IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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SUPER-COMMITTEE SHOULD SHUN THE GANG OF SIX ON THE TAX ISSUE

A budget deal has been reached. Growth of discretionary spending and Medicare would be cut relative to the rising baseline by a bit over $900 billion in the next ten years, and the current debt ceiling would be raised by $900 billion immediately. Spending caps would be imposed, and failure by Congress to act to implement the agreement would result in automatic across-the-board reductions.

In a second step, a "super-committee" of twelve Members of the House and Senate would try to agree on a package of an additional $1.5 trillion in deficit reduction by late November, to accompany a similar rise in the debt limit. If they fail, the debt ceiling would rise by a slightly lower $1.2 trillion anyway, and additional automatic caps would kick in on discretionary outlays.

The initial agreement contains no tax increases, a plus for the economy. It is based on the CBO baseline, which assumes the expiration of the Bush tax cuts, meaning that the super-committee cannot use the elimination of those cuts to reduce the need for further action on the deficit. However, all other types of tax increases would be up for consideration by the super-committee. That could be very bad for the economy if the super-committee botches the tax issue.

What the Committee needs to know

The super-committee must understand two things. First, government spending does not increase employment and output; it crowds out private sector output, usually with a decrease in value to the public, and creates dead-weight losses from the taxes imposed to fund the spending. Second, "perfecting" the income tax by "broadening the base and lowering the rate" would hurt, not help, the economy; we need a more fundamental shift to a different tax base.

The current income tax system is heavily biased against saving and investment, and is seriously depressing output and income. Many Members of Congress and the Administration may be unaware of these biases, of the burden on the economy, and what sorts of changes would be beneficial as opposed to harmful. Some Members have studied the less-biased, more growth-friendly tax alternatives (such as the cash flow tax in the Report of the President's Panel on Tax Reform — the Bush panel — or the Flat Tax or USA Tax or Bradford "X" tax.) Most have not.

If one is content with superficial solutions, it is very easy to lower tax rates. Here's the new IRS Form 1040:

Line 1. Enter your income.
Line 2. Multiply line 1 by three.
Line 3. Pay tax at half the old tax rate.

Presto! The tax rate is cut in half and the revenue jumps by half. What a deal! Of course, it is too good to be true. The tax rates on the actual income have gone up by half due to the mismeasurement of

the tax base, the economy will shrink due to the larger tax wedge on productive activity, and revenue will fall short of the hoped for gains.

Unless the membership of the super-committee is chosen very carefully, any plan the super-committee might come up with between now and November, based on propping up the current "broad-based" income tax, is likely to do serious economic damage. The Gang of Six's "Bipartisan Plan to Reduce Our Nation's Deficit" is a case in point. It was based on the Bowles-Simpson Deficit Reduction Commission. The Commission's preferred tax options, and the tax elements of the Gang of Six proposal, are poorly crafted and damaging to investment, employment, and GDP.

Both the Deficit Commission and the Gang of Six Plan purport to maintain progressivity, reduce tax rates, raise revenue, and promote growth by closing tax expenditures and broadening the tax base. Merely playing "close the loophole" with the tax expenditure tables of the Treasury and the Joint Tax Committee won't do the job. These tables accept the anti-saving biases in the income tax as the norm, and do not distinguish between loopholes and genuine costs of production that must be allowed as a deduction from revenue to correctly determine income. They fail to distinguish provisions that avoid double-tax situations that would otherwise destroy jobs and income from blatant subsidies of money-losing activities that reduce jobs and GDP.

The Gang of Six Plan envisions a net tax increase of $2 trillion from current levels, but states that CBO would score it as a reduction in taxes of $1.5 trillion relative to the higher taxes assumed under current law. The Gang of Six Plan accepts CBO's March 2011 baseline as its starting point, which projects roughly $3.5 trillion in taxes above current levels. That baseline includes the assumption that the Bush tax cuts (recently extended) will expire in 2013, no extension of the AMT patches of recent years, and an end to the capital cost expensing provisions recently put in place to support a higher level of capital formation. The upshot must be a slower rate of economic expansion than we would see under current policies. The Plan then calls for an additional $1 trillion in revenue for further deficit reduction, in part through the elimination of unspecified tax expenditures. That would bring the tax increases to $4.5 trillion.

The Plan would use some of the added tax money to eliminate the AMT ($1.7 trillion) and reduce marginal income tax rates for businesses and individuals. It would shift to a territorial tax system for businesses to enhance international competitiveness. These are all steps in the right direction, but they do not go far enough to be able to increase economic output. Taxes would be higher under the Plan than under current law. That cannot promote growth unless the revenue raisers are restricted to those items which are wasteful and non-growth related, while incentives for additional investment and employment are enhanced, a very tall order. Neither the Deficit Commission nor the Gang of Six seem to have made such distinctions, nor did they ask for or receive the quantitative analysis needed to determine whether the balance of its proposals would move the economy forward or drag it down.

The Gang of Six Senators served on the Bowles-Simpson Deficit Reduction Commission. While offering a range of options, the Commission's highlighted plan was more specific than the Gang of Six proposal. The Commission advocated 28% top rates for individuals and corporations. To get there, it explicitly called for taxing capital gains and dividends at the same rate as other individual income. That would increase the double taxation of income produced by labor and capital in the corporate sector. The Gang of Six Plan is not so specific on how high they would set the tax rate on capital gains and dividends, and offer a wide range of tax rates as an objective. One can hope that they have reconsidered the Commission's error.

The dividend tax is on top of the corporate tax, and the capital gains tax is largely a tax on after-tax retained earnings that raise the value of the company.

With a 35% corporate tax rate and a 15% tax rate on capital gains and dividends, shareholders keep 55.25 cents on a dollar of income in the corporate sector after taxes (57.93 cents with the manufacturers' credit). With two 28% top tax rates, shareholders would keep only 51.84 cents, a 6% (or 10.6%) drop in the rate of return. The tax rate at either the corporate level or the shareholder level would have to be much lower than in the Commission proposal for shareholders to break even (very low 20s, less for manufacturing). Otherwise, the tax hurdle for corporate capital would be raised. According to a macroeconomic analysis by IRET, the resulting reduction in capital formation would slash GDP by almost 3%, and the capital stock by $2.5 trillion, relative to levels they would otherwise reach. The dynamic damage would cancel out $70 billion of the $80 billion the Bowles-Simpson panel wanted to raise.

The Deficit Commission seems to have modelled its system on the Tax Reform Act of 1986, the last time we treated cap gains as ordinary income. But this is not 1986. The starting point is very different.

The Tax Reform Act of 1986 (TRA86) raised the net tax at the margin on capital and reduced it for labor. On balance, it slightly reduced potential output. It would have been a modest positive for the economy if Congress had followed the Treasury reform plan as submitted, but it did not. Treasury had recommended indexation of depreciation allowances for inflation. That would have helped to reduce slightly the required "service price" or "hurdle rate of return" that capital must earn in order to be a feasible investment, in spite of longer assets lives and repeal of the investment tax credit under the bill. Congress dropped the indexing provision, and the hurdle rate went up, discouraging investment.

Nonetheless, TRA86 cut the corporate rate 12 points from 46% to 34%; Bowles-Simpson would cut it from 35% or 31.85% (with the manufacturing credit) to 28%, only a 4 to 7 point cut. TRA86 raised the top rate on capital gains from 20% to 28%, but lowered the top rate on dividends from 50% to 28%, reducing the double tax on corporate income. Under Bowles-Simpson, both would rise from 15% to 28%, increasing the double tax from current levels. TRA86 eliminated the investment tax credit. Bowles-Simpson would eliminate the current expensing provision, equally bad.

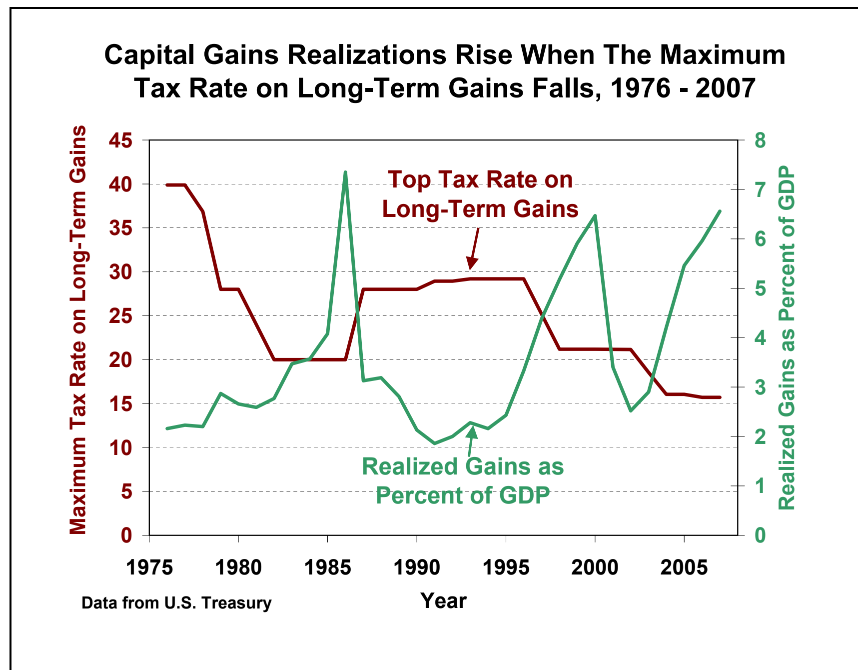
TRA86 fixed some excesses within the framework of the income tax, but it did not change the character of the tax much. It was not the sweeping pro-growth reform of a shift to the neutral base of the Flat Tax, Bradford X tax, or the cash flow tax of the Bush panel. That type of fundamental reform has the potential to add ten percent to national output and income. The Bowles-Simpson Commission also rejected a major shift in the tax base, and its changes within the confines of the income tax would be far more damaging to tax neutrality between saving and investment than those of TRA86.

When TRA86 raised the capital gains tax rate, CBO and Treasury estimated it would cause a reduction in the taking of gains (realizations) only briefly. In fact, capital gains realizations crashed (after soaring in the year before the effective date to avoid the rate hike) and they remained depressed below their 1985 share of GDP for a decade until the rate was reduced again to 20% in 1997 by Archer, Gingrich, and Clinton. The effect of the higher tax rates on realizations was permanent, not temporary. If Congress makes that mistake again, the Treasury will not gain a nickel. (See graph.)

The "broad-based" income tax is biased, hitting income used for saving and investment repeatedly and more harshly than income used for consumption. Pay tax on your income (tax layer one) and consume the remainder, and there are few added federal taxes (other than alcohol, tobacco, and gasoline). But save your after-tax income (outside of limited pension and IRA options), and the profit, interest, dividends, or capital gains are taxed (tax layer two). Dividends and stock-related capital gains also face the corporate tax (tax layer three). For all businesses, corporate and non-corporate, investment expenses must be

deducted over many years instead of when they are made (when expensing is not in force), overstating income, creating a back-door increase in effective tax rates. Save too much, and you become subject to the estate tax (tax layer four).

The income tax was designed by its intellectual godfathers, Professors Robert Haig and Henry Simons, to redistribute income at the expense of thrift and production, not to foster economic growth. (Although even Haig and Simons thought the corporate tax on top of the personal tax was going too far.)



The tax expenditure lists made up by Treasury and the Joint Tax Committee are based on deviations from the broad-based income tax. They assume the added tax layers and biases in the income tax against saving and investment are part of the ideal norm. Many of the items on the list of tax expenditures are partial offsets to the biases in the income tax. These offsets include all the pension and retirement and education saving arrangements, accelerated depreciation and expensing provisions, lower tax rates on capital gains and dividends, and most offsets to the corporate income tax. The credit against the estate and gift tax and exempt amounts for annual giving are also offsets to an extra tax layer of tax on capital. Perfecting the income taxes or estate levies by eliminating offsets to these added tax layers would increase the tax bias against saving and investment.

The anti-saving bias is more important, and more damaging to the economy, than many of the differences in tax preferences among industries. Eliminating the preferences by raising the tax on the partially protected sectors, rather than extending the tax relief to the sectors not now favored, would depress economic activity, not improve it.

During the last five years of the G.W. Bush administration, U.S. Budget documents showed an alternative list of tax expenditures under a "saving-consumption neutral" tax. Most of the big ticket expenditures (other than health insurance) fell out, including all retirement plans, expensing or rapid depreciation, and lower tax rates on dividends and capital gains. Under a consumed-income or neutral tax system, the corporate tax is a "negative" tax expenditure, as is the ordinary tax treatment of saving outside of retirement plans. President Obama's budget document dropped that expanded coverage of the alternative view of tax expenditures. Now all we see is the broad-based income tax (and a closer-to-Haig-Simons variant) as the ideal tax base, and the tax expenditures associated with that base.

Real tax reform alternatives, which would treat saving and consumption evenly, such as a cash flow tax, Flat Tax, or national sales tax, are not on the table. Those taxes do not punish investment versus consumption. They regard pensions and immediate "expensing" of investment costs as the norm and not deviations from the "ideal." All saving would be taxed only once, with no double-taxation of corporate income and estates.

The Bowles Simpson Commission did not examine the economic benefits of a real tax reform, one example of which they briefly considered and dismissed. No estimates were provided by Treasury or the Joint Committee on Taxation of the effect of their proposals on the cost of capital. The economic damage from their net tax hikes on capital was not factored into the revenue estimates. No money would be raised, and the public would suffer a drop in income.

The nation needs a change to a better tax system. If the super-committee is not able to provide that, it should stick entirely to spending cuts.

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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.