IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

October 30, 2008 **Advisory No. 246**

NEW TAX AND SPENDING PROPOSALS SINCE THE MARKET MELTDOWN

With financial markets continuing to plunge since Washington's passage of the financial bailout package, Senator Obama and Senator McCain have each proposed additional tax and economic policy changes that were not included in their original programs. Members of Congress have been working on similar ideas. These policies would be temporary responses to the expected economic downturn associated with the banking panic. The proposals might be considered if Congress returns after the election to pass a second "stimulus package." If not, they could be offered in the next Congress. The two parties are also offering other stimulus proposals, many on the spending side of the budget.

Some of the proposals would help people cope with the downturn, but most would not limit the downturn itself. Some would make the downturn worse. Some of the proposals make tax policy sense, and would be good permanent additions to the tax code. Most would not. Only one, a proposed cut in the corporate tax rate by Representative John Boehner (also in the original McCain package), would spur growth quickly. The proposals do not include other attractive and effective options for growth and damage control, such as extending 50% expensing and continuing the 15% caps on the tax rate on dividends and capital gains, or expanding saving incentives to help innocent savers recover from the crash in their financial assets.

An ideal tax policy would move the tax code from an "income" base, which contains biases against saving and investment relative to consumption uses of income, toward a "neutral" or "consumed income" base, under which saving and consumption face the same tax burdens. We evaluate the tax proposals accordingly.

Much of Congress and the media continue to labor under old-fashioned Keynesian ideas about "economic stimulus" and the benefits of government spending and transfer payments. Contrary to that view, neither tax cuts nor government spending work by increasing "demand" in the economy. These policies have to be paid for either by raising other taxes, cutting other spending, or increasing federal borrowing, which crowds out more private activity. The initial demand effect of these policies is nil. Government efforts to promote growth work only when they increase incentives to work, save, and invest in the private sector, or rein in regulations that are impediments to production. Higher production generates higher incomes that in turn generate higher demand. Supply first, demand second. No output, no income.

Presidential candidates' new tax proposals

Both Senators would temporarily exempt unemployment compensation from tax. Senator McCain would limit that benefit to people earning less than $100,000. A second stimulus package may further increase or extend the duration of unemployment compensation. Perversely, increases in unemployment compensation reduce employment. The higher payments allow people to wait longer before returning to work after a lay-off. Similarly, making unemployment benefits tax-exempt would prolong the duration of unemployment. The exemption would be more valuable for higher income families, including those which have a second worker or income from saving. If a family has sufficient income to owe income tax even with one worker out of work, that family should pay tax like any other family with the same income.

Both Senators would ease the requirement for people over 70½ years of age to withdraw money from their retirement plans. The objective is to avoid forcing seniors to sell assets at the current depressed prices, which would unnecessarily shrink their portfolios. Forced withdrawals would make it harder for seniors to share in the eventual recovery of the stock market, and would reduce their retirement incomes for the rest of their lives. This is a good step for the current situation, and in line with optimal tax policy. An ideal, unbiased tax system would treat saving no more harshly than immediate consumption. In such a system, all saving would get the sort of tax deferral that we currently allow for pensions and regular IRAs, but without any limit on contributions and no age-related limitations or mandatory withdrawals. Withdrawals for consumption would be taxed when they occur.

Senator Obama would eliminate the 10% penalty tax on withdrawals of up to fifteen percent of assets (up to $10,000) from 410(k) and IRA plans in 2008 and 2009. Ordinary income tax would apply. This is consistent with unbiased universal tax deferral on saving, where there should be no limits and no penalty taxes on any withdrawals for any reason at any age.

Senator McCain would cut the tax rate to 10% on the first $50,000 in withdrawals from retirement accounts in 2008 and 2009. This could reduce the amount of assets that retirees would have to sell at depressed prices to get any given amount of after-tax money for consumption. Nonetheless, it would be an unnecessary break for families with sufficient income to owe income tax. Since the income originally deposited in such plans was tax-deferred, it should be taxed on withdrawal. Seniors age 65 or above already receive a preferential standard deduction, and most are not taxed on their Social Security because their incomes are below certain thresholds (which are set well above the incomes at which other households must begin to pay tax). If they have sufficient income to owe income tax, they should pay tax like other families at the same income level.

Senator McCain would reduce the top tax rate on long term capital gains from 15% to 7.5% for 2009 and 2009. This assumes anyone still has gains after the recent market crash. The tax on capital gains is a form of double taxation. In a neutral tax system, if the original saving was not tax deferred in a retirement plan, then the associated capital gains (or interest, or dividends) should not be taxed at all (as in a Roth IRA). This would be a small step toward universal IRA or pension treatment of saving, but it is temporary. (For investment in a small business, see below.)

Senator Obama favors elimination of capital gains taxes on small and medium businesses. Narrowly targeted provisions distort the allocation of capital, and do less for economic growth than broad tax relief for capital formation. Nonetheless, investment in a small non-corporate business that was not sheltered by some form of tax deferral (including the initial investment in the business and any reinvested after-tax earnings of the business) should not be taxed again, and some capital gains relief would be appropriate. This is also the case for shareholders in small and medium corporations (and large ones!).

The exemption does not really help small businesses very much until they are sold. More immediate relief could consist of expensing of investment in plant, equipment, and inventory by the business. In fact, small businesses may expense part of their investment in equipment (deduct them immediately instead of depreciating them over time). Insofar as deductions are delayed by depreciation rules, or have had to be deferred because a start-up business did not have profits for the first few years and has carry-over deductions, then the right approach is to increase the allowable deductions by an appropriate interest rate to make them equal to immediate expensing when they are finally taken.

Senator McCain would increase the amount of net capital losses deductible against other income. Under current law, one may deduct capital losses against capital gains in any amount, but if losses exceed gains, only $3,000 may be deducted against other, "ordinary" income. The $3,000 limit has not been raised for years. Senator McCain would raise it to $15,000 a year through 2009. The limit is unjustified, and any increase would be welcome. It should be made permanent. The limit means that, if you have gains, you must pay tax at once, but if you have losses, you must sit on them until you have gains. The government is saying: "Heads I win, tails you lose!" (It does that a lot.)

Other "stimulus" ideas of dubious value

Increased aid to the states. Senator Obama would raise federal transfers to the states by $25 billion. It is expected that Congressional Democratic proposals for a new stimulus bill would also increase aid to the states. Federal subsidies for state and local spending merely force the federal government to borrow more, and do nothing to regenerate private sector activity. The excuse offered is that it would prevent the states and local governments from having to raise their sales, income, or property taxes, which would help the private sector. The real answer to a recession-related hit to state and local revenues is for state and local governments to trim their spending to avoid burdening their suffering taxpayers. When households have to economize, they should be able to cut their spending across-the-board. That includes the services they "buy" through their local governments.

Infrastructure spending. The second "stimulus package" will probably contain additional outlays for roads, bridges, commuter rail, and dams. If history is a guide, there will also be funding for earmarks for other less compelling projects such as local bicycle paths, street lights, boardwalks, and museums of various odd sorts in every district in the nation. Spending on public works usually takes so long to get started that the spending comes on stream after the economy has recovered from the downturn, and usually crowds out other forms of investment. While some infrastructure projects are highly beneficial, most projects are not subjected to any form of cost benefit analysis, and many are far less valuable than the private investment they displace. Random infrastructure spending is no substitute for cutting taxes on private investment. The taxes eventually imposed to pay for public works would have disincentive effects that retard private activity down the road. The dead-weight losses from the taxes are hidden costs that must be added to the on-budget costs of the infrastructure projects to judge their real worth.

Hiring credit. Senator Obama proposes to give a $3,000 tax credit to businesses for each new hire. In theory, it would offset the up-front costs of training new workers, and encourage employment in the downturn. The proposal is reminiscent of Senator Dan Quayle's Targeted Jobs Tax Credit of the 1980s, except it would not be so targeted to the disadvantaged. The TJTC eventually morphed into the existing Work Opportunity Tax Credit, recently expanded in the minimum wage bill. The WOTC can total $2,400 for each new adult hire, $1,200 for each new summer youth hire, $4,800 for each new disabled veteran hire, and $9,800 for each new long-term family assistance recipient hired over a two year period. Food stamp recipients; "High-Risk Youths" who are residents of enterprise communities, empowerment zones, and rural renewal counties; SSI recipients; and qualified ex-felons are among the categories of people who are also eligible. From a policy standpoint, these credits work best when employers are considering permanent additions to their staffs. Then the cost to the Treasury is really best viewed as a small subsidy stretched out over the working life of the employee. The effectiveness of such credits is questionable. In a bad economic environment, new hiring is one of the first things to be stopped, and one of the last things to recover. Given the current degree of uncertainty about where the economy is headed, the credit is not likely to achieve much for many months, until we are already on the upturn, at which time it would not be needed.

More rebate give-aways. It appears that the second "stimulus package" will involve direct federal spending, without a repeat of the up to $600 or $1,200 hand-outs to single filers and joint-filing taxpayers, plus $300 for eligible children, that were the main feature of the last stimulus package passed in February 2008. The rebate checks were largely saved or used to pay down debt. They were as much a Keynesian flop this year as similar measures have been in the past (e.g. the Ford Administration rebates in 1975). They "stabilized" nothing. As mentioned above, tax cuts do not work by giving people money to spend, only by altering incentives to produce.

Reforms that would actually help

Aiding ordinary savers hit by the downturn in the stock market. The provisions of the recent bailout package, elaborated upon by Treasury's latest mortgage guarantee ideas, provide hundreds of billions of dollars to help people who unwisely bit off more real estate than they could chew, or who bought the associated toxic debt. But what about the millions of more innocent people who have suffered losses on other assets as a result of the financial panic?

Several proposals (above) have been made to help retirees better manage their savings in the current stock market downturn by easing *withdrawal* rules for people taking money out of the markets. But what about *contribution* rules for people who want to (or need to) put money into the markets? No one has yet addressed the damage to people approaching retirement who have suffered steep drops in the value of their financial assets as a result of the housing/banking fiasco, and need to rebuild their savings.

To aid people hit by the stock market downturn, it would make sense to help people to save more to make up their losses in their retirement accounts. One way to do so is to expand the current law "catch-up" provision for contributions to retirement plans enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001. That provision allows people who are at least 50 years of age to contribute an extra $5,000 a year to their 401(k), 403(b), 457, and SAR-SEP plans; $2,500 to SIMPLE IRAs; and $1,000 to regular IRAs (all in 2006 dollars, indexed for inflation in later years). The catch-up contributions let the participants bulk up their savings in the few years they have left before retirement. The provision helps to make up for the lack of such plans when these workers were younger. It would be a good idea to make these "catch up" amounts larger and extend them to younger savers. That would encourage people to add to their savings and stock holdings while prices are low, so that whatever recovery there is in the market can help rebuild their holdings more quickly and more completely. This would be a desirable move in the direction of universal tax-deferred saving.

Extend the 50% expensing provision of the 2008 package. This was the only feature of the 2008 stimulus package that has done any good. It is encouraging more investment spending in the last half of 2008, partly making up for the slump in the home-building sector and weakness in other manufacturing. (Similar provisions in 2002 and 2003 worked to invigorate what had been a weak recovery. Also helping were lower taxes on capital gains, dividends, and small business income in the 2003 Tax Act.) The current partial expensing provision is due to expire at the end of the year. It should be extended for at least two years, and should really be made permanent until real tax reform provides for full immediate expensing.

Extend the 15% cap on dividends and capital gains. This provision of the 2003 Tax Act is due to expire in 2011. Senator Obama would raise the rate to 20%, which would probably reduce federal revenues. Higher taxes on capital income would certainly reduce the value of shares, increase the required rate of return for investment in plant, equipment, and buildings to break even after taxes, cut the capital stock, and reduce productivity and wages. The pending rise in these taxes has already been scaring the markets and discouraging capital investment, not a good thing in a potential recession, and with the additional panic created by the housing and banking crises. A little certainty and stability in tax policy would go a long way toward rebuilding confidence and strengthening the real economy.

Cut the corporate income tax to 25%, permanently. House Minority Leader John Boehner (R-OH) has recommended this step (also in Senator McCain's tax package) to spur capital investment, productivity, wages, and job growth. It would also strengthen the cash flow of companies having trouble finding lenders during the difficult financial market situation. The cut would lower the required return on physical capital, and improve the tax climate for investment in the United States, which has the second highest corporate tax rate in the developed world. This would be a major reduction in the double taxation of corporate income (on the order of the 15% rate caps on dividends and capital gains), and a major reform of the tax system. It would significantly increase saving, investment, and production in the United States.

Stephen J. Entin
President and Executive Director

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.