

JEC Macroeconomic Conference

RETURN TO PROSPERITY: CREATING THE STRONGEST ECONOMY OF THE 21ST CENTURY

**Presentation of
Stephen J. Entin**

Institute for Research on the Economics of Taxation

February 23, 2010

IRET • 1710 Rhode Island Ave., NW, 11th floor, Washington, DC 20036

(202) 463-1400 • www.iret.org

Policy Targets And Policy Tools

Two Policy Targets:

- Stable Prices And A Sound Dollar
- Vibrant Economy -- High Real Output, Income, Employment

Two Policy Weapons:

- Monetary Policy (Federal Reserve) – Best Used To Keep Prices Stable
- Fiscal Policy -- Taxes & Govt. Spending (Congress, Mainly) – Can Facilitate Growth If Used Properly
- Reversing The Roles Leads To Trouble

Two Strategies:

- Shoot The Right Weapon At The Right Target And You Might Hit Both.
- Shoot The Shotgun At The Elephant And The Elephant Gun At The Quail And You Will Get Gored And Go Hungry.

Policy Assignments:

Nixon/Ford/Carter Years:

- Set Monetary Policy To Promote Real Growth And Reduce Unemployment With Easy Money While ...
- Congress Spent Like Crazy And Let Inflation Raise Taxes, Growing The Public Sector And Restricting The Private Sector.

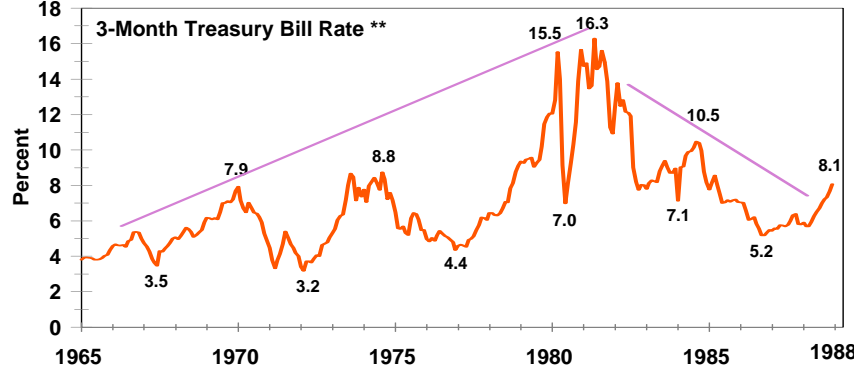
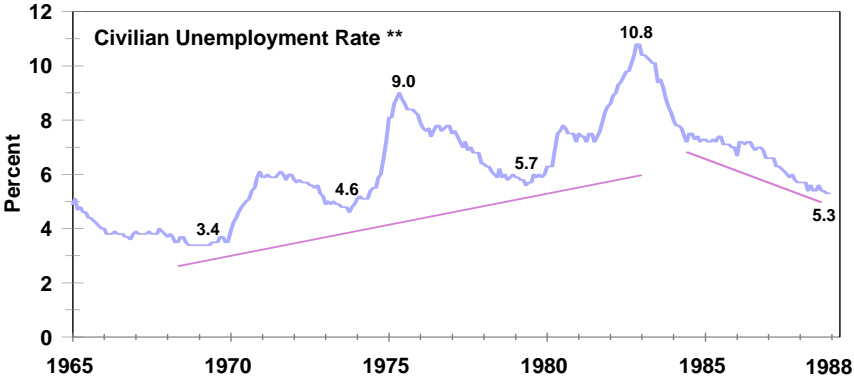
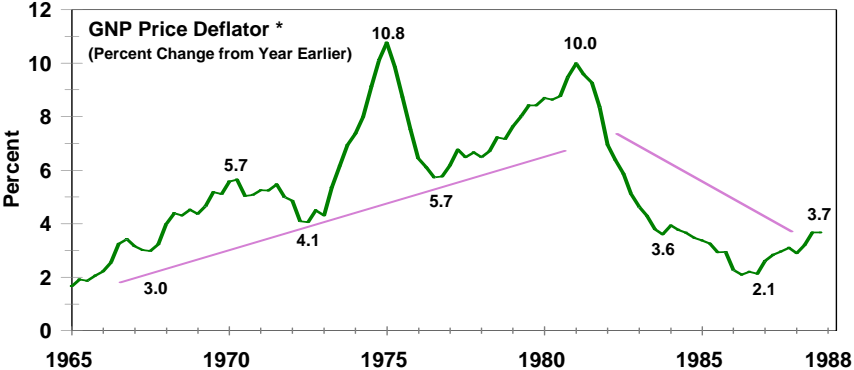
Result: Stagflation.

Kennedy/Reagan/Clinton(Gingrich) Years:

- Set Monetary Policy To Promote Stable Prices While ...
- Congress Restrained Spending To Shrink The Public Sector And Cut Taxes In A Pro-Growth Manner.

Result: Strong Private Sector Growth Without Inflation.

Inflation, Unemployment, And Interest Rates, 1965 - 1988



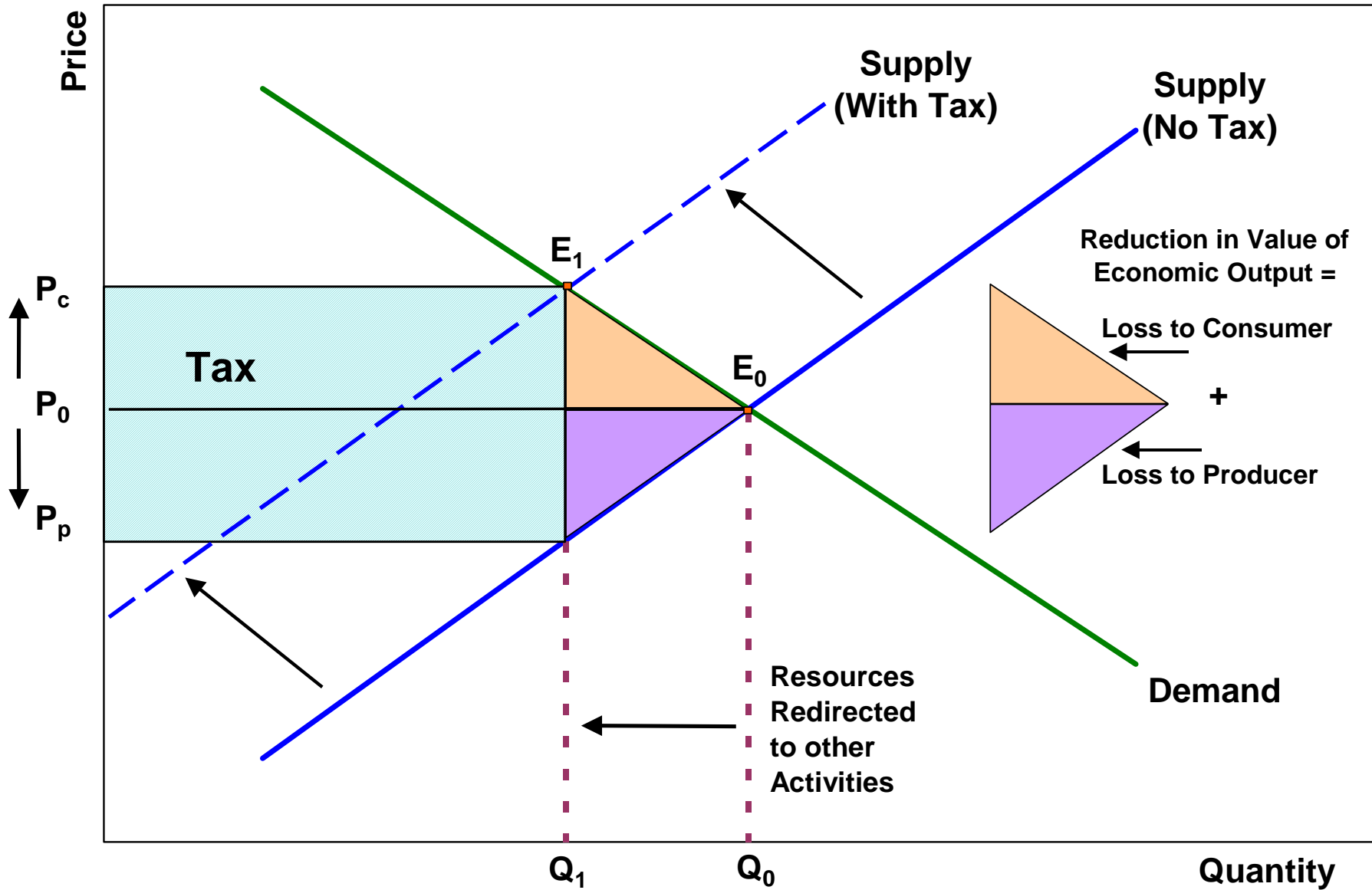
Does Fiscal Policy Have Demand Effects?

- The Keynesian Focus On Managing Demand Is Misguided According To Friedman. Tax Cuts And Govt Spending Do Not Stimulate Demand, Because The Govt Must Fund Them Through Borrowing Or Offsetting Taxes/Spending Cuts.
- With Rare Exceptions, Govt Spending Takes Resources From The Private Sector And Shrinks Real Output By Putting Them To Inferior Uses.
- Tax Cuts Don't Work By Giving People Money To Spend (Raising "Disposable Income" Or "Aggregate Demand"). Unless Matched By Spending Cuts, The Tax Cuts Are Borrowed Back By The Treasury.
- If The Federal Reserve Buys The Added Debt With New Money, Demand Will Rise, But The Likely Effect Is Higher Prices, Not Higher Output.

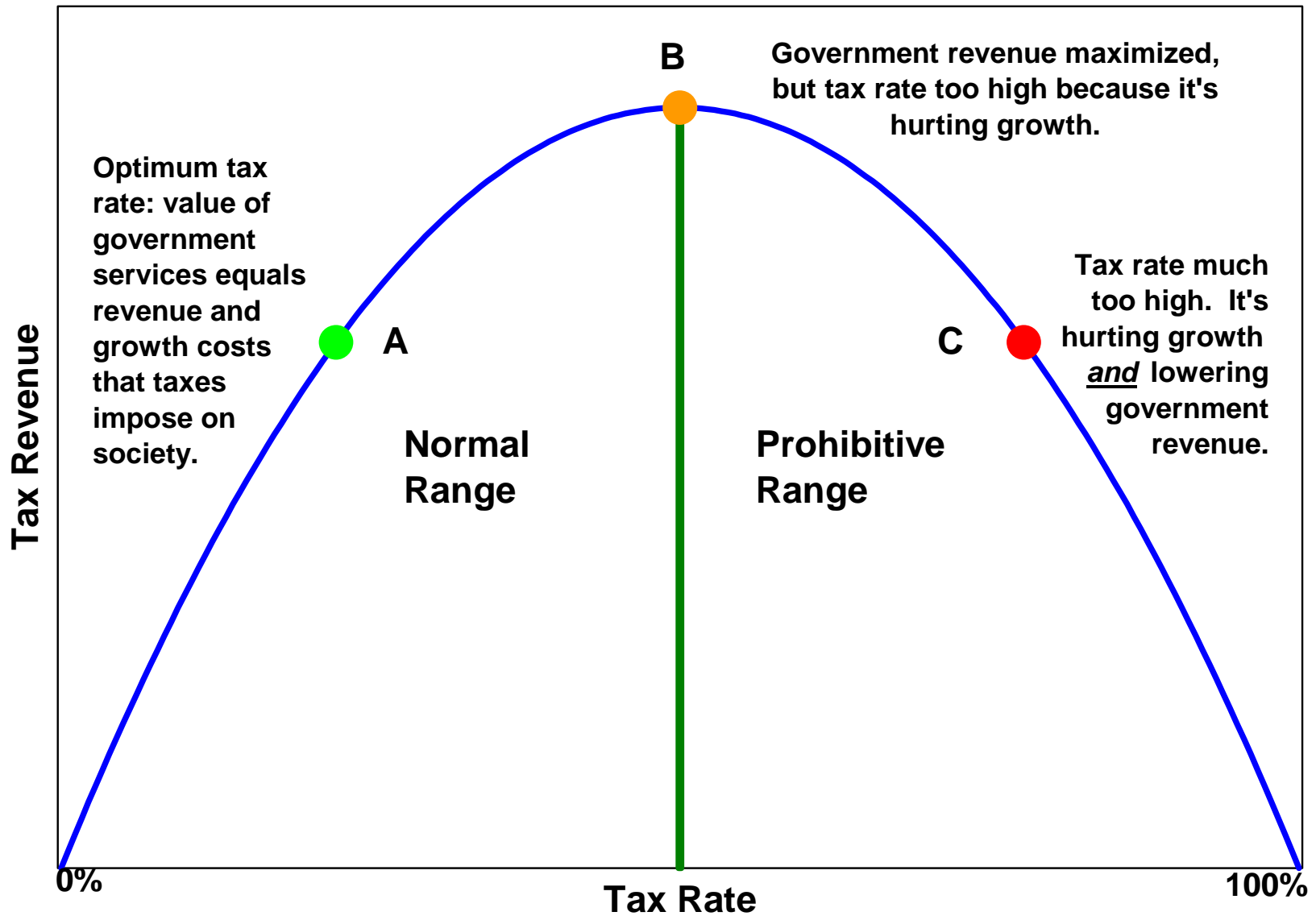
Or Must We Rely On Incentives To Supply?

- Tax Cuts Can Boost Output By Creating Incentives To Produce; Only Those Tax Cuts That Affect These Incentives Have A Pro-Growth Effect.
- Tax Cuts That Simply Redistribute Income Do Not Increase Work, Saving, Or Investment; They Do Not Increase Employment, Productivity, Output, Or Income. They Probably Reduce Them By Rewarding Non-Work.
- Tax Cuts That Improve After-Tax Rewards At The Margin For Additional Work, Saving, Investment, Production, Raise Output, Employment, Income.
- There Are No "First Order Income Effects" From A Tax Cut. A Tax Cut Raises Income Only As It Encourages Supply. As Supply Increases, People Get Paid For Their Productive Services, And Only Then Does Demand Rise. (Says' Law, Not Keynes' Claptrap).

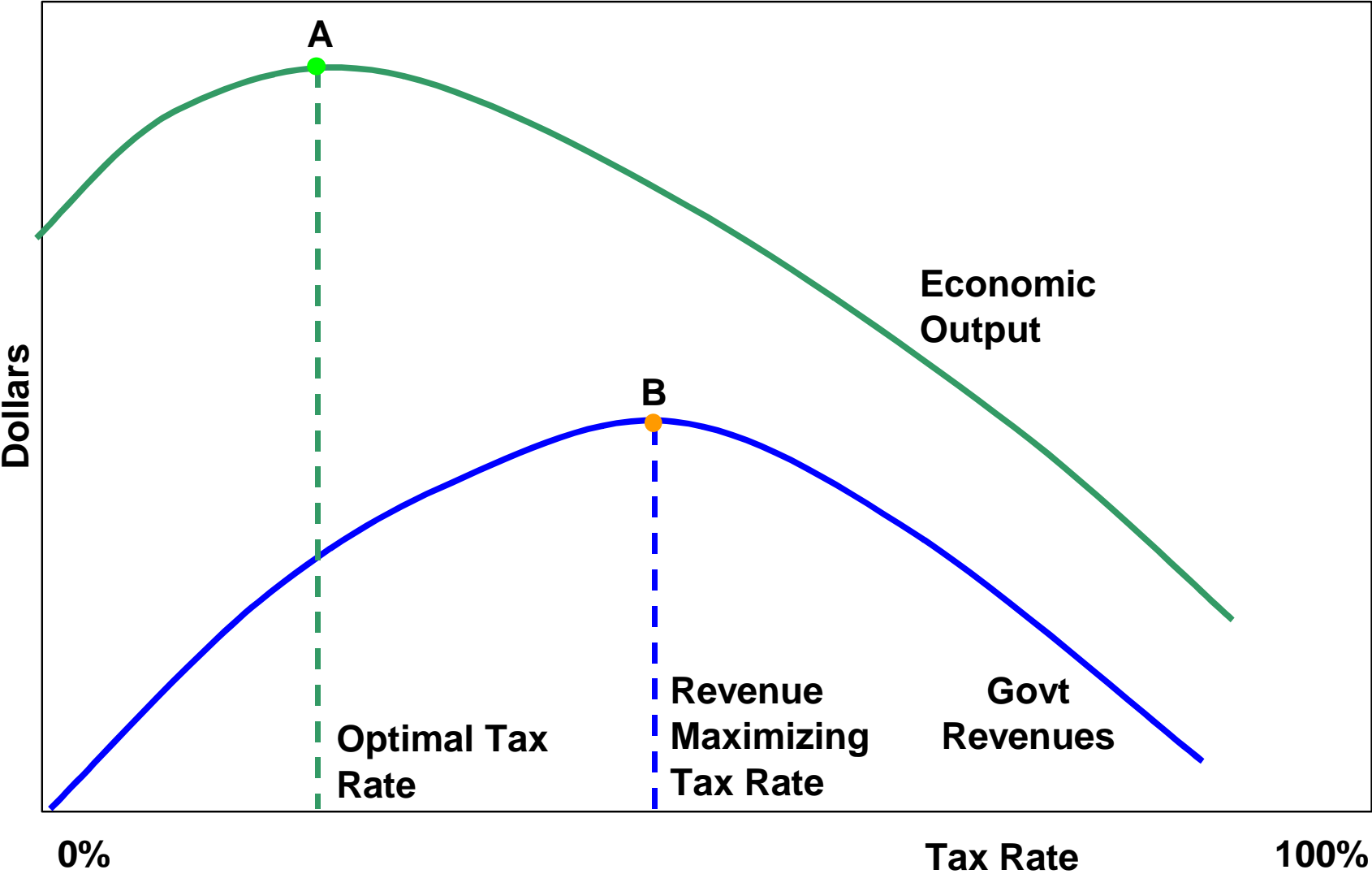
Imposition Of A Tax



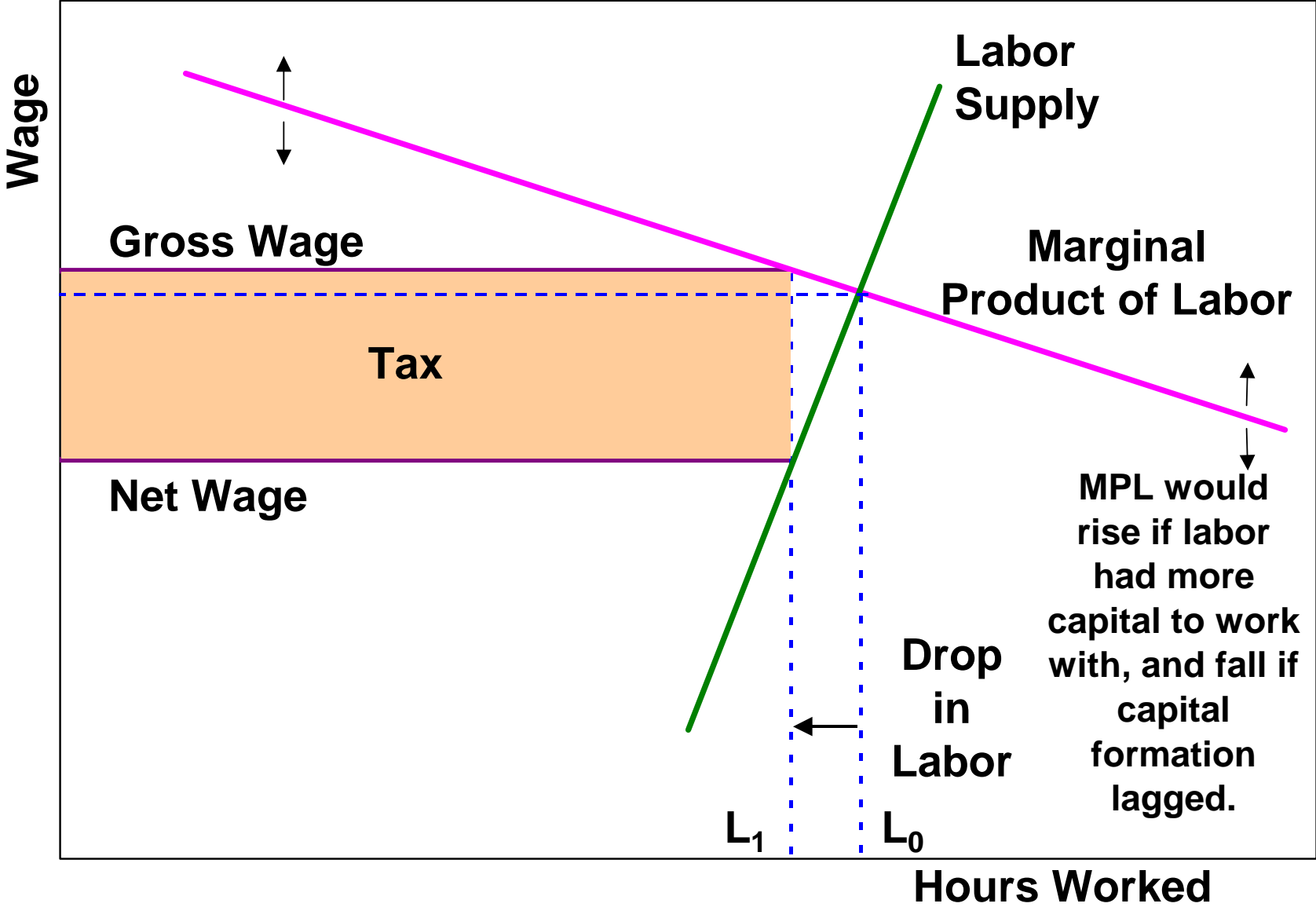
Laffer Curve



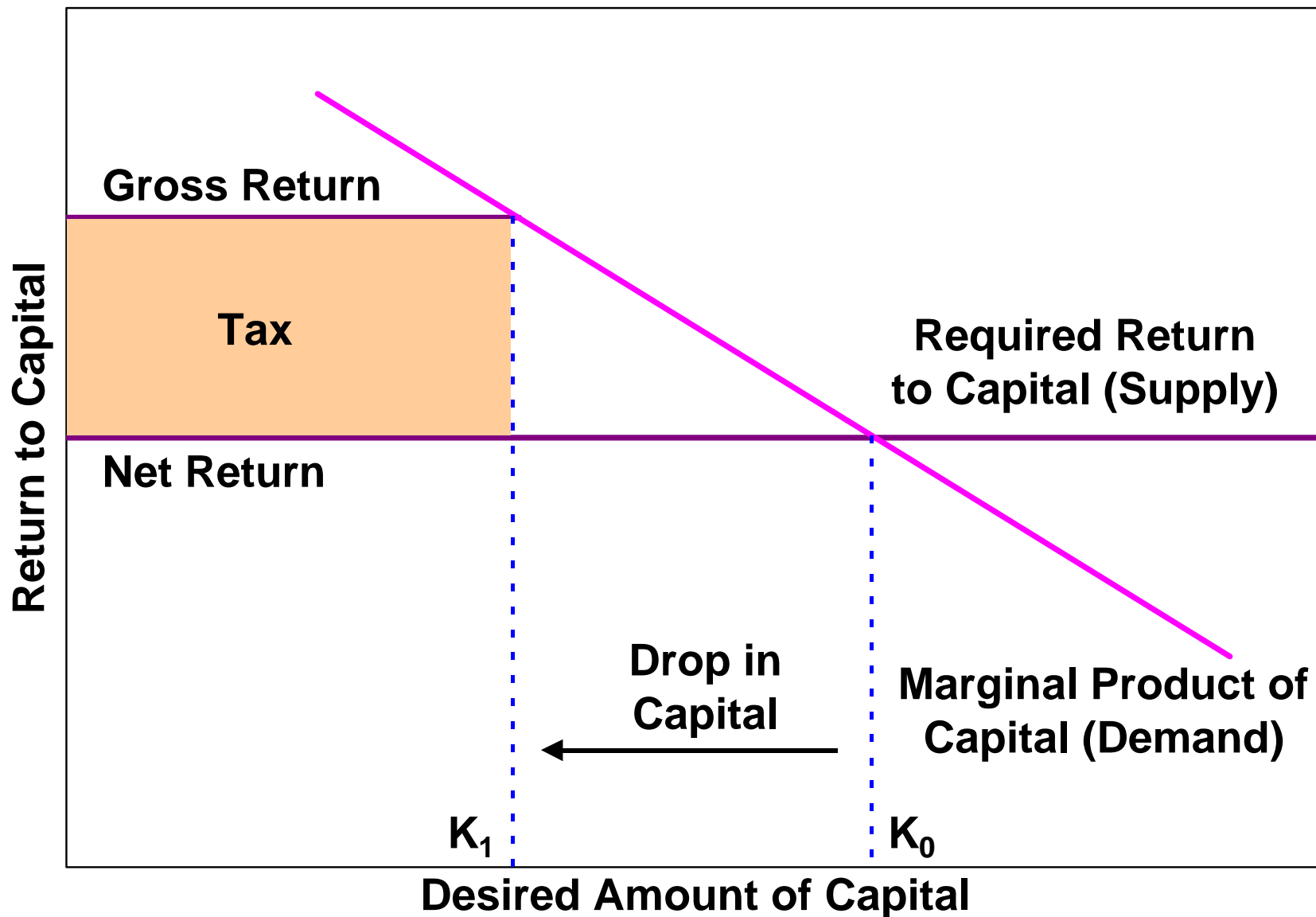
Tax Increases Reduce Economic Activity Long Before They Reduce Tax Revenues



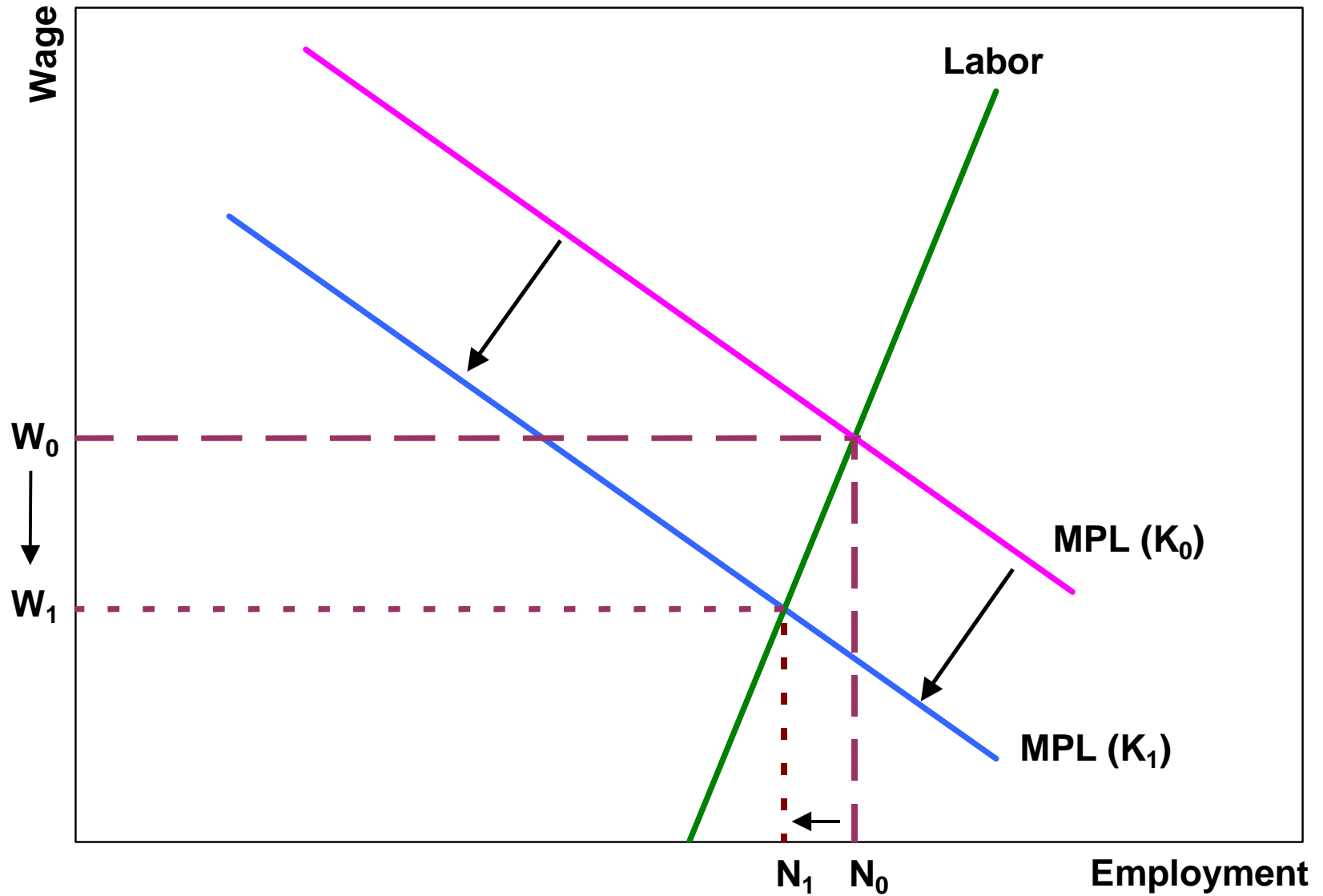
Effect of Tax On Labor



Effect of Tax On Desired Capital Stock



A Smaller Stock Of Capital Reduces Wages



Taxing Capital Hurts Labor

- Labor Bears The Economic Burden When Taxes Drive Capital Offshore Or Discourage It From Existing At All.
- Taxing Income Used For Consumption Instead Of “Haig-Simons Income” Would Raise After-Tax Wages And GDP.
- A 10% Rise In GDP And Wages Would Benefit Workers And Families More Than Misc. Tax Credits And Govt Jobs.

Marginal Vs. Average Tax Rates

Income = \$50 K. Desired Tax Take = \$10 K.

System 1: Tax All \$50 K @ 20%.

Tax = \$10 K.

Average Tax Rate = 20%.

Marginal Tax Rate = 20%.

Earn \$100 More, Keep \$80.

System 2: Exempt \$25 K. Tax \$25 K @ 40%.

Tax = \$10 K;

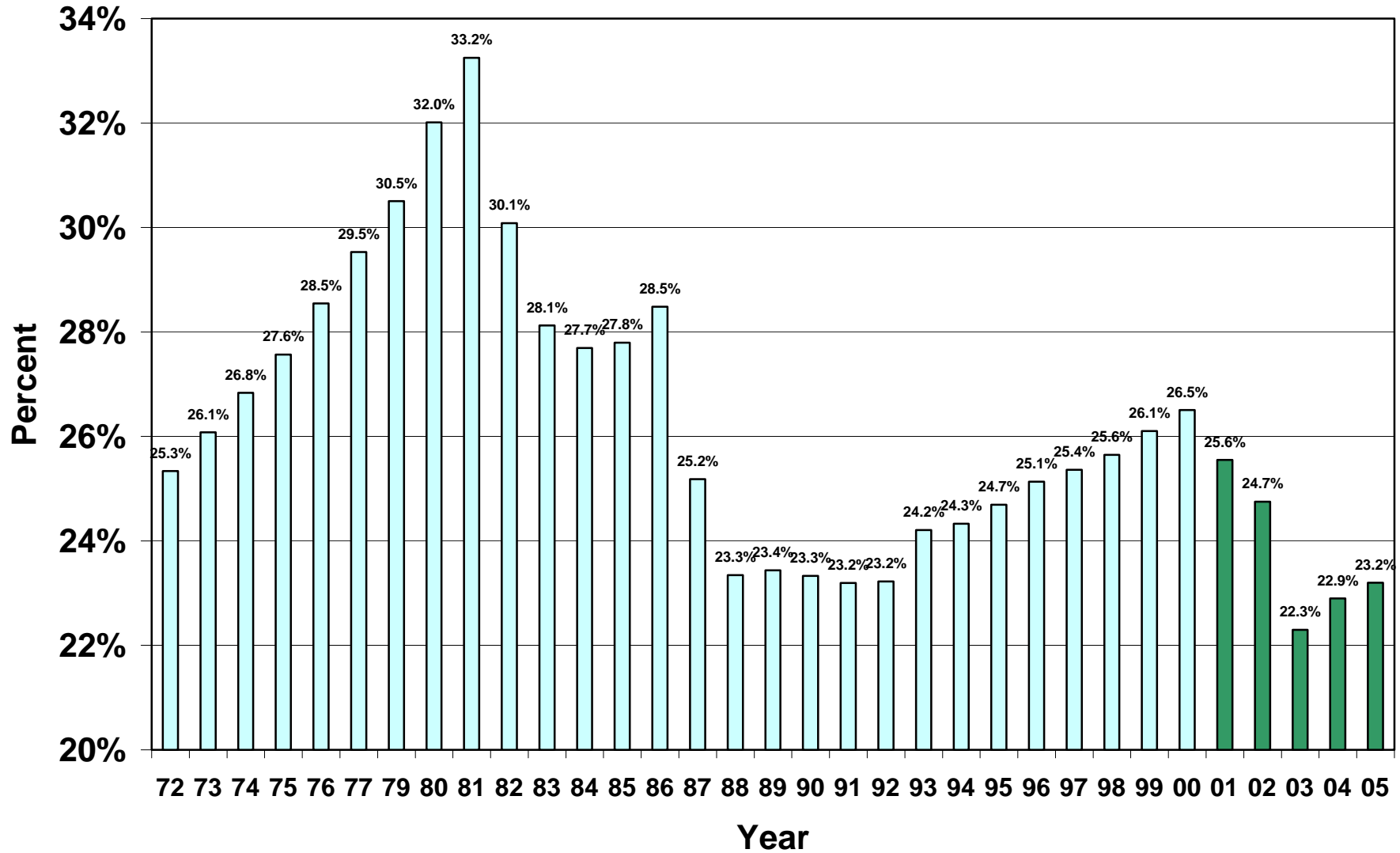
Average Rate 20%

Marginal Rate 40%.

Earn \$100 More, Keep \$60

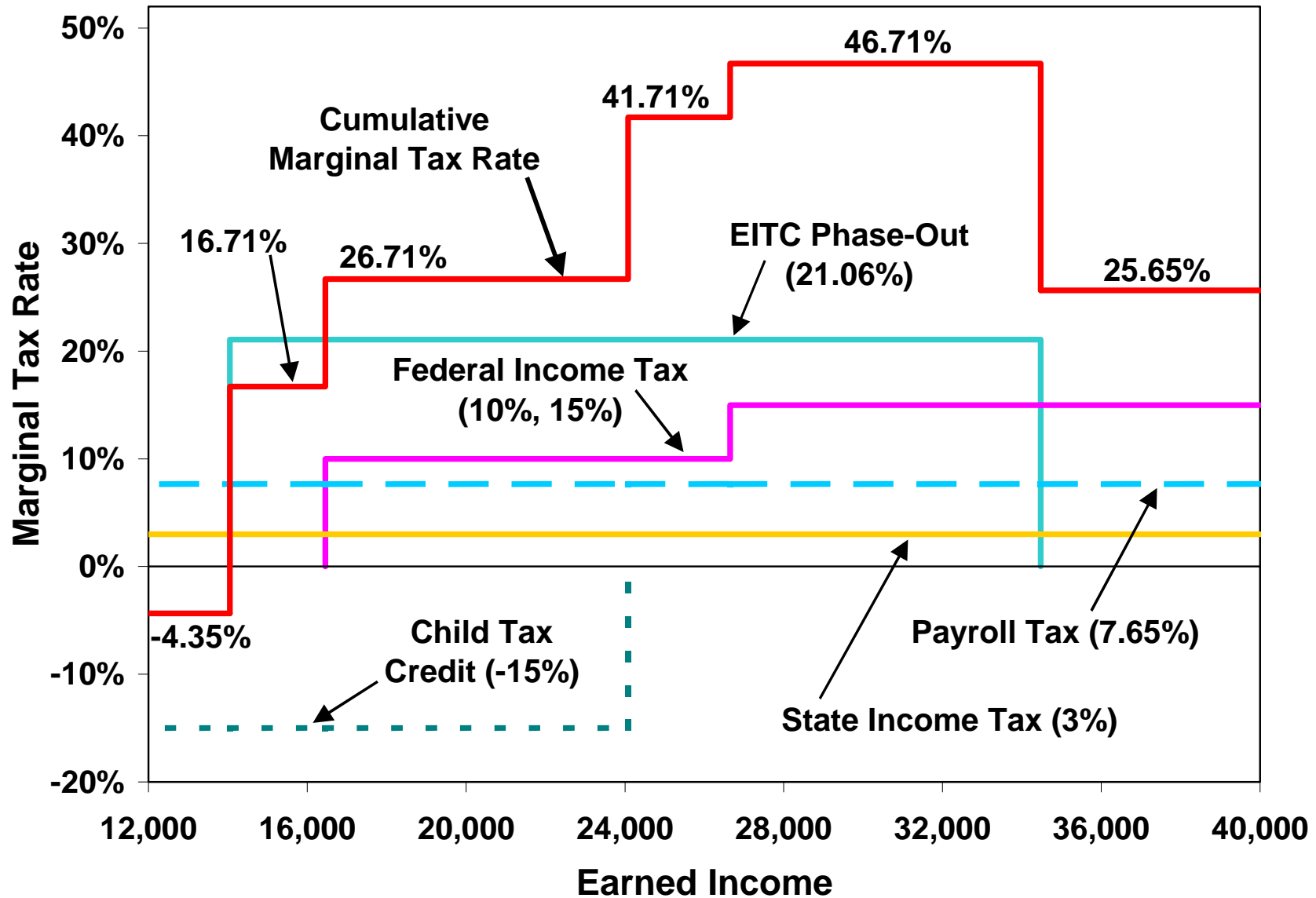
Under Which System Will People Be
More Eager To Earn Additional Income?

Weighted Marginal Individual Income Tax Rate

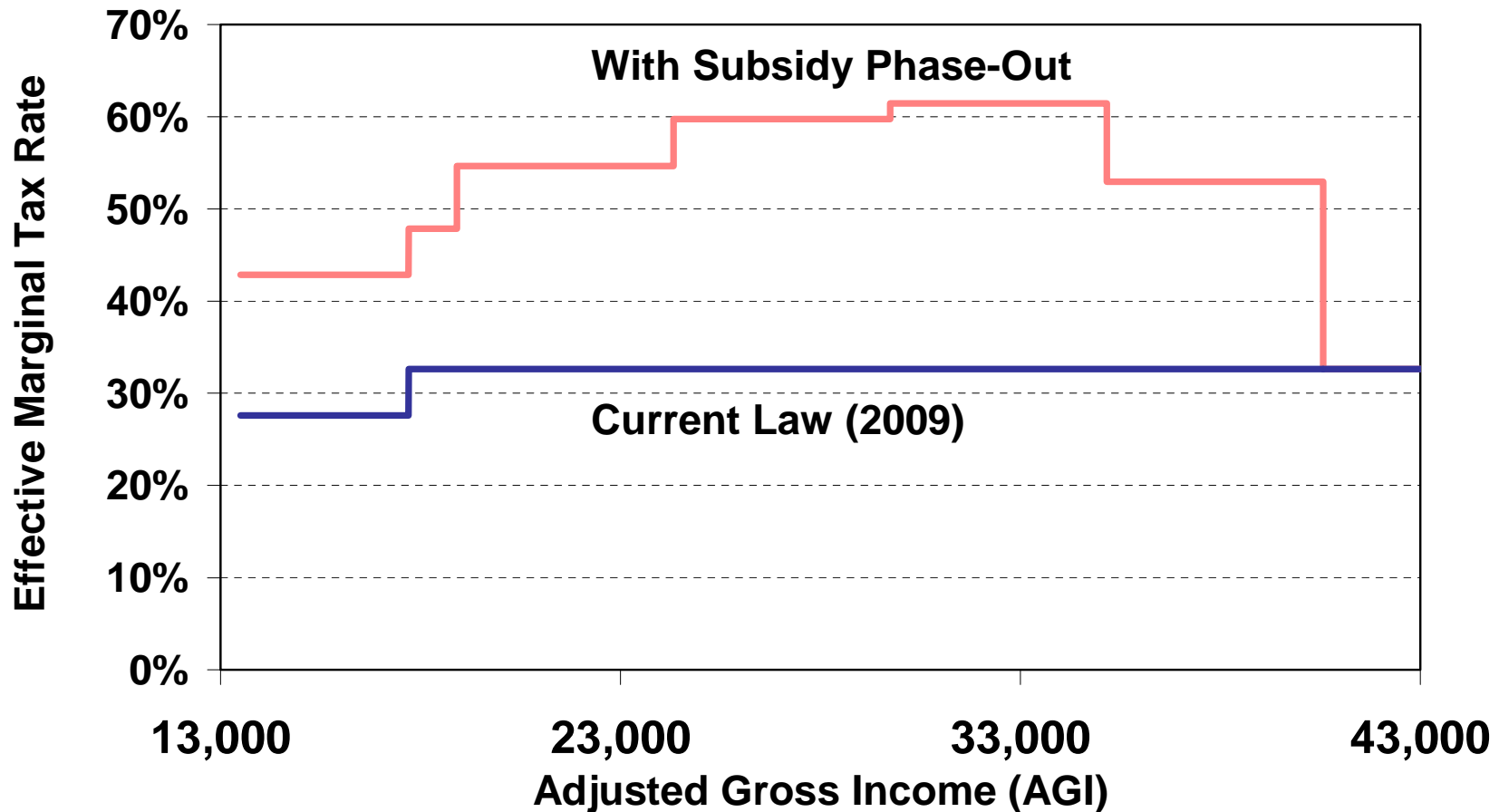


Data Source: Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, various issues; Internal Revenue Service, Statistics of Income Bulletin, various issues. (Data not published for 1978)

Cumulative Marginal Tax Rate For A Single Taxpayer Earning \$12,000 to \$40,000 With 2 Children



The Phase-Out Of The Health Exchange Subsidy Would Create A Huge Marginal Tax Rate Spike Single Individual



Sources: CBO for estimates of Health Exchange Subsidy; and calculations by author, based on Federal Income Tax, State Income Tax, Federal Payroll Tax, and Phase-Out of Health Exchange Subsidy. See text for more details.

Tax Base Vs. Tax Rates

- The Tax Base -- What We Tax --
Is At Least As Important As
The Tax Rates We Impose.
- The Income Tax Is Seriously Biased
Against Saving And Investment.
- All Tax Reforms Worthy Of The Name
Reduce Or Eliminate These Tax Biases.
- A Good Tax System Is
Saving/Consumption Neutral.

Multiple Taxation of Saving

One Tax on Consumption, Four Taxes on Saving

Layer 1 – Tax on Earnings

Income is taxed when earned. If it is used for consumption, there is usually no further federal tax.

Layer 2 – Personal Income Tax on Returns

If the income is saved, the returns are taxed as interest, dividends, capital gains, or non-corporate business profits.

Layer 3 – Corporate Income Tax

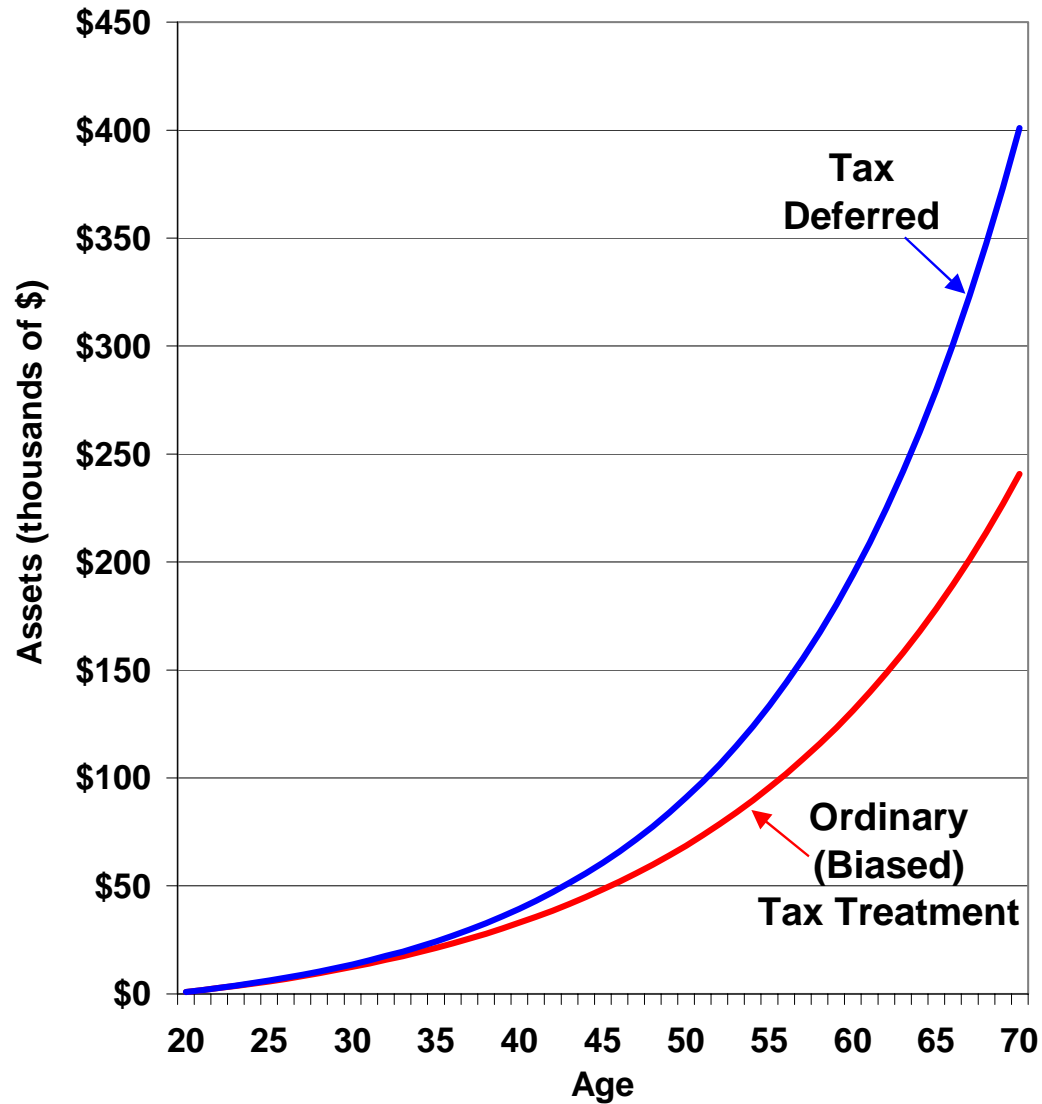
If the saving is in corporate stock, the corporate tax hits the income before it is either paid out to shareholders or reinvested to boost future earnings.

Layer 4 – Transfer (Estate and Gift) Tax

Another tax on already taxed assets.

(Similar taxes at the state and local levels increase the multiple taxation.)

Advantage Of Tax Deferred Saving Over Ordinary (Biased) Tax Treatment: Build-up Of \$1,000 Saved per Year



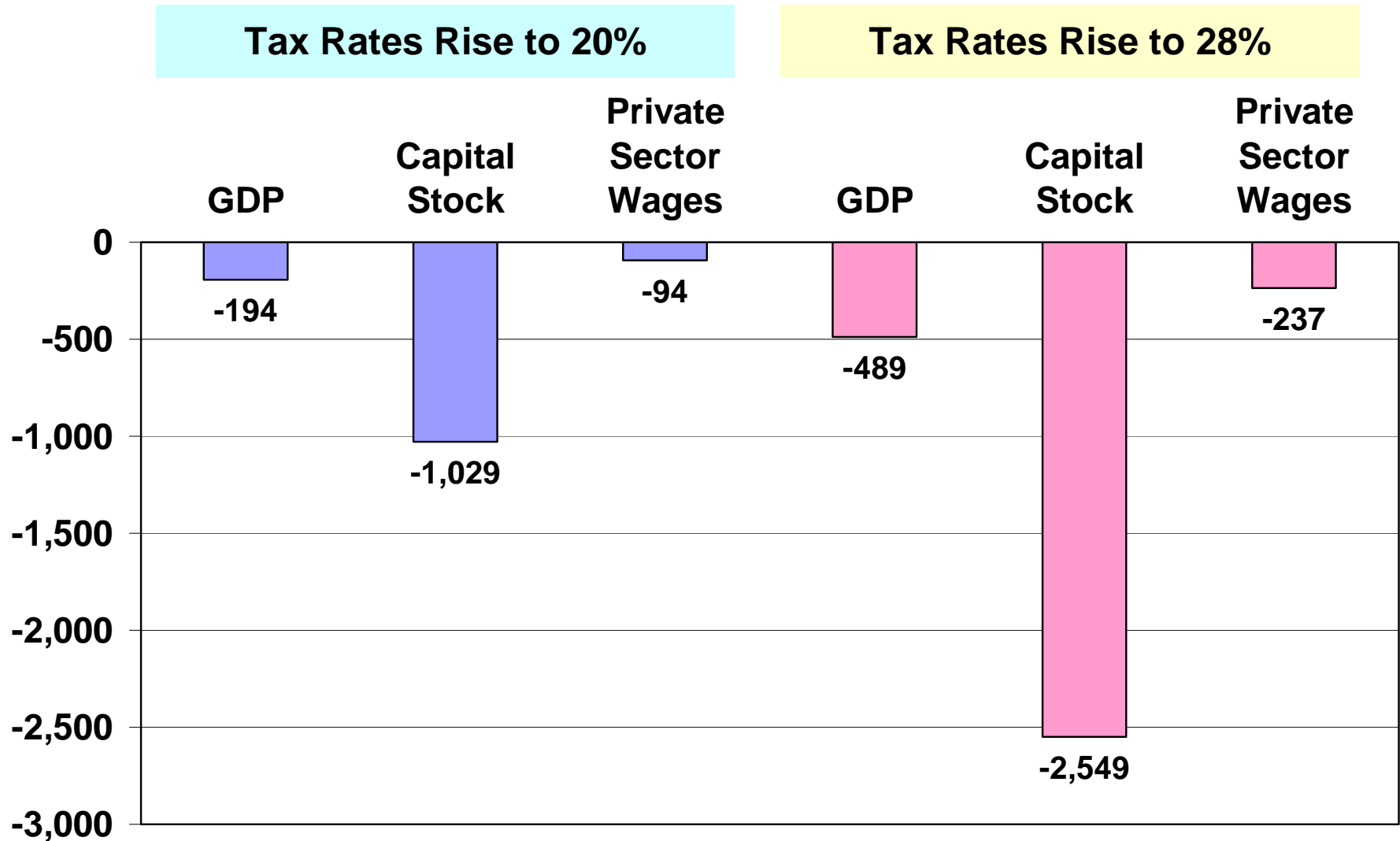
Saving from age 20 onward, under tax-deferred system and ordinary "double taxation" (7.2% interest rate, 20% tax rate).

Multiple Taxation of Corporate Income

	(a) Retained Earnings, Pre-2003 Act	(b) Dividend Payout, Pre-2001 Act	(c) Retained Earnings and Dividends, 2003 Act
1) Corporate Income	\$1.00	\$1.00	\$1.00
2) Corporate tax at top rate	\$0.35	\$0.35	\$0.35
3) After-tax corporate income: Either retained, raising stock price (columns (a), (c)), or paid as dividend (col. (b), (c))	\$0.65	\$0.65	\$0.65
4) Individual income tax at top rate (dividends as ordinary income, retained earnings as capital gain)*	\$0.13 (tax rate 20%)	\$0.2574 (tax rate 39.6%)	\$0.0975 (tax rate 15%)
5) Total tax	\$0.48	\$0.6074	\$0.4475
6) Total tax rate	48%	60.74%	44.75%
7) Income left to shareholder	\$0.52	\$0.3926	\$0.5525
<p><i>* Top corporate rate excludes corporate surtaxes, and top individual rate ignores phase-outs of exemptions and deductions and taxation of Social Security, which may push effective top tax rates higher than statutory rates. Retained earnings are assumed to trigger a long-term capital gain with a maximum rate of 20% or 15%. Short-term gains are taxed at ordinary tax rates.</i></p>			

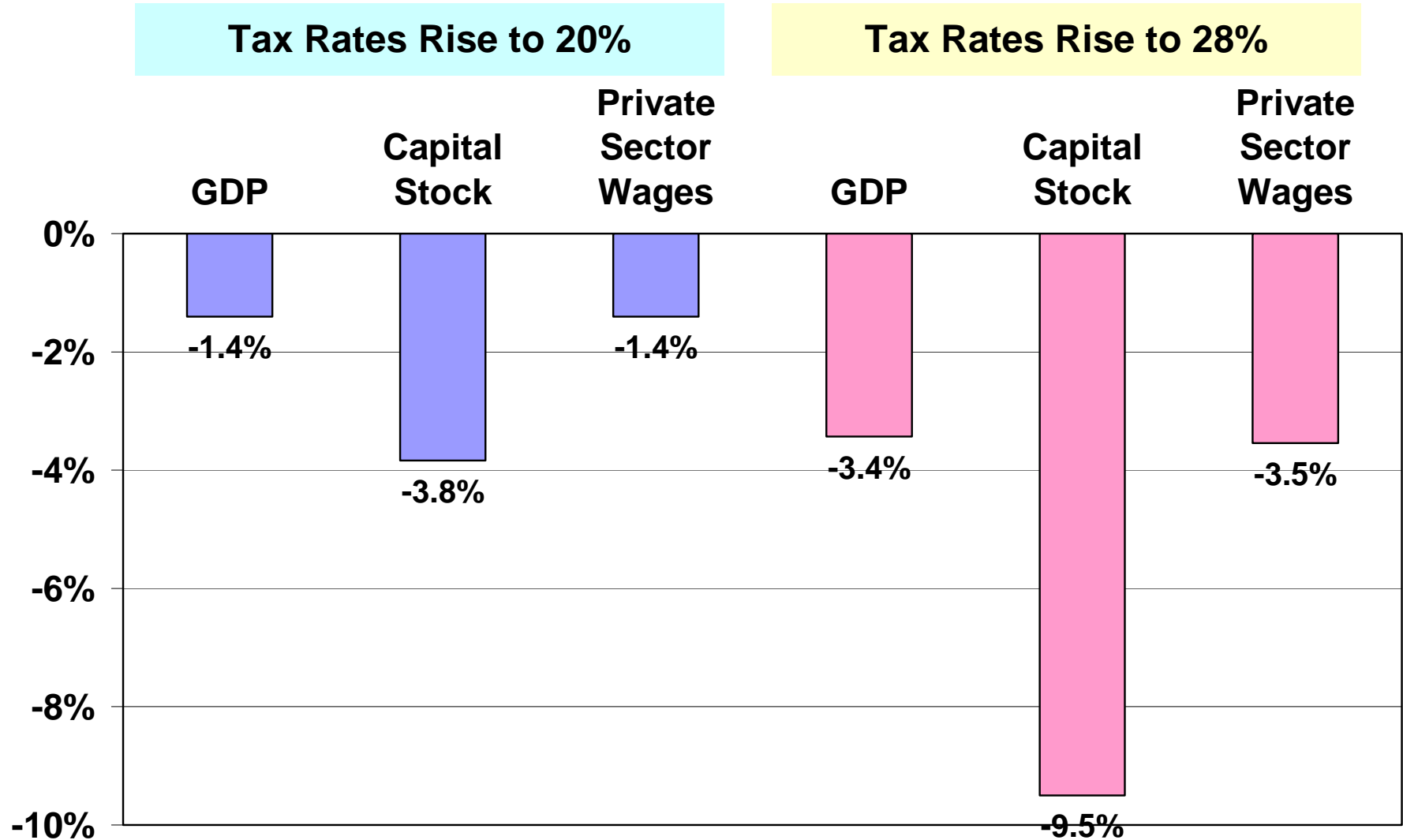
Changes In GDP, Wages, and Capital If Capital Gains and Dividends Tax Rates Increase

Changes in Billions of Dollars

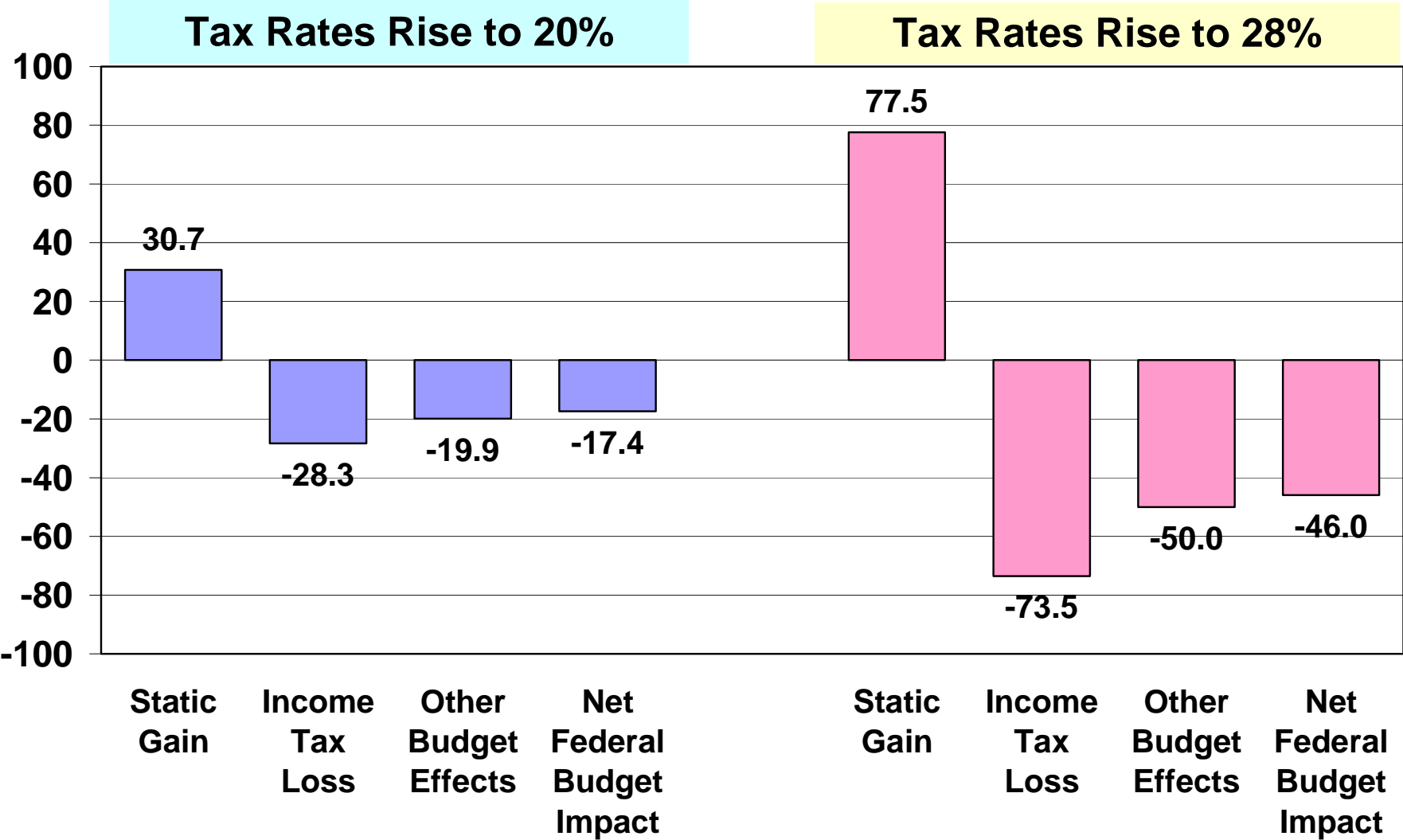


Changes In GDP, Wages, and Capital If Capital Gains and Dividends Tax Rates Increase

Changes in Percent



Static Versus Dynamic Federal Budget Effects Of Capital Gains And Dividend Tax Changes In Billions



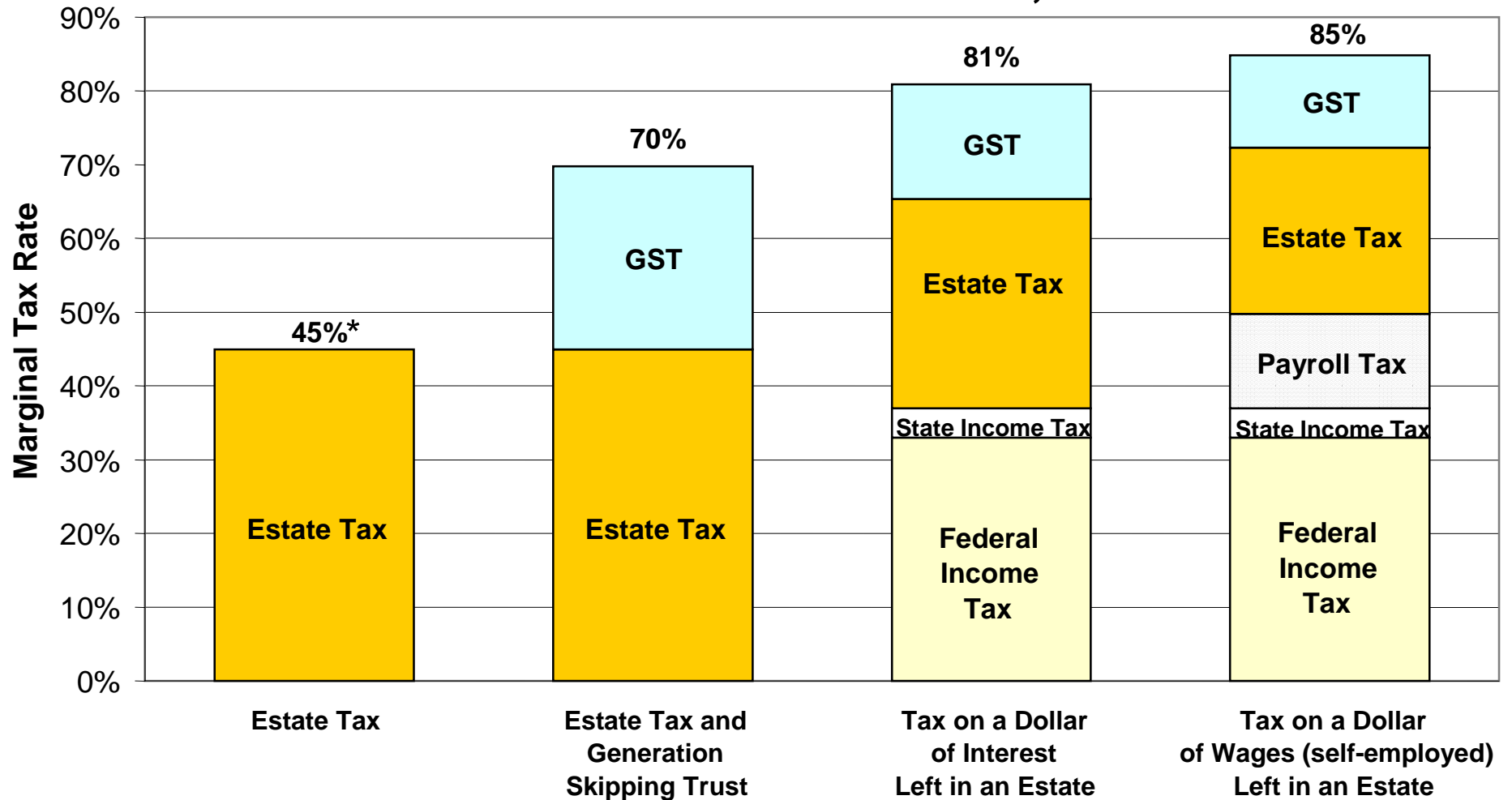
Present Value of Current Law Capital Consumption Allowances per Dollar of Investment Compared to Expensing (First-Year Write-Off)

Asset lives:		3 Yrs	5 yrs	7 yrs	10 yrs	15 yrs	20 yrs	27.5 yrs	39 yrs
Present value of first-year write-off of \$1 of investment:		\$1.00	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00	\$1.00
Present value of current law write-off of \$1 if inflation rate is:	0%	\$0.96	\$0.94	\$0.91	\$0.88	\$0.80	\$0.74	\$0.65	\$0.55
	3%	\$0.94	\$0.89	\$0.85	\$0.79	\$0.67	\$0.59	\$0.47	\$0.37
	5%	\$0.92	\$0.86	\$0.81	\$0.74	\$0.60	\$0.52	\$0.39	\$0.30
Assumes a 3.5 percent real discount rate, 3-20 year assets placed in service in first quarter of the year, 27.5 - 39 year assets placed in service in January.									

Expensing Versus Depreciation: Depreciation Overstates Taxable Income and Depresses Return on Capital

Expensing (Full Cost Recovery)		Depreciation	
Revenues from machine, present value	\$115	Revenues from machine, present value	\$115
Full cost of machine	\$100	Full cost of machine	\$100
Actual profit	\$15	Actual profit	\$15
Full cost write-off for tax purposes (expensing)	\$100	Allowable depreciation write-off, present value	\$85
Taxable profit = Actual profit	\$15	Taxable profit exceeds actual profit	\$30
Tax	\$5	Tax	\$10
Actual after-tax income	\$10	Actual after-tax income	\$5
Rate of return	10%	Rate of return	5%

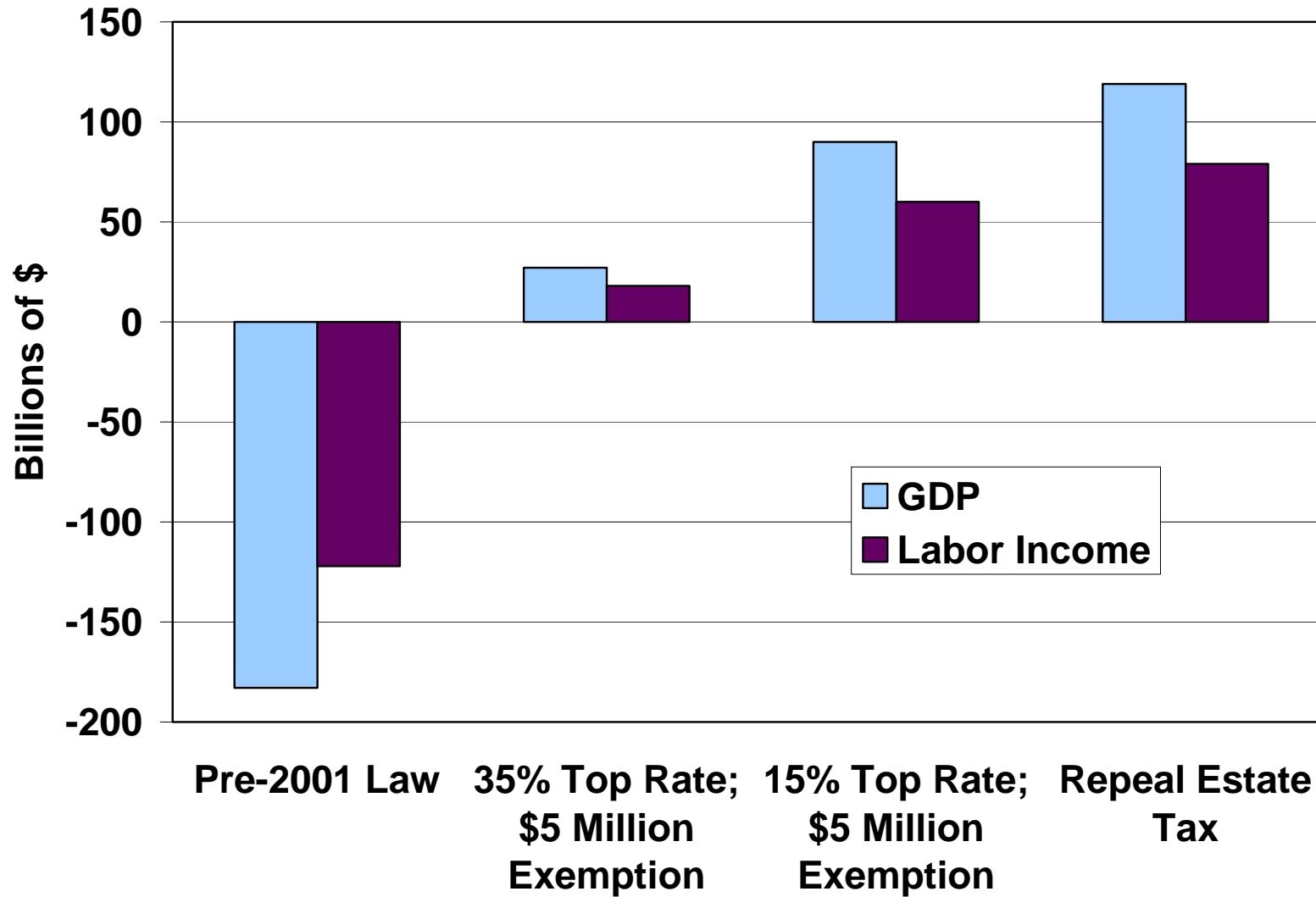
Marginal Tax Rates On Estates And Income Contributed To Estates, 2009



* 45% Estate Tax Rate became effective in 2007.

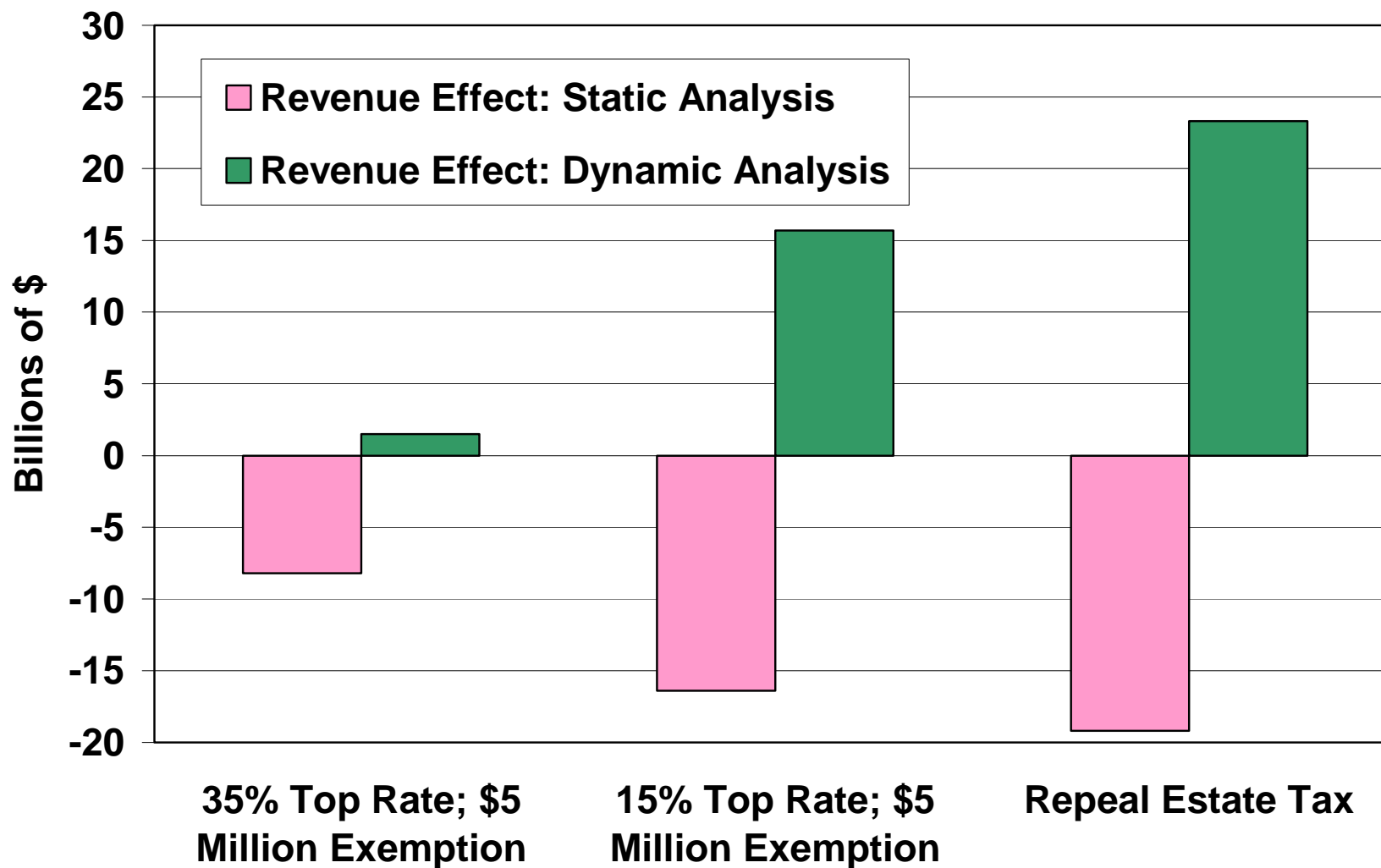
Assumes married couple in 33% tax bracket, who are self-employed, with a 6% state income tax.
Computed prior to Estate Tax Repeal, which is now scheduled for 2010.

Effect Of Estate Tax Alternatives On Gross Domestic Product And Labor income



Calculations by Author

Revenue Effects Of Estate Tax Reform: Static Versus Dynamic Revenue Estimates



Calculations by Author

STEPS TOWARD NEUTRALITY:

ALL SAVING GETS DEFERRAL
OR RETURNS EXEMPT EQUIVALENT;

EXPENSING OF INVESTMENT;

NO DOUBLE TAX OF CORPORATE INCOME;

NO ESTATE AND GIFT TAX.

TAX BASES OF FOUR NEUTRAL TAXES & POINTS OF COLLECTION

NRST -- INCOME LESS SAVING = CONSUMPTION
(NOT IMPOSED ON INVESTMENT GOODS).
TAXED AT POINT OF SALE.

VAT -- INCOME LESS SAVING = CONSUMPTION
(INVESTMENT EXPENSED). CAPITAL AND LABOR
INCOME TAXED AT BUSINESSES, IN STAGES.

CASH FLOW TAX -- INCOME LESS SAVING =
CONSUMPTION. TAXED ON INDIVIDUAL TAX FORM.

FLAT TAX -- INCOME LESS INVESTMENT = CONSUMPTION.
CAPITAL INCOME ON BUSINESS OR PROPRIETOR TAX FORM
(INVESTMENT EXPENSED); WAGES ON INDIVIDUAL TAX
FORM.

The Kennedy and Reagan Tax Cuts

The Kennedy rate cuts were roughly the same percentage rate reductions across the board, but rewards rose most where rates were highest:

➤ **Top tax rate cut from 91% to 70%.**

After-tax reward rose from 9% to 30%, up 230%.

➤ **Bottom tax rate cut from 20% to 14%.**

After-tax reward rose from 80% to 86%, up 7.5%.

Similarly for the Reagan Tax cuts:

➤ **Top tax rate cut from 70% to 50%.**

After-tax reward rose from 30% to 50%, up 67%.

➤ **Bottom tax rate cut from 14% to 11%.**

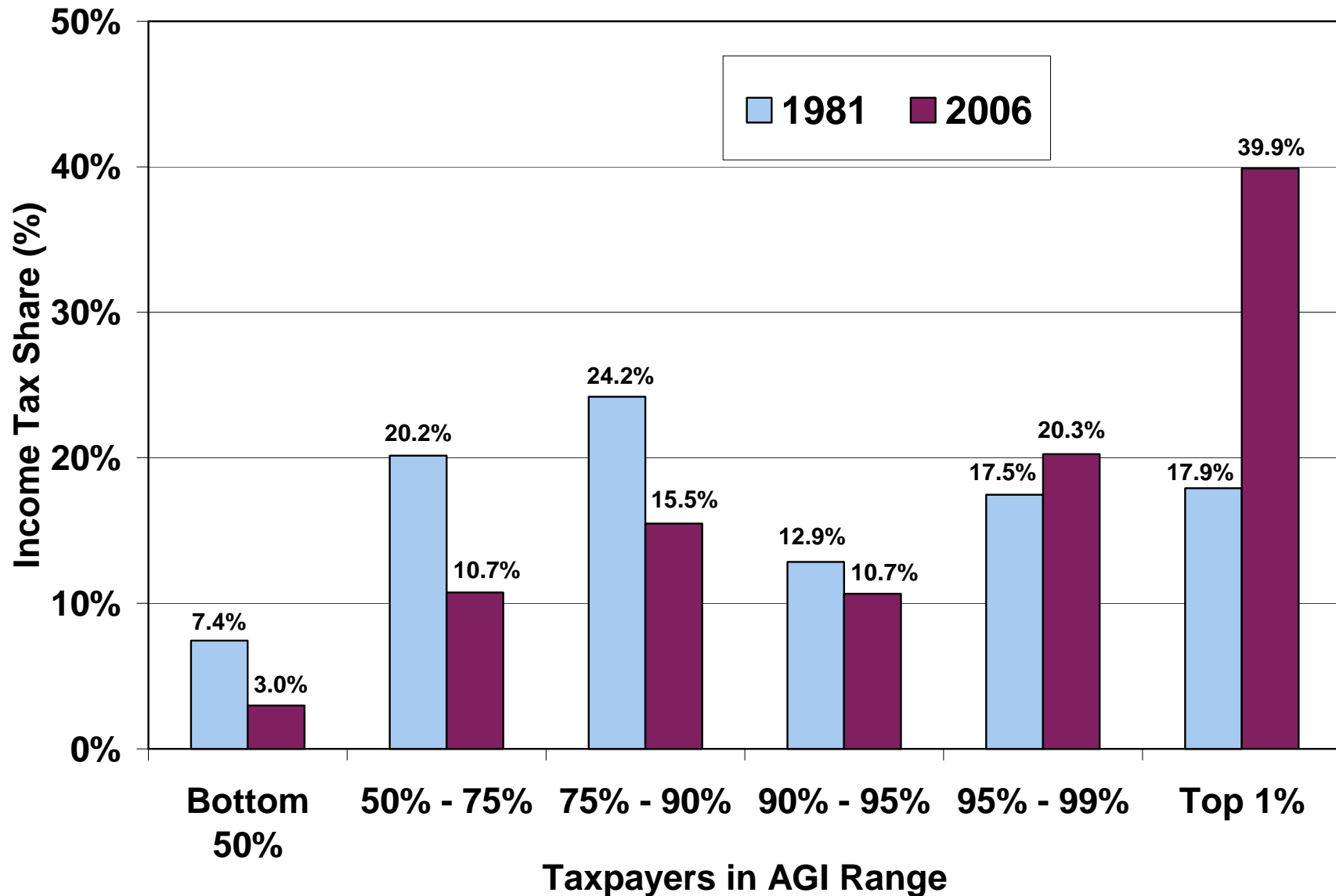
After-tax reward rose from 86% to 89%, up 3.5%.

In both cases, a greater response by upper-income taxpayers raised the total share of taxes they paid.

The Kennedy and Reagan Tax Cuts, cont.

- **Kennedy also cut the corporate tax rate, introduced the ITC, and accelerated depreciation.**
- **Reagan (1981) also accelerated depreciation, increased the ITC, and enhanced saving incentives.**
- **Both altered business taxes as well as individual tax rates.**

While Marginal Tax Rates Have Fallen, High Earners' Income Tax Shares Have Risen



Marginal Individual Income Tax Rates Under Old Law And 2001 / 2003 Tax Acts

1986 Tax Reform Act*	1990 Tax Act	1993 Tax Act	2001 / 2003 Tax Acts			If Congress Lets Tax Cuts Sunset
			1988 - 1990	1991 - 1992	1993 - 2000	
---	---	---	10% [†]	10%	10%	---
15%	15%	15%	15%	15%	15%	15%
28%	28%	28%	27.5%	27%	25%	28%
33%**	31%	31%	30.5%	30%	28%	31%
28%	---	36%	35.5%	35%	33%	36%
---	---	39.6%	39.1%	38.6%	35%	39.6%

* 1986 Tax Reform Act had transition rate for 1987, fully effective in 1988.

** The 5% surtax recaptured the "benefit" of the initial 15% rate, creating the 33% "bubble"; marginal rate returned to 28% after taxpayer had lost all "benefit" from the 15% rate.

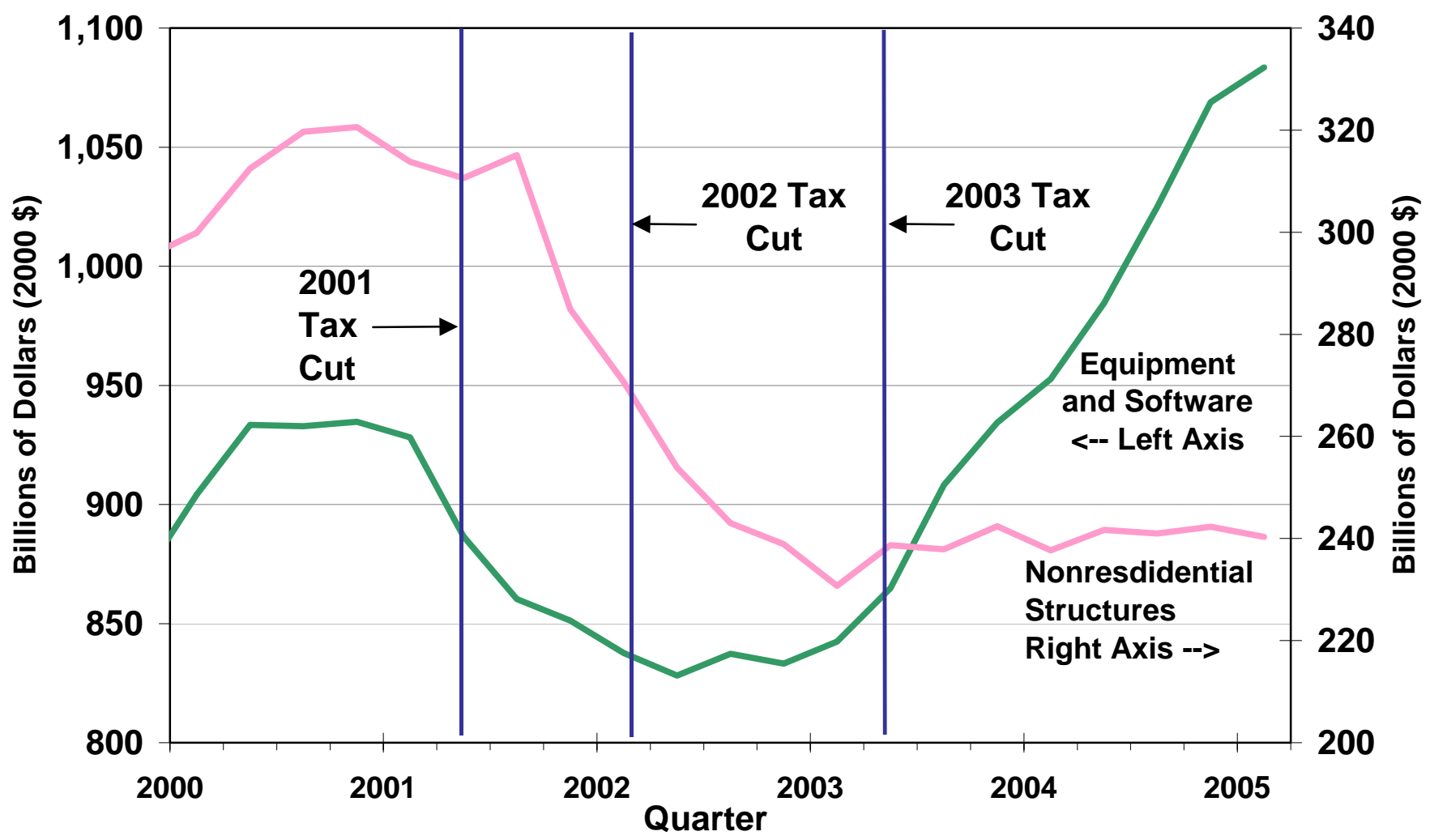
† Rebate in 2001 equivalent to 10% rate.

‡ 2001 / 2003 Tax Acts sunset at end of 2010. Old rates return in 2011 in the absence of further legislation.

Other 2001-2003 Tax Changes That Affect Growth

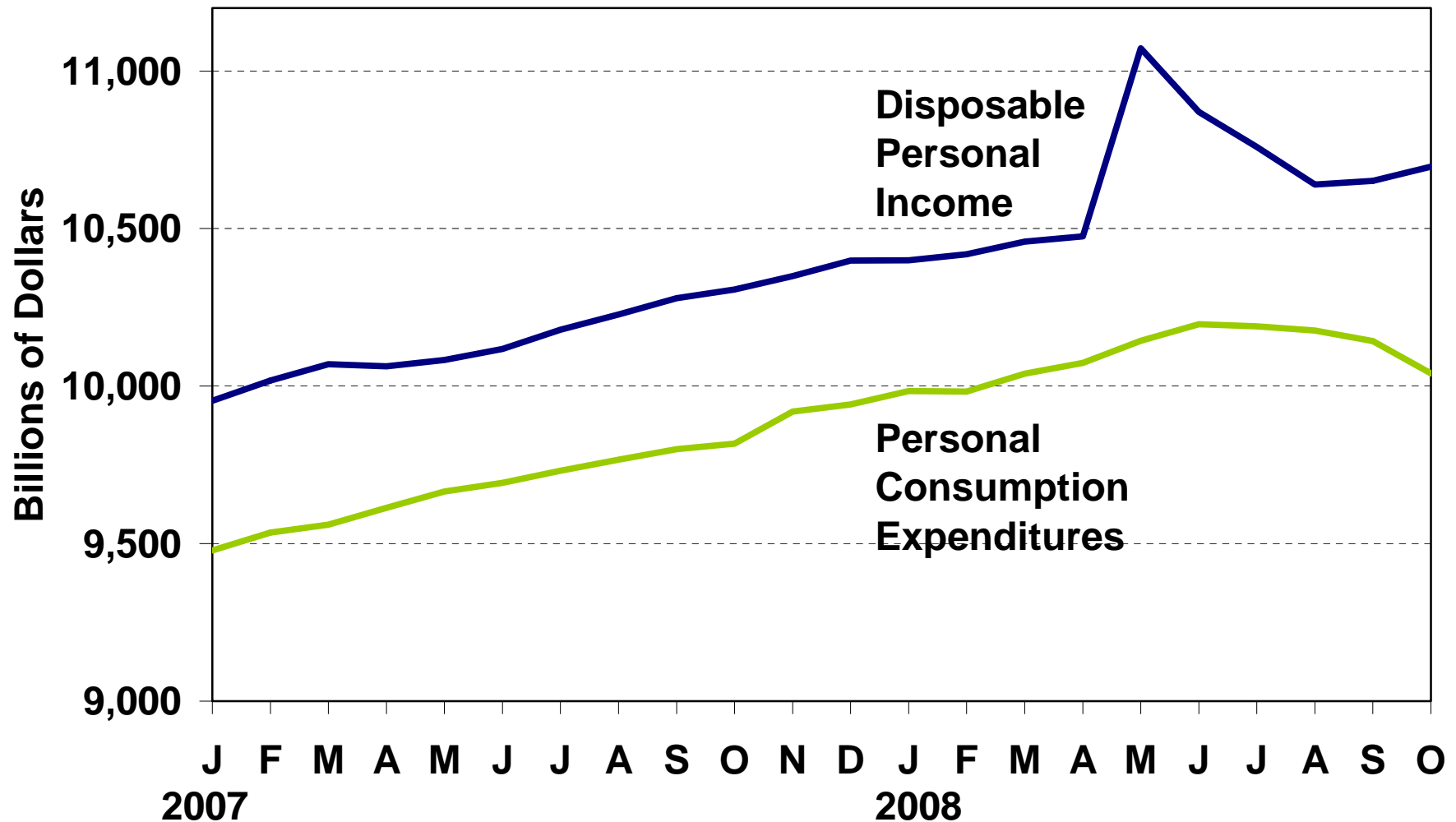
- Enhanced Saving Incentives (2001)
- Phase-Out Of Estate Tax (2001-2010)
- Reduction Of Tax Rates On Dividends And Capital Gains (2003)

Real Private Investment And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

Rebates Did Not Boost Consumption



Data Source: U.S. Bureau of Economic Analysis <<http://www.bea.gov>>. Based on John B. Taylor, "Why Permanent Tax Cuts Are the Best Stimulus," Wall Street Journal, Nov. 25, 2008.

Interim Steps -- What Works And What Doesn't

- **Pro-Growth Tax Provisions:**
 - End/Reduce Death Tax
 - Augment Expensing (At The Margin)
 - Lower Cap Gains, Dividend Tax Rates
 - Lower Corporate Tax Rate
 - Expand IRAs, Pensions (At The Margin)
 - Lower Marginal Personal Tax Rates (Especially In Top Brackets)

- **Social Tax Cuts:**
 - They Have Their Role, But Do Not Create Jobs
Or Boost Investment, Wages, Or Output.
 - E.g. Child Credits, Personal Exemptions, Standard Deductions.

Don't Meddle, Don't Distort

- **Distorting Provisions Hurt:**
Targeted Credits/Taxes That Favor Or Penalize One Activity Over Another
Grow One Area But Shrink Another, And Reduce Total Output And Welfare. e.g., Green Credits, Excises, Housing Breaks.

- **You Can't Raise GDP, Income, And The National Welfare By Making People Do Things The Hard Way.** e.g., Locking Up Cheap Energy And Favoring Sources That Cost More And Deliver Less.

Recovery Assignments: Who Does What?

- Never Rely On The Federal Reserve To Create Real Growth With Easy Money.
- The Best The Fed Can Do For Growth Is Focus On Price Stability, Because Inflation Raises Taxes On Investment And Kills Growth Of Jobs And Output.
- It Is The Job Of Congress To Aid The Growth Of The Real Economy. That Is Best Done By Curbing Government, Leaving Productive Resources For Private Sector Uses.
- Tax Rates And Regulations That Drive Up Costs Are Barriers To Production And Hiring That Must Be Kept Under Control.

Final Thoughts

- People who do not learn from history are condemned to repeat it.
- When governments do not learn from history, the people are condemned to repeat it.
- Economics is not the dismal science, if you have a morbid sense of humor.

Final Thoughts, cont.

- There is hope: we have in the past, and we can again, adopt policies that set the people free to flourish and prosper.
- We even know what those policies are.
- They do not require sacrifice by the people.
- They require sacrifice by Washington.