IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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December 8, 2010 **Advisory No. 271**

THE TAX COMPROMISE

The Congressional leadership and President Obama have agreed on a tax compromise. It would:

■ Extend the Bush income tax cuts for two years, including the tax rate reductions in the top brackets affecting upper income taxpayers, and various tax credits that are part of the Bush tax cuts, including increases in the Earned Income Credit (EIC), child credits, and education credits;

■ Reimpose an estate tax at 35% top rate with a $5 million exempt amount for two years (restoring the tax at the levels in effect in 2009, after it had lapsed entirely for 2010);

■ Reduce the employee share of the retirement portion of the payroll tax by two percentage points for 2011 (from 6.2% to 4.2%);

■ Increase the temporary 50% expensing provision to 100% for 2011 for some investments, followed by a return to 50% for 2012.

■ Enact a number of "extenders" including a two year alternative minimum tax (AMT) "patch" and renewal of the R&E tax credit.

■ Extend long term unemployment benefits through 2011.

It is incorrect to analyze the economic effects of the tax changes by looking at how much money they leave people to spend. The government will have to increase its borrowing by a similar amount, offsetting any immediate "demand" effects of the tax relief.

Instead, one should look at the incentive effects of the tax changes – how much more people get from working an extra hour or saving and investing an extra dollar. That is what determines the quantities of labor and capital available for producing output and income. We employ a neoclassical model combined with a tax calculator that responds to changing income levels to calculate the dynamic GDP and income effects of tax policy changes.[1]

Without the extension of the income tax cuts, we estimate that the GDP and individual incomes would slip over time by 7.1 percent, compared to levels achievable under retention of the tax cuts. Note that extending the Bush tax cuts is not a reduction in tax rates from current levels. It is the prevention of an increase. Without the extension, production incentives would fall sharply, eventually trimming about seven percent off the long run path of GDP. We need the extension of the Bush cuts (along with the AMT patch and R&E credit) just to keep things from getting worse. Even the threat of the tax increases has held back investment and hiring in recent months. To the extent the threat has been removed, there will be some improvement in economic production and incomes from current levels. The extensions will mean a big improvement compared to what would occur without them.

The marginal tax rate extensions – particularly keeping the maximum tax rates on dividends and long term capital gains at 15% – are the main source of economic incentives in this package. The biggest effect is to prevent what would otherwise be a significant reduction in saving and investment had

the tax rates on dividends, capital gains, and non-corporate businesses been allowed to rise.

A smaller effect applies to the labor force. The labor supply is less "elastic" than the supply of capital. Nonetheless, preventing a sharp rise in the marginal tax rates on labor avoids the moderate reduction in employment that would otherwise occur. By contrast, the various individual credits have almost no effect on incentives at the margin to increase production. They are social policy, not economic policy.

The extension of the Bush income tax cuts for couples earning over $250,000 ($200,000 for single filers) has been controversial. But well over half of the Bush reduction in the service price of capital and resulting growth in the capital stock came from extending the 15% tax rate cap on dividends and capital gains to upper income taxpayers, and a few percent more came from the income tax rate cuts in the two top income tax rates affecting non-corporate business investment. (The service price is the pre-tax return required to make an investment in plant and equipment feasible, covering the depreciation of the asset, taxes, risk, and a normal after-tax return of roughly 3 percent.)

Not extending those rate caps to the upper income would eliminate nearly 60 percent of the economic benefit of the package, reducing economic activity, job opportunities, productivity, and wages across all income levels. The dividend and capital gains relief is key, and is important at lower income tax brackets as well, where the tax rate drops to zero for the lowest income savers. Together, the effect of the capital gains and dividend provision for all incomes, and the cut in the two top income tax rates, account for 80 percent of the economic gains from the Bush income tax reductions (about 5.7 percent out of the 7.1 percent change in GDP).

Without the capital gains, dividend, and upper bracket rate relief, the capital stock would drop by more than 14 percent, and federal revenues would fall by more than $80 billion. The economic losses would reduce federal tax revenues from all sources, turning the supposed revenue gains from raising the upper income taxes into a significant revenue loss. Capital is very sensitive to taxes "at the margin," and raising these rates is about the least efficient way to try to raise money. Revenue is apt to drop, not rise, at higher levels of taxation of capital.

The figures above exclude the GDP gains and revenue effects from estate tax relief. Restoring the estate tax is a mistake. It will cost the government revenue in the long run because it will reduce capital formation and hiring, depressing earnings at all income levels. Of the alternatives offered, the 35% rate with a $5 million exempt amount is less damaging than a 45% rate with a $3.5 million exemption or the scheduled return of the old 55% rate with a $1 million exemption that some liberal Members of Congress have favored. By lowering GDP, all of these estate tax provisions lose about twice the revenue from other taxes that the estate tax is estimated to raise, turning each projected revenue gain into an equal and opposite revenue loss.[2]

The temporary small reduction in the payroll tax will have only a modest effect on employment. If workers capture the reduction, there will be little incentive to hire new people. If new employees are willing to work for a 2% lower wage, it could, at best, partially cover the initial cost of the hiring paperwork and job training. When the tax jumps back up in a year, the incentive to retain the new workers would be gone.

Expensing is a key part of any permanent fundamental tax reform. It eliminates the understatement of the cost of equipment that occurs when depreciation write-offs are delayed for years. They lose value to inflation and the time value of money, overstating business income and raising effective tax rates. Partial expensing for equipment has raised the present value of the write-offs closer to the full cost of the investment. Full expensing would finish the task. It would be an improvement over just extending the existing tax relief. There would be a gain of about 1.5 percent in GDP and

incomes, and a 4% increase in the capital stock over about a decade. If expensing were made permanent, there would be no long term revenue loss, rather, an eventual increase of more than $30 billion in additional annual revenue from the higher GDP and income.

However, the proposal's expensing provision would only be temporary, and only for equipment and some select structures. It would reward investment in 2011, and to a lesser extent in 2012, but it would restore the normal tax burden on capital in later years. It would borrow investment from 2012 and beyond, giving an artificial kick to 2011 with no permanent gains in the stock of plant and equipment, which is what is needed to raise wages and employment going forward. This is part of an erroneous pump priming mindset, as if the economy only needs a temporary burst of investment to jump start the economy. In reality, we need a permanent increase in the capital stock, and the investment to acquire and maintain it, if we are to raise incomes and employment. Expensing should be made permanent.

Extending long term unemployment benefits will extend long term unemployment. When you make something less costly, you get more of it.

Opponents of the tax compromise who think that the extension of the capital gains and dividend relief for the upper income taxpayers is too expensive have it backwards. The individual credits, 10% bracket, payroll tax relief, and other largely social provisions of the bill are the revenue losers. The spur to consumption that is attributed to them is spurious, as the government must borrow as much back from the public as it hands out in such tax relief. It is the reduction in the cost of capital from the incentive-oriented tax rate reductions that will raise investment and the capital stock, which in turn will boost the demand for labor, and personal incomes across the board. These tax cuts will either cost nothing or raise revenue down the road.

If the tax compromise passes the Congress, the economy will have dodged a bullet that would have struck on January 1, 2011. Perhaps it is more accurate to say that the bullet has been slowed down, but is still scheduled to strike in 2013. Congress has two years to muster the will to cut spending and make room for a permanent tax fix that keeps rates low enough to sustain growth.

Stephen J. Entin
President and Executive Director

Endnotes

1. The model uses a Cobb-Douglas production function, labor supply equation, and a long run target service price (cost of capital) to determine labor and capital inputs and equilibrium output. We thank Gary Robbins of the Heritage Center for Data Analysis for furnishing the tax calculator and modelling advice.

2. See Stephen J. Entin, "Economic Impact Of The Estate Tax: Effects Of Various Possible Reform Options," *IRET Policy Bulletin*, No. 93, June 4, 2009, available at http://iret.org/pub/BLTN-93.PDF.

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.