would give the worker a real asset to own and to pass on to heirs. The reform would act as a tax cut to encourage additional work and hiring.

The diversion of part of the payroll tax would require the government to find other money to pay for the retirement benefits of those who are currently retired or about to be retired. As much as $2 trillion might be necessary for some of the Commission plans, more for larger reforms. The transition costs, however, are generally far less than the unfunded future obligations promised under current law. The reform would yield significant savings for the government, that is, for future taxpayers, on a net basis. The economic benefits of reform would be maximized if the short term transition costs were paid for as much as possible by restraining the growth of federal spending. Next best would be to borrow to cover the initial costs. Least helpful would be to raise other taxes.

Social Security reform, and the added personal saving associated with it, would benefit the economy by making additional investment possible. The added investment would boost productivity, employment, and wages. Workers would gain even before they retired. This outcome would be most likely if government were to cut spending to avoid borrowing the added saving, and if added investment were to be encouraged by moving toward expensing of investment outlays or by lowering corporate tax rates. In fact, the reform would work best if coupled with fundamental tax reform. The two reforms would be mutually reinforcing.

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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.*