IRET Institute For Research On The Economics Of Taxation

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The U.S. Economy and Middle-Class Tax Relief

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Mr. Chairman, Members of the Committee, I am pleased to have the opportunity to appear here today to discuss basic issues of tax and fiscal policy with which the Committee must be concerned. The views expressed in this discussion are my own, not necessarily those of IRET, its board of directors, or contributors.

You have asked the witnesses invited here today to address the questions of how to alter the tax code to promote growth in the short run and the long run, and to furnish middle income tax relief. You have also inquired about how to increase the low U.S. saving rate and about the relationship between the budget deficit and saving and between the deficit and the government's ability to adopt a counter-cyclical or pro-growth program.

In seeking answers to these questions, the Committee should focus on reducing the costs imposed by the tax system on businesses and households. The guide to this effort should be to remove impediments to growth, competitiveness, and efficiency cast up by tax provisions that distort market signals

Quick fixes vs. Long-Run Growth

Much of the current economic policy discussion focuses on things to do to stimulate the economy in the short run and other things to do to promote long-term growth, as if there were two separate policy agendas. In fact, there are not two distinct species of tax policies that work in different time horizons. Good policy will provide a tax climate which least blunts incentives to undertake growth-generating activities. This is the very thing that is needed to get the economy moving now to a higher growth path.

A tax policy is either of the variety that is pro-growth, or it is not. Pro-growth tax policies enhance the reward to work, saving, and investment. Policies that promote long term growth also promote short term growth.

Any <u>permanent</u> tax change is likely to have the same effect on the economy in the short term as it will have in the long term, at least in direction if not in quantity. That is, whatever the tax change does, for good or ill, will begin to reveal itself in the near term.

In contrast, policies that are designed to work only in the short term are unlikely to work at all. Such policies are generally aimed at stimulating short-run spending rather than creating permanent incentives to supply capital and labor to the market.

Any tax change that is <u>purely temporary</u> will have only temporary effects, if any at all. A case in point is the President's rather feeble proposal to advance 15 percent of existing capital recovery allowances to the first year of an asset's life, but only for the next eleven months. It may accelerate currently-planned investment, but will do so only by borrowing against next year's investment spending, and will do nothing to increase the capital stock for the long term.

Another such case is the President's proposal to decrease tax withholding without actually reducing the eventual tax liability. This will put money into some people's hands in the short run. But it will <u>simultaneously</u> take money out of the hands of those who buy the additional Treasury bills that the government will have to issue in the short run to cover the revenue shortfall. No increase in disposable income available for <u>private</u> spending will result, not even in the short run. For the same reason, the proposed cut in withholding will produce no increase in aggregate demand. Think ahead to next year when taxpayers would have to give the money back in the form of a smaller rebate or a larger final tax payment.

Even a <u>permanent</u> tax reduction, if it doesn't reduce the cost of productive effort, would have no effect in expanding aggregate demand. Unless government spending were cut to match, the added disposable income of the tax-cut recipients would be offset by a reduction in the disposable funds of those who buy the bonds the Treasury would have to issue, or by a reduction in the disposable income of those whose taxes would be raised to recover the lost revenue.

To promote growth, tax changes must free up incentives.

The only tax changes that promote growth are those that increase the reward for growth-generating activities -- working, saving, investing, innovating, entrepreneurship -- relative to the payoff for non-growth activities of consumption and leisure. Policies aimed at pumping up consumption are not good for the economy in the short term because they are simply ineffective. Any pump-priming exercise that does not first stimulate supply will fail to stimulate demand. Conversely, any policy which encourages people to increase the labor, capital, and entrepreneurial services they put to work in the market will increase demand as well as supply. When the workers and the owners of the machines used to produce goods and services are paid what they contribute to output, they are paid enough to purchase their own output. Demand and supply rise together.

The Economic Recovery Tax Act of 1981 was specifically designed to promote long term growth. In doing so, it also promoted rapid recovery from the recession. ERTA provided marginal tax rate reductions for individuals, lowering the cost of labor to employers and raising employees' after-tax wages for additional work. The individual rate cuts also reduced taxation of income from saving and capital gains, thereby lowering the cost of capital. The increase in the investment tax credit and the Accelerated Cost Recovery System enacted in ERTA provided additional reductions in the cost of capital and further encouraged capital formation. With the cost of labor and capital reduced, the economy enjoyed a long, strong investment-led recovery from the 1980-1982 recessionary period in which close to 18 million additional jobs were created and the employment-population ratio reached record levels.

Tax disincentives have helped to bring the expansion to a halt.

Unfortunately, these growth incentives did not last. The marginal tax rate on much of the labor force has been increased in recent years by rising payroll tax rates and sharp increases in the taxable wage base. The rising tax burden has raised the cost of labor, reduced employment, and made it harder for American businesses to compete in the world economy. The reduction in the cost of capital for machinery and equipment enacted in 1981 was partially repealed in TEFRA (1982). This capital cost was further increased by the repeal of the ITC and the modification of ACRS in the 1986 Tax Reform Act which also greatly increased the cost of capital invested in structures. The 1986 Act also raised the tax rate on capital gains, and limited the deductibility of so-called passive investment losses. The combined effect of these changes was to increase enormously the cost of capital invested in real estate, precipitating the S and L crisis that has accentuated the economic downturn. The Alternative Minimum Tax, also enacted in TEFRA, has had a devastating impact on capital formation. AMT is an excise on business growth and cruel and unusual punishment for loss businesses. These tax policy errors were major contributing factors in bringing us to our present state.

A new round of growth incentives is needed.

The policy errors of recent years have erected serious obstacles to capital formation and employment. They will not be overcome by measures which seek temporarily to stimulate consumer spending. They can only be reversed by permanent repeal or amendment.

<u>To reduce the cost of labor</u>, the Committee should move to cut the payroll tax rate, with no offsetting increases in the taxable wage base or in other tax rates. If unwarranted fear of reducing the Social Security Trust Funds is a barrier to this highly constructive action, the Committee should consider instead a refundable tax credit of 15 percent of the employees' share of the payroll tax against the income tax, without income limits. Either tax change would reduce the tax burden on additional earnings of low- and middle-income workers "at the margin", raising the incentive to earn additional income by offering additional labor services to the market. In neither case should any tax be increased to pay for the tax reduction. There is no point in improving work incentives for some people while worsening them for others.

<u>To reduce the cost of capital</u>, a wide range of tax changes would be desirable. The existing tax system raises the cost of capital relative to consumption and relative to labor by taxing income that is saved and invested and again taxing the earnings produced by the capital, sometimes several times over. The Committee should give high priority to reducing the tax biases against saving and capital formation.

A major step would be to <u>improve capital consumption allowances.</u> The ideal (neutral) depreciation system is first-year write-off (expensing). Anything less results in excess taxation of the amounts invested in capital assets. The Committee should adopt some version of the neutral cost recovery system, which provides depreciation deductions, spread out over a number of years, that are equal in present value to expensing with far less initial drain on federal tax revenues. This enhanced depreciation should be available to all businesses, including those ensnared by the AMT. NCRS would lower the cost of capital invested in depreciable property in the United States, raise the level of capital formation, and enhance productivity, real wages, and employment.

Another major step is to <u>reduce the taxation of capital gains.</u> The Committee should move to cut the capital gains tax rate without imposing lengthy or complex holding periods and index the basis of capital assets for inflation. The purpose of capital gains tax relief is to lower the cost of capital and spur saving and investment. The cleaner and deeper the cut in the tax rate, the greater will be the reduction in the cost of capital, and the greater the increase in investment, productivity, and wages.

Tax fairness demands a rate reduction. A tax on capital gains is a form of double taxation. The really fair rate is zero. Most capital assets are purchased out of after-tax income;

the income used to purchase these assets has already been taxed. If the assets are shares of corporate stock, the corporate earnings attributable to those shares are subject to the corporate income tax, a second layer of income tax. If the company retains some of its after-tax earnings, its net worth rises, and so does the market value of its stock. If the shareholder sells his shares at this increased price, the capital gain he realized is subject to the capital gains tax -- a third layer of tax, only a little less than the tax imposed on dividends.

Income earned by investment of the retained corporate earnings will itself be subject to corporate income tax, another layer of tax. The rise in the company's anticipated after-tax future earnings will increase the share price today. To tax this increase in the share price today, if realized as a capital gain by the shareholder's sale of his shares, is to tax an increase in stock values that is merely the discounted value of the future after-tax corporate earnings, i.e., to lay on another tier of tax.

The Committee should repeal or modify the AMT. The AMT imposes a double whammy tax on companies that are heavily dependent on depreciable capital in their production activities. When such a company adds to its stock of such property, its depreciation deductions as computed for ordinary tax purposes increase much more rapidly than the highly limited deductions allowed for AMT purposes. This growth-generating investment pushes the company into paying the higher AMT. If the company's earnings fall in the next few years, because of recession or other economic reverse, its regular income tax liability may well be zero while its AMT liability remains steep because of difference between depreciation allowed for regular tax and for AMT purposes.

Perhaps the most productive of the President's recommendations in the State of the Union Address was the recommendation that ordinary Modified Accelerated Cost Recovery System schedules be substituted for the depreciation rules in the AMT. This would effectively eliminate the "accelerated" portion of depreciation as a preference item in the AMT. Without this measure, the large segment of U.S. industry that is subject to the AMT would experience no reduction in the cost of capital, and no incentive to add to its investment, from virtually any other type of incentive under consideration.

Other changes are needed. Many other features of the tax code, especially some of the ill-advised changes made in the TRA86 Reform Act, should be amended or repealed. These include the 1986 alterations in the tax treatment of foreign source income and the restrictions on the deduction of so-called "passive investment losses," that have been particularly damaging to real estate investment. Saving incentives, such as restoration and expansion of IRA deductions, or variants on that program, should be adopted. The Committee should move toward true integration of the corporate and individual income taxes.

Middle-income tax relief

The most effective way to provide tax relief to middle-income people is to reduce tax and other policy barriers to economic growth. The reduction of the payroll tax and the payroll tax credit alternative, described above, are would not only reduce taxes for most taxpayers but would provide the added advantage of promoting employment and growth. Such growth-oriented tax changes should be adopted in lieu of some of the blatantly redistributionist schemes that have been floated in recent weeks under the label of "pro-family" tax relief.

Tax policy should focus on easing the burden on growth, not on redistributing the existing economic pie. Redistribution is a less-than-zero-sum game, because the tax disincentives that accompany it shrink the pie.

Family-oriented middle income tax relief has become a major issue in the current tax debate. The best thing that can be done for middle-income families, for low-income families, for upper-income families, for the elderly, and for single people of all incomes, is to promote growth. Families do not need a $300 or $800 handout. They need greatly expanded job opportunities and the prospect of rising productivity and rising real wages that will lift their incomes year after year, not just between now and the next election.

The years 1979 to 1982 were a time of inadequate investment, declining productivity, and falling real wages and family income. The investment-led economic expansion that began in 1982 reversed these trends, and from 1982 through 1989 lifted employment and real family incomes at all levels of the income distribution.

Tax changes that expand job opportunities are very pro-family. Unfortunately, under the welfare laws of many states, unemployed fathers or fathers stuck in low-paying jobs can best benefit their children by deserting them. It is time to increase the rate of investment to boost labor productivity, the number of jobs and the pre-tax wage, and to reduce the taxes on labor to boost the share of that wage kept by the worker.

A single-person household has at most one potential jobholder. A married couple has two potential workers. A family with teenage or college-age children has three or more potential workers. Which household has the most to gain from a stronger labor market?

Income redistribution will not generate jobs. A case in point is the President’s proposal to increase the personal exemption for children by $500. This will put money into the hands of those below a certain income level with children, but take money out of the hands of others. Such a plan provides no boost for the economy, no incentive effects that would increase work effort, saving, investment, or output. There would be no stimulus to "demand" and no increase in employment, investment, total output, or total income.

The question of the deficit.

The deficit is not an obstacle to pro-growth tax changes, except insofar as the 1991 budget agreement makes it so. That agreement should be amended to allow for the tax changes needed to restore incentives and growth.

Without growth, it will be immeasurably more difficult to bring the budget under control. The President's budget document shows how great the slippage in the budget has been between last year and this as a result of the weak economy. Growth-oriented tax reduction will recover much of its cost by raising the GNP. But even if it fails to recover all of its cost in revenue growth, the gains in GNP will far exceed any increase in the deficit, and will diminish the need for income support, unemployment relief, and other federal outlays. Any remaining budget gap could and should be closed by restraining spending growth.

The claim is often made that we cannot afford tax reduction because the deficit will increase, and this will reduce national saving, drive up interest rates, and reduce growth. This argument is specious.

The deficit is not the channel through which fiscal policy affects growth. The only way that deficit reduction can be said to increase growth is if it comes through government spending restraint. Government spending diverts productive resources to government use whether it is paid for by taxing or by borrowing. It raises the costs confronting households and businesses in pursuit of their income-producing activities. Spending restraint releases the manpower and physical resources needed for other uses, including investment. If investment is an attractive use for the released resources, investment will rise.

National saving is the use of current income to acquire assets that produce more income in the future — that is, investment in expanding the GNP. Taxes are not a part of national saving. They are a means of paying for government spending, which seldom has anything to do with investment in income-producing economic capacity.

When taxes are raised in the name of deficit reduction, they are usually spent. Even when they are applied to deficit reduction, they do not increase national saving. A reduction in the deficit does reduce federal borrowing, but tax increases reduce private saving, usually dollar for dollar, very likely more. Raising taxes to reduce the deficit does not increase the amount of private saving available for private investment. Instead, tax increases frequently reduce the incentive to invest and to save, reducing both.

People are not quick to change their spending habits, and changes in personal taxes are offset by changes in personal saving. In the case of corporate tax changes, there is an immediate offset through changes in capital consumption allowances and retained earnings, which constitute corporate saving.

Conclusion.

Each year that the tax code retains its anti-growth bias, the economy will underperform its potential. Each year, individuals and families will experience thousands of dollars in lost income. Employment and wages will be lower than otherwise, and opportunities for people to better their economic condition will be fewer than otherwise. The country would be best served by a bold program of permanent pro-growth tax changes, carefully designed to ease tax barriers against working, saving, and investing. Tax changes designed simply to pump up spending in the short term, or to redistribute a fixed or shrinking economic pie from one group to another, should be avoided.

I have appended to this discussion my suggestions for a pro-growth, pro-competitiveness, pro-efficiency tax agenda. With the Committee's permission, I would like to have this material included in the record.