IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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A PROGROWTH AGENDA FOR CONGRESS

Uncertainty about future public policies coming out of Washington, D.C., and the prospect of huge tax increases is stifling potential recovery and job creation. Business owners do not know what capital, labor or facilities will cost if they expand—or what their personal tax rates will be. The most important step Washington can take to spur recovery is to immediately and permanently reduce taxes on capital and labor.

Following are five measures that will lower the tax burden, create jobs and accelerate economic growth.

Extend the Bush Tax Cuts

The 2001 and 2003 Bush income tax cuts lowered rates for all taxpayers, reduced taxes on capital gains and qualified dividends, eliminated the phase-out of personal exemptions and itemized deductions that hiked marginal tax rates on many middle and upper income earners, and phased out the estate tax. But the reduced rates will expire at the end of 2010, and President Obama does not want to renew them for all taxpayers.

Congress seems eager to renew other 2001 provisions related to children, marriage and low income earners—but, however worthy, these did not drive economic growth from 2003 to 2008. It is less certain to renew the progrowth elements of the Bush tax cuts. Extending them would dispel some of the fear that is holding back the current expansion. Letting them expire would weaken the economy.

Small Business Taxes. Unless Congress acts, the top two personal income tax rates will return to their pre-2001 levels, and the phase-outs of exemptions and deductions will return:

- The top marginal personal income tax rate will increase from 35 percent to 39.6 percent.
- The second highest rate will increase from 33 percent to 36 percent.
- The loss of personal exemptions will further increase the top four tax rates (25 percent and above) by about 1 percentage point for single filers to 4 percentage points for families of four, and the loss of itemized deductions will add roughly another percentage point to the tax rate.

Many small businesses would pay these higher personal income tax rates. The Joint Committee on Taxation found that 50 percent of business income will be reported on returns facing 36 or 39.6 percent tax rates.

Capital Gains and Dividends. The increased value—capital gains—of assets held more than a year are currently taxed at a flat 15 percent. (The capital gains of individuals in the 10 percent and 15 percent tax brackets are not taxed.) Corporate shareholders' dividends are also taxed at a 15 percent rate. In 2011, however:

- Long-term capital gains tax rates will increase from 15 percent to 20 percent.
- Dividends will be taxed at marginal income tax rates of up to 39.6 percent—like short-term capital gains, dividends would be taxed as ordinary income.
- These rates will also increase with the return of the phase-outs of deductions and exemptions as incomes rise.

Estate Tax. The 2001 Bush tax cut gradually reduced the estate tax (through 2009) to a 45 percent top rate and higher exemption of $3.5 million. The tax rate was zero for 2010. In 2011 it is scheduled to return to the 55 percent, pre-2001 rate with a $1 million exemption. If this happens:

- Gross domestic product (GDP) would be cut by $183 billion and labor compensation by $122 billion.
- By contrast, repealing the estate tax entirely would boost labor income by $79 billion and add $119 billion to GDP.

Extend the R&D Tax Credit and the AMT Patch

Congress routinely extends a number of tax provisions, but failure to renew the Research and Development (R&D) tax credit and the Alternative Minimum Tax (AMT) patch would retard growth. Supposedly enacted to raise taxes on wealthy Americans who were able to take a variety of deductions, the AMT hits millions of middle-class taxpayers. If the patch is not extended, about 21 million additional taxpayers would now be subject to the AMT. Making the R&D credit permanent would increase its effect on investment.

Allow Immediate Expensing of Investment

Businesses are typically required to depreciate plant, equipment and other buildings over many years. A temporary measure (2003-2004) allowed businesses to deduct half their equipment expenditures from current income (and reduced the top rate on capital gains and dividends to 15 percent). Equipment spending began to soar. The expensing provision lapsed (2005-2007), then was restored temporarily (2008-2009), and was recently extended (through 2011).

President Obama has suggested raising the expensing percentage to 100 percent through 2011. This would increase the after-tax return on capital by about 2.5 percentage points, spurring economic growth. However, permanent expensing would be more effective. By itself, however, the expensing increase would offset only about a third of the economic damage from higher capital gains and dividends taxes if the Bush tax cuts expire.

Cut Corporate Tax Rates

Including average state corporate taxes, the total U.S. corporate income tax is 39.2 percent, second only to Japan's 39.5 percent. In contrast, the average corporate tax rate in other developed countries is 25.3 percent. Higher after-tax returns and increased capital formation from lower corporate tax rates would raise labor productivity, wages and employment. Workers would be the biggest beneficiaries. Greater employment and income would replace much of the tax revenue loss.

Eliminate the Individual and Employer Health Insurance Mandates

The Affordable Care Act (ACA) mandate to purchase health insurance will increase labor costs. The estimated cost of the required minimum benefit package is $2.28 an hour for individual coverage and $5.89 an hour for family coverage. Ten-dollar-an-hour workers and their employers cannot afford $6-an-hour health insurance. Employers who do not provide health insurance will be fined $2,000 per worker. This will also discourage employers from hiring workers.

Repeal Medicare Tax Hikes

Beginning in 2012, the health bill will add 0.9 percent to the current 2.9 percent Medicare tax on individuals with wage incomes over $250,000 (joint filers) or $200,000 (single filers). Another provision extends the resulting 3.9 percent tax to individuals above these thresholds with income from savings. This tax hike would be as large as the rise in the top income tax rate if the Bush tax cuts expire. Together, they would seriously damage capital formation and employment.

Conclusion

Extending the Bush tax cuts for everyone, allowing immediate expensing for businesses, passing expiring R&D and AMT tax provisions, reducing the corporate tax rate, and eliminating the health reform taxes and mandates on individuals and corporations will help the economy grow.

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