tax break

by William G. Gale and Peter R. Orszag

The President's Tax Proposal: Second Thoughts

William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution. Peter R. Orszag is the Joseph A. Pechman Senior Fellow at Brookings. The authors thank David Gunter for outstanding research assistance, Len Burman, Robert Cumby, Joel Friedman, and Robert Greenstein for helpful comments, and Jeff Rohaly and Matt Hall for programming the analyses that are used extensively in this article. The views expressed are the authors' and should not be attributed to the trustees, officers, or staff of the Brookings Institution.

On January 7, 2003, President Bush proposed a new package of tax cuts, consisting primarily of a new tax cut for dividends and capital gains on corporate stock and an acceleration of most but not all of the provisions of the 2001 tax cut that were scheduled to take effect in future years.[1] In the last two weeks, this column provided initial reactions to the package and a more focused examination of the proposal to cut taxes on dividends and capital gains. This week, we build on these findings and focus on four broad aspects of the plan:

- Budget effects

The new package will cost at least $925 billion (including debt service) through 2013. The long-term cost exceeds one-quarter of the 75-year actuarial deficit in Social Security. The new proposal, in combination with AMT reform and making the 2001 tax cut permanent, would reduce revenues by between two and three times the size of the actuarial deficit in Social Security over the next 75 years.

- Distributional effects

The proposed tax cuts would make the federal tax system more regressive. The percentage increase in after-tax income is higher for those with higher incomes. The share of the tax cut received by households in the top 1 percent significantly exceeds the share of federal taxes they are slated to pay under current law in 2003. By 2010, the share of the tax cut going to the top 1 percent is almost double the share of all federal taxes they would pay under current law. The tax cut becomes more regressive over time because the main permanent feature of the tax cut — the change in taxation of dividends and capital gains — is regressive. Most of the other items are temporary. In 2003, the package would provide a tax cut of $100 or less to almost one-half of tax filers, while providing an average tax break of $90,222 to those with more than $1 million in income.

- Economic effects

According to the administration's own analysis, the proposals would have a negligible effect on economic activity during 2003. In the short term, the plan would have only a modest impact because it is not targeted at boosting demand for goods and services; in the long term, any positive effects on corporate activity would be offset substantially or completely by the expansion in the budget deficit and associated reduction in national saving, and reductions in noncorporate activity.

- Corporate tax reform

The dividend exclusion proposal would fail to achieve the goal of taxing all corporate income once and only once. It would not address the portion of corporate income that is received by nontaxable shareholders. It would also undermine the political viability of true corporate tax reform and create costly new loopholes in the tax code.

I. Tax Cuts and the Budget

Large tax cuts should be evaluated in the broader context of the federal budget. In 2001, the Bush administration pushed ahead on its tax cut plans even before it formulated or submitted a budget. Given the rapid and massive deterioration in fiscal prospects and the collapse of the budget process since then, one might have expected any tax cut in 2003 to be proposed as part of an overall budget plan. Instead, the administration once again has proposed a substantial tax cut without providing the appropriate budgetary context or any realistic explanation of how it would be financed.

The new tax proposal is just one of many tax cuts that the administration has embraced. In addition to the 2001 tax cut (which sunsets in 2010), the administration has advocated making the 2001 tax cut permanent and has acknowledged the need to address the looming alternative minimum tax problem.

As shown in Table 1, enacting all of these proposals (not including the 2001 tax cut) would cost in excess of $2 trillion through 2013. These estimates do not take into account a Medicare prescription drug benefit,

[1]"Taking Action to Strengthen America's Economy," Chicago, Illinois, January 7, 2003, available at http://www.whitehouse.gov.

Table 1: Costs of Administration Tax Proposals (in addition to enacted 2001 tax cut)			
FY 2003-2013	Revenue Cost	Debt Service	Total
New administration proposal*	$674 billion	$250 billion	$924 billion
Remove sunset on 2001 tax legislation**	$680 billion	$55 billion	$735 billion
AMT reform (estimate)***	$500 billion	$75 billion	$575 billion
Total****	$1854 billion	$380 billion	$2234 billion

*See Richard Kogan, "Total Cost of Bush Growth Plan Extends $900 Billion," Center on Budget and Policy Priorities, Jan. 9, 2003.
**Does not incorporate interactions between new dividend proposal and cost of removing the 2001 sunset.
*** Based on estimate from Leonard E. Burman, William G. Gale, Jeff Rohaly, and Benjamin H. Harris, "The Individual AMT: Problems and Potential Solutions," Urban-Brookings Tax Policy Center, September 2002.
**** Does not include Medicare prescription drug benefit, discretionary spending adjustment, Social Security reform, or other possible costs.

higher real discretionary spending (including for defense and homeland security), or Social Security reform.

In evaluating these budget costs, it is important to appreciate the scale of the budget difficulties already facing the nation. The aging of the baby boomers and lengthening lifespans generally will place increasing pressure on the federal budget in years to come.[2] The revenue loss from the new proposal in 2012 would amount to 0.3 percent of GDP. Saving that amount of revenue (relative to GDP) over the next 75 years would address more than 40 percent of the actuarial deficit in Social Security.

Combined with the cost of making the 2001 tax cut permanent, the total tax cuts proposed by the administration amount to between two and three times the actuarial deficit in Social Security over the next 75 years (see Table 2).

II. Distributional Effects and Fairness Issues

A. Progressivity and Vertical Equity

The tax proposals would widen the after-tax inequality of income in the United States. The most insightful metric for measuring the progressivity or regressivity of a tax cut is its effect on the distribution of after-tax income. Table 3 shows that under the administration's plan, high-income households would experience a larger percentage increase in after-tax income than low-income households. The implication is that inequality in the after-tax distribution of income would widen.

In contrast, the administration compares the allocation of the tax cut in 2003 to the allocation of income tax payments in 2003. This comparison is misleading for two reasons. First, the income tax is one of the more progressive federal taxes. In 2003, for example, the top 1 percent of tax filers would pay 36.7 percent of income taxes under current law, but only 24.8 percent of all federal taxes in the absence of the administration's proposal (Table 3). Since the top 1 percent would receive 28.8 percent of the administration's proposed tax cut in 2003, it would receive a larger share of the tax cut than its share of all federal taxes paid. As a result, the share of total federal taxes paid by the top 1 percent would decline if the administration's proposal were enacted. The administration reaches the opposite conclusion only by misleadingly excluding federal taxes other than the income tax.

Second, the administration's proposal becomes more regressive over time, since the provisions primarily affecting the middle class are overwhelmingly temporary (reflecting merely the acceleration of several provisions from the 2001 tax cut), whereas the major provision primarily affecting higher earners (the dividend tax proposal) would be permanent. For example, in 2010, the top 1 percent of tax filers would enjoy 44 percent of the tax cut — almost twice their share of federal taxes paid and substantially more than their share of income taxes paid (Table 3).

The administration and other tax cut advocates also like to look at the *percentage* reduction in *income* taxes.[3] This is a particularly misleading measure of who benefits from the tax cut. A taxpayer with $30,000 in income whose income tax liability is cut from $1 to zero is considered to have a 100 percent cut in taxes, whereas a taxpayer with $100 million in income whose liability is cut from $10 million to $1 million gets "only" a 90 percent tax cut by this measure. Again, examining the distribution of changes in after-tax income is more insightful: In this example, the individual with $30,000 in income would experience a 0.003 percent increase in after-tax income ($30,000 / $29,999), whereas the in-

[2]The Congressional Budget Office projects that federal expenditures on Social Security, Medicare, and Medicaid will rise from about 9 percent of GDP in 2012 to 15 percent by 2040 and 21 percent by 2075, the last year of the long-term projections. Congressional Budget Office, "A 125-Year Picture of the Federal Government's Share of the Economy, 1950-2075." Long-Range Fiscal Policy Brief, revised July 3, 2002. By way of comparison, *total* federal spending averaged 20 percent of GDP over the last 40 years and was 18.4 percent of GDP in 2001.

[3]*See* "Distribution Table for the President's Growth Package," Department of Treasury, January 5, 2003; and "Lucky Duckies Again," *The Wall Street Journal*, Jan. 20, 2003, p. A14.

Table 2: Costs of Administration Tax Proposals	
	As percent of GDP, in present value, over next 75 years
Cost of new administration tax cut proposal	0.3*
Cost of 2001 tax cut if made permanent	1.5-1.9**
Total cost	1.7-2.1
Social Security actuarial deficit***	0.72

* The precise figure will depend on details of the proposal.
** Based on Auerbach, Gale, Orszag, and Potter (forthcoming). The range in estimates reflects different assumptions about whether the alternative minimum tax is adjusted.
*** Social Security Trustees Report is available at http://www.ssa.gov/OACT/pubs.html. See Table VI.E5 on page 164 of the Trustees Report, dated March 26, 2002.

dividual with $100 million in income would experience a 10.0 percent increase in after-tax income ($99 million/$90 million).

B. Other Ways of Slicing the Data

A variety of other distributional issues are worth mentioning. Many administration officials have been advertising the package as providing an average tax cut of $1,083, suggesting to many Americans that they would receive a tax cut of this size.[4] In fact, under the administration's proposal, 78.4 percent of income tax filers and 71.1 percent of income tax payers would receive less than $1,000 (see Table 4). By way of contrast, the average tax cut in 2003 for those filers earning more than $1 million would amount to $90,222.

In addition, the White House claims that the proposed tax cut will provide benefits to "everyone who pays taxes — especially middle-income Americans."[5] This is simply false. Millions of households that pay payroll taxes but not income taxes will not benefit at all.

On a related note, the administration's claims about the effects of the tax cut on the elderly and small businesses would also be easy to misinterpret. The reality is:

- More than two-thirds of elderly tax filers (67.3 percent) would receive a tax cut of $500 or less.
- More than half (51.6 percent) of tax returns with small business income would receive a tax cut of $500 or less.[6]

Furthermore, the proposal would divert capital from the small business sector and put upward pressure on interest rates, which would increase the cost of capital for small businesses. The loss in revenue entailed by the proposal may also ultimately force reductions in government programs that disproportionately assist the elderly, as well as middle-income and lower-income families.

The administration has also advertised that a family with two children and income of $39,000 would receive a tax cut of $1,100. As a recent study pointed out, however, this carefully chosen example actually serves to show that the vast portion of the tax cut has nothing to do with middle-income families. Fully 76 percent of the tax cut over the next decade would provide no benefits to the family in question. Put differently, if the goal were to benefit this type of family, the costs could be reduced by three-quarters. Moreover, most of the benefits that go to this type of family are already scheduled to take place in future years, whereas the dividend tax cut is new and permanent.[7]

C. Is Double Taxation Unfair?

The president has claimed that double taxation of corporate profits is "unfair."[8] But is it? And if so, to whom? For purposes of this discussion, we assume that all corporate income really is taxed twice, even though, as discussed below, this assumption is false. (We also abstract from the relative level of taxation on different forms of income, which is much more important than the number of times a flow of income is taxed.)

The key to understanding the fairness issue is to compare the options available to an investor making a new investment. If she buys corporate stock, the profits will be taxed twice. If she buys a bond, the profits will only be taxed once. Why, then, would anyone buy a stock? The answer is that *asset market equilibrium requires that the purchase price of the stock adjust downward* to reflect the double taxation. That is, the investor is able to pay a lower price for the stock when it is subject to double taxation than if it were not. Moreover, the stock prices have to fall sufficiently so that after-tax returns, adjusted for risk, are equated between the stock and the bond. Thus, for a new investor, there is no fairness issue associated with double taxation.

[4] *See, e.g.,* "Taking Action to Strengthen America's Economy," Chicago, Illinois, January 7, 2003, available at http://www.whitehouse.gov.

[5] http://www.whitehouse.gov/infocus/economy.

[6] For further discussion of the effects on small businesses, see Andrew Lee, "President's Radio Address and Other Administration Statements Exaggerate Tax Plan's Impact on Small Businesses," Center on Budget and Policy Priorities, January 18, 2003.

[7] Andrew Lee and Isaac Shapiro, "President's Own Example Shows Bulk of Tax Package Irrelevant to Middle-Income Americans," Center on Budget and Policy Priorities, January 13, 2003.

[8] "President's Radio Address to the Nation," January 11, 2003, http://www.usnewswire.com/topnews/ qtr1_2003/0111-109.html.

Table 3: Distributional Implications of Administration Proposals					
	Share of income taxes paid, 2003	**Share of total federal taxes paid, 2003**	**Share of administration tax cut, 2003**	**Share of administration tax cut, 2010**	**Change in after-tax income, 2003**
Bottom 80 percent	16.8%	30.5%	21.3%	15.5%	+1.0%
Top 1 percent	36.7%	24.8%	28.8%	44.2%	+3.7%
Source: Urban-Brookings Tax Policy Center and author's calculations.					

Table 4: Size of Tax Cut Under Administration's Proposal		
Size of tax cut received, 2003	**Percent of income tax payers**	**Percent of income tax return filers**
$100 or less	37.5%	49.3%
$500 or less	60.0%	68.6%
$1,000 or less	71.1%	78.4%
Source: Urban-Brookings Tax Policy Center and author's calculations.		

For someone who currently owns stock, there is also no fairness issue as long as the person bought the stock when the corporate income tax already existed.

III. Effects on the Economy

In releasing his proposals, President Bush stated: "This growth and jobs package is essential in the short run; it's an immediate boost to the economy." The proposals " . . . are essential for the long run, as well — to lay the groundwork for future growth and future prosperity."[9]

In the short run, the key economic difficulty is that the nation is not fully using the capacity it has available to produce goods and services. In December 2002, the capacity usage rate computed by the Federal Reserve Board of Governors was 75.4 percent, significantly below its average of 81.5 percent for the past three decades.[10] The primary macroeconomic issue in the short run is therefore to boost demand for the goods and services that firms could produce given current capacity. From that perspective, the administration's package is poorly designed, since it fails to target the middle-class and lower-income families who would be more likely to spend any tax cut. According to data from the Tax Policy Center, the 69 percent of tax filers with incomes below $50,000 would receive just 13 percent of the total tax cut in 2003 under the administration's plan.[11]

In the long run, the key to economic growth is to expand the capacity of the nation to produce goods and services. That capacity, in turn, depends on national saving. Yet the administration's plan will expand the budget deficit, which will have the effect of *reducing* national saving. Only if the economic benefits of the policy changes generating the deficits *more than offset* the losses imposed by reduced national saving would the net effect be positive.

The only study of which we are aware that has examined the net effect of the new proposal (including the adverse effect on national saving) was undertaken by Macroeconomic Advisers.[12] The major conclusions include:

- The plan would have no effect on average GDP between 2003 and 2007.
- Employment would grow by an average of just 21,000 jobs per year over the next five years.
- The yield on 10-year Treasury notes would rise by 23 basis points by 2004 and by about 50 basis points by 2007; and
- In the long term, productivity would *fall* and the cost of capital would *rise*, due to the effects of increased deficits on national saving and interest rates.

It is worth emphasizing that the plan's main effects on growth are likely to occur through its effect on the capital stock. The plan will help allocate an existing amount of investment more efficiently across sectors (although more significant corporate tax reforms would do an even better job in this regard), but by raising the deficit and reducing national savings, the plan is likely to reduce the total amount of capital owned by Americans. The impact on corporate investment will be muted to the extent that interest rates rise and the extent to which investments tend to be financed with debt or retained earnings. Note also that to the extent the proposal would attract funds to the corporate sector, those funds may simply generate one-time windfall gains in corporate stock without affecting investment. In addition, to the extent that funds are channeled to the corporate sector, fewer funds may be available to finance investment by unincorporated

[9]"Taking Action to Strengthen America's Economy," Chicago, Illinois, January 7, 2003, available at http://www.whitehouse.gov.

[10]*See* http://www.federalreserve.gov/releases/G17/Current/default.htm.

[11]By contrast, the House Democratic stimulus plan would deliver 58 percent of its total tax cut to these filers.

[12]"A Preliminary Analysis of the President's Jobs and Growth Proposals," January 10, 2003, Macroeconomic Advisers, LLC, http://www.macroadvisers.com.

businesses and S corporations. To the extent that interest rates rise, investment in interest-sensitive sectors like housing may decline.

IV. Issues in Corporate Tax Reform

Most corporate income in the United States is not taxed twice. A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies, and other factors.[13] Recent evidence suggests growing use of corporate tax shelters.[14] Furthermore, half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and nonprofits.[15] Although data limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the nontaxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

The administration's proposal would have no effect on firms' incentives to shelter and retain earnings to the extent that firms are owned by nontaxable shareholders. To the extent that firms are held by taxable shareholders, the administration's proposal would reduce incentives to shelter somewhat, but firms would still maximize shareholders' after-tax returns by sheltering corporate income from taxation and then retaining the earnings — the same strategy that maximizes taxable shareholders' after-tax returns under current law. The proposal therefore does not eliminate, and may not even reduce to a significant degree, the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings.[16]

In addition, the administration's proposal may result in a variety of new tax shelters.

A partial dividend exclusion is not a solution to these problems either. It just reduces both the benefits and costs of the proposal. Proponents of the dividend exclusion often note that many European countries have partially or fully integrated their corporate and personal tax systems. However, it is also the case that several European countries have recently moved away from integrated systems.[17] In addition, the large share of corporate equities that are held by shareholders that are not subject to individual dividend and capital gains taxes appears to be much higher in the United States than in most European countries.

The approach proposed by the administration would also undermine the political viability of true corporate tax reform. Any such reform would have to combine the "carrot" of addressing the double taxation of dividends with the "stick" of closing corporate loopholes and preferential tax provisions. Burman (2003) and Gale and Orszag (2003) discuss modifications to the administration's proposal that would represent a more balanced approach to changing the system of taxing corporate income.[18]

[Correction: In last week's column, we noted the possibility that the adminstration's plan would create new opportunities for taxpayers to shelter assets. We also wrote down a specific example of how this might work, suggesting that people could gain under the proposed EDA system by creating companies that pay taxes at the lowest corporate tax rate of 15 percent and then paying the profits as dividends to the owner. Although it is clear that the new proposal will create opportunities for taxpayers to rearrange their financial affairs to minimize their taxes, our example was flawed — the specific loophole we thought we had identified does not exist given the structure of the adminstration's proposal.]

---

[13]Robert McIntyre, "Calculations of the Share of Corporate Profits Subject to Tax in 2002," January 2003.

[14]Mihir Desai, "The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation," NBER Working Paper 8866, April 2002.

[15]William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes,* Nov. 11, 2002, p. 839. Although taxes are due on pensions and 401(k) plans when the funds are paid out or withdrawn, the effective tax rate on the return to saving in such accounts is typically zero or negative because the present value of the tax saving due to the deduction that accompanies the original contribution is typically at least as large as the present value of the tax liability that accompanies the withdrawal. Also note that a substantial share of capital gains on corporate stocks is never taxed because of the basis step-up at death.

[16]Modifying the administration's proposal to achieve true tax reform — which would tax corporate income once and only once at a nonpreferential rate and eliminate the incentives for corporate tax sheltering as well as double taxation — would require taxing dividends and accruing capital gains at the full corporate tax rate to the extent such capital gains or dividends reflected income not already taxed at the corporate level. The implication is that for the administration's proposal to achieve its ostensible goals, it would have to be modified to include an increase in the effective marginal tax rate on dividends and an increase in the effective tax rate on accruing capital gains. *See* William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes,* Jan. 20, 2003, p. 415.

[17]Reuven Avi-Yonah, "Back to the 1930s? The Shaky Case for Exempting Dividends," *Tax Notes,* Dec. 23, 2002, p. 1599.

[18]Leonard E. Burman, "Taxing Capital Income Once," Urban-Brookings Tax Policy Center, January 2003; Gale and Orszag, note 21 *supra.*