IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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FOUR GOOD STEPS TO EASE THE PAIN OF THE MARKET MELTDOWN BEING OFFERED IN THE SENATE. MORE NEEDED.

A bipartisan bill to promote investment and to deal with some of the worst consequences of the market meltdown has been offered by the leadership of the Senate Finance Committee (Chairman Max Baucus, D-MT; and ranking Member Chuck Grassley, R-IA;) and the Senate Committee on Health, Education, Labor, and Pensions (Chairman Ted Kennedy, D-MA; and ranking member Michael Enzi, R-WY).

The bill would:

■ Extend the 50% "bonus expensing" provision of the 2008 stimulus package for one more year, applying to property placed in service by the end of 2009.

■ Extend the enhanced small business expensing provision (Section 179) of the 2008 stimulus package until the end of 2009 (allowing immediate expensing of up to $250,000 for property placed in service by year-end 2009).

■ Suspend the forced minimum withdrawals from IRAs for people age 70½ or older.

■ Delay the new pension funding requirements of the Pension Protection Act.

These provisions are all steps in the right direction, either boosting investment incentives or providing more flexible rules to help individuals and businesses cope with the sudden, deep, and (one assumes) temporary dip in the stock markets.

More is needed. First, the two expensing provisions and the suspension of required withdrawals from IRAs should be made permanent. Second, savers and retirees need more help in dealing with the depressed returns on saving. Therefore, other expiring provisions that ease the tax burden on capital and raise returns to more normal levels should be extended as well. Third, people who are forced back into the work force to cope with the low returns on saving should be exempt from the remaining portion of the Social Security earnings test.

Partial expensing of equipment

For businesses, the plan would extend the 50% "bonus expensing" provision of the 2008 stimulus package, which will expire at the end of 2008. It first appeared as a 30% expensing provision in 2002, was increased to 50% in 2003, but was allowed to lapse at the end of 2004. Businesses would be allowed an immediate deduction for half of the cost of equipment purchased and placed in service in 2008. (The rest of the cost would be subject to normal cost recovery over time – i.e., depreciation.) In addition, small businesses would get an increase in the amount of investment they are permitted to expense under the Section 179 expensing rules, from $125,000 to $250,000.

Expensing is the best tax treatment for capital investment. It most closely reflects the true cost of the investment to the business, most correctly measures the real income (revenue less cost of production) of the business for tax purposes, and

yields the optimal economic outcome. Enactment of expensing, either complete or partial, on a permanent basis, would be a step toward a better tax system. It would cause a permanent rise in the amount of capital created and maintained. It would boost productivity, wages, and employment.

A temporary expensing provision, by contrast, would mainly cause businesses to buy replacements for current capital assets a bit sooner than otherwise. It would "borrow" investment spending from the future, and raise GDP in 2009, but weaken it in 2010. Any expansion of the capital stock under temporary expensing would be worked off later on if tax rates rose back to pre-expensing levels. There would be no permanent gain in capital formation, jobs, or wages.

The 2003 expensing provision contributed to the surge in growth in mid-decade, breaking out of the "jobless recovery" of the 2001-2002 period. The 2008 expensing provision has been helping keep investment from slumping as much as it might have in the current troubles. However, the expensing provision in 2003 was working with other 2003 tax provisions (moving up the personal rate reductions and putting a 15% rate cap on dividends and capital gains) that made it worthwhile to acquire, operate, and maintain a larger capital stock.

This time, the expensing provision faces some serious headwinds, due to the looming expiration of the Bush 2003 tax cuts. The lower marginal tax rates that encouraged small businesses to expand their use of capital will expire at the end of 2010. The 15% rate cap on dividends and capital gains will expire then as well, depressing the creation and use of capital in the corporate sector. Workers, retirees, and savers would all be better off if these other tax provisions were extended as well. A permanent cut in the corporate tax rate would also be extremely helpful in returning the economy to health.

Raising returns to saving

The real victims of the housing/credit crisis are not the homeowners and credit issuers who caused the collapse, and who by and large have none of their own money at stake in the houses and bonds that have lost value. The real victims are the innocent bystanders whose other saving, businesses, and jobs have been destroyed or threatened.

The elderly are suffering from very low rates of return on their savings (near-zero returns on Treasury bills and money market funds). They are also hard hit by the drop in the general stock market, or perhaps in the value of the housing-sector bonds they may have purchased. With returns so low, many retirees need to dip into principal by selling assets that are now at very depressed prices. People nearing retirement age find that their retirement accounts have lost value in the market crash, and must delay retirement plans. They have to hope that the markets will recover before they must start drawing on their saving.

Pension funds have also been devastated by the market collapse. Many pension fund that were fully funded a few months ago when the prices of their investments were high are now underfunded. Normal rules would force businesses to contribute more money to these pension plans at a time when they are struggling with depressed earnings, falling orders, and layoffs. Yet, when the markets recover, most of the plans will again be fully funded without new money being put in. The provision to suspend new contribution requirements is a reasonably flexible response to an unusual situation, without abandoning the longer term goal of getting all plans to be fully funded.

We need higher interest rates! Higher returns to capital would spur investment and employment while raising returns to the savers who fund the investment. Having the Federal Reserve keep interest rates artificially low (which helped cause the crisis in the first place) may bail out the financial sector in the short run. However, it does not work to spur real investment (which is what we need to revive), and it hurts savers and retirees. It does not work to raise investment because investment is driven by the long-term expected yield on the assets and long-term financing costs, not by short-term interest rates.

Alternatively, raising the after-tax return to capital would encourage investment, and would do so at normal rates of interest and normal payment levels to shareholders and bondholders. Asset prices and the economy would all rebound.

The best solution for retirees and savers, and the whole economy, is to cut taxes on the earnings of capital investment. That would raise returns on new investment, boost the stock market, and raise interest rates (in a good way – reflecting the higher returns to the investment being funded). Measures would include extending the 15% top tax rates on capital gains and dividends, cutting the corporate tax rate, and keeping the reductions in the top marginal tax rates from expiring.

End the Social Security Earnings Test

The remaining piece of the Social Security earnings test should be repealed. The suspension of the requirement to withdraw money from IRAs (and pay tax now on the withdrawn amounts) can help people who do not need the IRA money to live on right now, and who can afford to wait until the markets recover to sell their assets. It does nothing for people who are in need of retirement money right now. Many people cannot get by on the miserable returns now being paid by Treasury bills and money market funds, and they must sell assets in this depressed market unless they can find alternative income sources, such as by returning to work.

Going back to work is an option for some of the elderly who are in good health. The Social Security earnings test has been repealed for people over the normal retirement age (now 66, going up to 67 for those who reach age 62 between 2017 and 2022). That has encouraged people in that age group to work more.

However, early retirees ages 62 through 65 are still subject to the test. For each dollar of wage income above an allowed level, they lose $0.50 in Social Security retirement benefits.[1] This is a 50% add-on tax rate that can boost marginal tax rates (federal income and payroll tax, and state income taxes) to 90%, 100%, or even higher. It is an enormous disincentive to work extra hours. (The victims of the test may recover some of the lost benefits through a recalculation of their basic benefit amount based on the number of quarters they did not receive benefits, once they cease to earn over the limit, or reach normal retirement age. Not everyone lives long enough to recoup the lost benefits.)

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Endnote

1. In 2009, people who have not reached their normal retirement age (NRA) may earn up to $14,160 without penalty, and lose $1 in benefits for every $2 earned above the limit. People who reach their normal retirement age during 2009 may earn up to $37,680 without penalty in the months before their birthday, and lose $1 in benefits for every $3 earned above the limit. Earnings in or after the month one reaches NRA do not count toward the retirement test.

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.