IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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FISCAL COMMISSION REPORT FALLS SHORT

The National Commission on Fiscal Responsibility and Reform (Bowles-Simpson) has issued its deficit reduction plan. The good features are spoiled by some real clunkers.

The tax changes are a mixed bag. The plan would end the alternative minimum tax (AMT) and trade some distorting exclusions and tax credits for lower individual tax rates. But it would keep credits that do not aid growth, such as the earned income credit (EIC) and child credit, and end some legitimate deductions needed to measure net income properly. The Commission is too light on spending restraint. It is right to note the need for entitlement reform, but it scarcely touches medical entitlements.

The plan does well to reduce the corporate income tax rate and move to a territorial tax system. But it offsets the benefits by treating capital gains and dividends as ordinary income and, presumably, ending the 50% expensing provision for equipment. Some corporate heads may think this a good swap for a lower corporate tax rate, and class warriors think it harmless fun to raise taxes on shareholders. But the truth is, you can't love the corporation and hate the shareholders.

As a simple reality check, look at the tax on an added dollar of corporate income. The corporate tax takes 35 cents, leaving 65 cents subject to the 15% tax on shareholders' dividends or capital gains. Shareholders net 55.25 cents after both taxes. With the manufacturer's credit, which the Commission would end, they net 57.93 cents. The Commission's preferred plan has top personal and corporate tax rates of 28%, which drop the net return for top bracket shareholders to 51.84 cents, a 6% or 10.5% drop in yield. Shareholders would need a lower, 23% personal rate to break even (under 20% for manufacturing).

To avoid the tax hit on shareholders when raising new money, companies could increase leverage (like Bear Stearns and Lehman Brothers???) or sell out to foreigners (if enough step forward). Otherwise, they must issue new shares at prices depressed enough to compensate U.S. buyers for higher taxes on the earnings. That would raise the cost of new funds for investment.

Digging deeper, we ran the plan through a large sample of tax returns at 2008 income levels covering all rate brackets and types of income. The Commission plan trims marginal tax rates on wages, interest, and non-corporate business income between 9% and 18%. But it raises marginal tax rates on capital gains by 90% and on dividends by 84%. The tax changes were then fed into a neoclassical economic model. At these rates, the pre-tax return needed to justify investment would fall slightly for non-corporate businesses, but rise greatly for C-corporations even with the corporate rate cut. Over all, required pre-tax returns would jump an average of 7.2%, reducing capital formation by $2.5 trillion. GDP would be depressed 2.8%, costing $70 billion in annual tax revenue compared to the Commission's target. Mission not accomplished.

By contrast, keeping current capital gains and dividend rates and expensing, while adopting the tax rate reductions in the Commission plan, would lower required returns 3.7% and boost plant and equipment by $2.1 trillion. GDP would jump 3.5% versus the baseline, adding $90 billion to annual tax revenue, exceeding the Commission target. That's a gain of 6.3% in GDP and $160 billion in revenue versus the Commission plan outcome.

The Commission thinks raising tax rates on capital gains and dividends helps meet its revenue targets, and that a lower tax rate on capital gains and dividends would require higher tax rates on ordinary income. That is fallacious static thinking, assuming higher tax rates on capital have no effect on the economy. One cannot sensibly trade tax provisions based on their illusory static revenue costs. One must look at what they do to the economy. Raising taxes on capital would ensure the revenue targets are not achieved. Leaving them low would ensure the targets are met.

We have been down this road before. The 1986 Tax Reform Act treated capital gains as ordinary income, supposedly to pay for deeper, permanent cuts in tax rates (which Congress later raised). The top capital gains tax rate rose from 20% to 28%. But the amount of gains reported, and associated revenues, collapsed and stayed depressed for a decade as a share of GDP until the 1997 Tax Act dropped the capital gains rate back to 20%. (See table.) Dr. Paul Evans of Ohio State University recently estimated the revenue-maximizing capital gains tax rate at under 10%.[1] That is before the negative GDP effects on other tax flows.

Mindless base-broadening is a bad thing. Real tax reform moves toward a tax base that treats saving and consumption alike, not toward the "broad income" base where saving and its returns enter the tax system two or three times. The Commission erred in increasing the tax bias against the corporate form. Raising taxes on dividends, capital gains, and investment would turn the plan into a net loser, both in terms of GDP and government revenue. The plan is at best a stop-gap. It is no substitute for a serious pro-growth tax reform.

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Endnote

1. Paul Evans, "The Relationship Between Realized Capital Gains And Their Marginal Rate Of Taxation, 1976-2004," *IRET Capital Gains Series*, October 9, 2009, available at http://iret.org/pub/CapitalGains-2.pdf.