tax break

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Thinking Through the Tax Options

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I. Introduction

In January, President Bush proposed a set of tax cuts in his "Growth and Jobs" package that would reduce revenues by an estimated $726 billion over the next decade. On May 9, the House of Representatives passed a $550 billion version of the package and, on May 8, the Senate Finance Committee approved a package of tax cuts, expenditure increases, and offsetting revenue increases with a net cost of $350 billion. All three proposals would accelerate some provisions of the 2001 tax cut and — in different ways — reduce individual taxes on dividends. The first two proposals would also reduce taxes on capital gains. This column evaluates these proposals and considers alternatives.

> ***Our overarching conclusion is that the administration, House, and Senate Finance Committee proposals are seriously flawed and are strikingly removed from the economy's current and long-term problems.***

Our overarching conclusion is that the administration, House, and Senate Finance Committee proposals are seriously flawed and are strikingly removed from the economy's current and long-term problems. Although each of the proposals would provide a short-term economic boost, almost any increase in government spending or cut in tax revenues would stimulate a sluggish economy (assuming the Federal Reserve cooperates). The three proposals on the table, though, would provide their stimulus at an unnecessarily high cost: They would reduce long-term growth, exacerbate looming budget problems, and impose significant burdens on future generations. In addition, they would be regressive and would not only fail to meet their ostensible goal of integrating the personal and corporate taxes, but could also open up new sheltering activity. Better alternatives would include substantial aid to the states, an extension of unemployment insurance benefits, and reform of the alternative minimum tax (AMT). Our specific findings include:

- **Revenue effects:** Due to budget gimmicks, the official revenue estimates understate the likely costs. If the tax cuts in the House plan other than the acceleration of the 2001 tax cuts were made permanent, the 10-year cost would be about $1.6 trillion. The long-term costs would amount to about 0.5 percent of GDP, which is about two-thirds as large as the 75-year actuarial deficit in Social Security. The Senate Finance plan would create smaller long-term costs, especially if the offsets included in that plan were made permanent.
- **Short-term stimulus:** In the short run, in an economy operating with excess capacity, increases in aggregate demand can raise output and income even without raising the capital stock. Each of the proposals would boost aggregate demand in the short term and thereby generate higher levels of income in classic Keynesian fashion, but the proposals would fail to stimulate the economy in the least expensive and most equitable manner. As shown below, the two principal components of the plans — acceleration of the 2001 tax cuts and dividend/capital gains tax cuts — would be regressive. This implies that they will be less effective in stimulating current activity, holding the size of the tax cut constant, than more progressive options, since high-income households are less likely to spend available resources immediately than low- or moderate-income households. Alternatively, it would cost less to generate the same stimulus from a more progressive plan. It is ironic that tax cut advocates are selling dividend and capital gains tax cuts, which are traditionally associated with long-term, supply-side goals, as short-term stimulus for aggregate demand.

(Text continued on p. 1084.)

Table 1: Side-by-Side of Major Proposals

	Administration		House Ways and Means		Senate Finance Committee	
	Provision	**Cost, 2003-2013**	**Provision**	**Cost, 2003-2013**	**Provision**	**Cost, 2003-2013**
Reduce tax rates on dividends and capital gains:						
	Dividends that are fully taxed at the corporate level would be exempt from individual income tax. Earnings that are fully taxed at the corporate level but not distributed as dividends would result in a basis adjustment for shareholders.	$396 billion	Tax dividends and capital gain at a 15% rate (5% for those in the lowest two brackets). Sunsets at the end of 2012.	$276 billion	Exclude first $500 of dividends received by individuals, plus 10% of dividends in excess of $500 for 2004-2007 and 20% for 2008-2012. Sunsets at the end of 2012.	$81 billion
Accelerate upper-bracket rate cuts:						
	Top four statutory tax rates would be immediately reduced from 27, 30, 35, and 38.6 percent to 25, 28, 33, and 35 percent, respectively. The change would be retroactive to January 1, 2003.	$74 billion	Same as administration.	$74 billion	Same as administration.	$74 billion
Accelerate marriage penalty relief:						
	Effective 2003, the standard deduction for joint filers is set equal to twice that for singles. The beginning of the 25 percent bracket for couples is set equal to twice the threshold for singles. EITC marriage penalty relief is not accelerated.	$55 billion	Same as administration for 2003-2005. Sunsets at end of 2005.	$43 billion	Same as administration.	$51 billion
Accelerate expansion of the 10 percent tax bracket:						
	The beginning of the 15-percent tax bracket is increased from $6,000 to $7,000 for singles in 2003, and from $12,000 to $14,000 in 2003. Thresholds are indexed for inflation starting in 2004 (rather than in 2009).	$45 billion	Same as administration for 2003-2005. Sunsets at end of 2005.	$19 billion	Same as administration.	$45 billion

(Table continued on next page.)

	Administration		House Ways and Means		Senate Finance Committee	
	Provision	**Cost, 2003-2013**	**Provision**	**Cost, 2003-2013**	**Provision**	**Cost, 2003-2013**
Accelerate child credit increase to 2003:						
	Child tax credit is increased from $600 per child to $1,000 per child in 2003. Scheduled increase in refundability rate is not accelerated.	$90 billion	Same as administration for 2003-2005. Sunsets at end of 2005.	$45 billion	Same as administration, but accelerates increase in refundability rate to 15%.	$93 billion
Temporary AMT relief:						
	The alternative minimum tax (AMT) exemption is increased by $4,000 for singles and $8,000 for joint returns through 2005 (so that the threshold is $39,750 for singles and $57,000 for joint returns). The thresholds return to their current-law levels of $33,750 for singles and $45,000 for joint returns in 2006.	$37 billion	Exemption increases by $7,500 for singles and $15,000 for joint filers through 2005, then reverts to current law.	$53 billion	Exemption increases by $6,000 for singles and $12,000 for joint filers through 2005, then reverts to current law.	$49 billion
Increase expensing limit for small businesses:						
	Increase the amount of investment by small business that may be deducted currently (instead of amortized) from $25,000 to $75,000, starting in 2003. The expensing limit phases out dollar for dollar with income about $325,000 (compared with $200,000 under current law). The deduction and threshold are indexed for inflation after 2003. Includes software in section 179 property.	$29 billion	Increase deduction limit to $100,000 and phaseout threshold to $400,000; include software; index deduction and phaseout limit after 2003; sunset after 2007.	$3 billion	Same as administration, but sunset at end of 2012.	$23 billion

(Table continued on next page.)

	Administration		House Ways and Means		Senate Finance Committee	
	Provision	**Cost, 2003-2013**	**Provision**	**Cost, 2003-2013**	**Provision**	**Cost, 2003-2013**
Bonus depreciation:						
	No provision		Increase share of qualified investments that can be immediately deducted to 50% and extend through 12/31/05, for property placed in service after 5/5/03.	$21 billion	No provision	
Extend 5-year net operating loss carryback:						
	No provision		Extend through 2005 and waive the AMT 90% limitation on the allowance of losses.	$15 billion	No provision	
Other provisions:						
	Not applicable		Shift some corporate tax payments from 2003 to 2004.	$0 billion	State fiscal relief.	$20 billion
					Simplification measures, including unifying definition of qualifying child.	$4 billion
					Offsets, including customs users fees and taxation of foreign earned income.	-$92 billion
Total Net Cost		**$726 billion**		**$550 billion**		**$350 billion**

- **Long-term growth:** In the long run, economic growth reflects expansions in the capacity to produce goods and services. Such expansions, in turn, reflect increases in labor supply and capital, as well as technological advances. Tax cuts can increase growth by providing incentives to raise the level, and improve the allocation of, labor supply, saving, and investment. But tax cuts can reduce long-term growth by raising after-tax income (which discourages work), by providing windfall gains (which encourages consumption rather than saving), and by reducing public and national saving. Although the three proposals are called "Growth and Jobs" packages, this moniker is misleading. A new study by the Joint Committee on Taxation (JCT) estimates the macroeconomic effects of the House plan. Using a variety of models and assumptions, the JCT shows that the House plan would reduce the size of the economy in the second half of the decade, and by implication would reduce the size of the economy by increasing amounts after that. Analysis by the Congressional Budget Office (CBO) leads to similar conclusions about the administration's budget.
- **Distributional effects:** All three plans would make the distribution of after-tax income less equal. In the administration plan, the percentage increase in after-tax income rises as income rises, reaching a whopping 4.2 percent for households with income above $1 million. The House plan is even more regressive. Although the Senate Finance plan is less skewed, it is still regressive. Although the average tax cut in the House plan would be $731 in 2003, more than one-third of tax filing units would receive no benefits and another sixth would receive less than $100. The notion that the tax cut would provide significant help for the elderly is misguided: under the House plan, for example, more than half of all elderly tax filing units would receive no tax cut and the average tax cut among the bottom 80 percent of elderly households would be just $70.
- **Accelerating EGTRRA:** Accelerating the scheduled marginal tax reductions from the

2001 tax cut (the Economic Growth and Tax Relief Reconciliation Act, or EGTRRA) would be expensive and regressive. The 10-year budget cost, including interest payments, would be about $117 billion. More than half of the benefits would go to households with incomes above $100,000 and after-tax income would rise by 3 percent for households with incomes above $1 million, compared to between zero and 1.1 percent for the 85 percent of households with incomes below $75,000. The distribution of benefits is important not only on equity grounds, but also because it reduces the short-term boost to aggregate demand from the proposal, as noted above. The acceleration would reduce marginal tax rates for fewer than one-third of all tax-filing units and so is unlikely to have substantial supply-side benefits. Despite claims suggesting sizeable benefits for small business, only about one-third of small business returns would receive marginal tax rate cuts and only 2 percent of all small business returns would benefit from the reduction in the top tax rate.

- **Dividend and capital gains tax cuts:** Taxing all corporate income once is a sound idea, other things being equal. But it requires not only eliminating tax on the doubly taxed portion of corporate income under current law but also taxing the sizable untaxed portion of corporate income. None of the dividend and capital gains tax cut proposals under consideration accomplishes the latter objective. While the administration's and Finance Committee's proposals have some features that would discourage corporate tax shelters, the House plan would probably increase both corporate and individual sheltering. The common feature of the dividend and capital gains proposals is that they would represent large, regressive tax cuts.

- **Better alternatives:** Substantial aid to the states would be a more effective short-term stimulus than the administration, House, or Senate Finance approaches. It would be more equitable, helping support education, homeland security, and health care. It would be less damaging to the long-term budget outlook. In addition, a very high proportion of any funds spent on extending unemployment benefits would translate into immediate increases in spending. If policymakers feel the need to enact long-term tax cuts, reform of the alternative minimum tax, a problem that was made far worse by the 2001 tax cut, would simplify taxes, reduce marginal tax rates, and help resolve fiscal uncertainty.

We begin by describing the three proposals and examining their effects on revenue, growth, and income distribution. Following that, we explore the two most prominent components of the plans: acceleration of marginal tax rate cuts in EGTRRA and tax cuts for dividends and capital gains. The last section discusses alternatives for reform.

II. Revenue Effects and Budget Gimmicks

Table 1 describes the administration, House, and Senate Finance packages and the FY 2003-2013 revenue cost estimated by the JCT. As indicated in the table, the dividend and capital gains provisions in the administration and House proposals account for slightly more than half of their respective 10-year costs.

The revenue estimates are constructed according to established rules, but may be misleading indicators of the likely medium- or long-term revenue losses stemming from the proposals. Policymakers have become increasingly creative in circumventing budget constraints.[1]

For example, the House bill (designed by Ways and Means Committee Chair Bill Thomas, R-Calif.), sunsets the dividend and capital gains treatment in 2012 (whereas the budget window extends through 2013) and sunsets several other changes in 2005 (see Table 1). The sunsets create uncertainty in gauging the underlying revenue losses. Chairman Thomas and other Republican leaders have stated their intent to make the provisions permanent at a later date. Given this stated intent, it is appropriate to examine the costs assuming the provisions were made permanent.

Using a variety of models and assumptions, the JCT shows that the House plan would reduce the size of the economy in the second half of the decade.

A recent study by the Center on Budget and Policy Priorities shows that if all of the provisions in the House bill were made permanent except the increase in the AMT exemption, the revenue loss would be $1.12 trillion through 2013, or twice the size of the official estimate (Greenstein, Kogan, and Lee 2003). Tax Policy Center (TPC) microsimulation model calculations show that extending the House AMT exemption through 2013 would cost an additional $500 billion, raising the overall revenue loss to $1.6 trillion. One reason the cost is so high is that House bill contains a very generous increase in the AMT exemption through 2005.

[1]The 2001 tax cut, for example, contained a number of features that artificially reduced the official costs of tax proposals. These included: moving corporate payments from September 2001 to October 2001 as a way of reducing the net cost of the tax cut within the 10-year budget window (which at that time covered fiscal years 2002-2011 and began on October 1, 2001); phasing in the tax cuts very slowly, to hold down the 10-year cost, even though the long-term costs would be unaffected; ignoring the problems that the tax cut created in raising the coverage of the alternative minimum tax, a problem that will now require between $500 billion and $1 trillion to address; and most prominently, sunsetting all of the provisions in 2010, to reduce the 10-year costs.

Table 2: Revenue Loss in 2005 ($ billion)		
Provision ($ billion)	**House**	**Senate Finance (without offsets)**
Reduce tax rates on dividends and capital gains:	20.8	4.4
Accelerate upper-bracket rate cuts:	19.8	19.8
Accelerate marriage penalty relief:	11.0	11.0
Accelerate expansion of the 10 percent tax bracket:	6.6	6.6
Accelerate child credit increase to 2003:	15.5	17.2
Temporary AMT relief	20.0	18.7
Increase expensing limit for small businesses	2.0	3.1
Bonus depreciation	62.6	
Extend 5-year net operating loss carryback	10.9	
Total	**169.2**	**80.8**
As share of GDP	1.42%	0.68%
Total minus accelerated provisions	**116.2**	**26.2**
As share of GDP	0.97%	0.22%
Adjusted total*	**61.3**	**28.1**
As share of GDP	0.51%	0.24%
Social Security 75-year actuarial deficit as % of GDP	0.73%	

Note: CBO projected GDP for FY 2005 from March 2003, 11934
*Adjusted figures exclude accelerated provisions and assume that the sunsets included in the legislation are removed. The figures also assume that (in present value) 70 percent of the revenue loss associated with the bonus depreciation and expensing limit provisions would be recaptured through future reductions in depreciation allowances, and that (in present value) 90 percent of the revenue loss associated with the net operating loss carryback provision would be recaptured through future reductions in loss deductions. The figure for the Senate Finance Committee bill reflects the exclusion of 20 percent of dividends above $500 effective in 2008, rather than the 10 percent exclusion in effect 2004 through 2007. (The 2005 cost of the 20 percent exclusion reflects the JCT estimated cost in 2010 as a share of projected GDP, multiplied by projected GDP for 2005.)

Another way to see the implicit long-term costs is to note that in 2005, the final year in which all the House proposals are scheduled to be in effect, the revenue loss amounts to $169 billion or 1.4 percent of GDP (Table 2). Roughly $50 billion of that cost, however, is associated with provisions that accelerate the 2001 tax legislation. Those provisions do not involve any long-term revenue loss, since the reductions were due to occur by 2010 under current law. Subtracting those provisions leaves $116 billion in other tax cuts. In addition, some of the revenue loss in 2005 from the bonus depreciation, small business expensing, and net operating loss carryback provisions would be offset by reductions in depreciation or loss deductions in the future. Under a reasonable set of assumptions,[2] the result is a net tax cut — other than the accelerated portion — that amounts to 0.5 percent of projected GDP, which provides a rough estimate of the long-term cost if the provisions were made permanent. This represents a significant reduction in revenue. By comparison, the actuarial deficit in Social Security amounts to 0.73 percent of GDP over the next 75 years.

The Senate Finance legislation relies on a set of revenue-raising provisions that offset the cost of its tax cuts. Many of these provisions represent sound tax policy, but are unlikely to be enacted. Without the offsets, the Senate will have to either scale back the tax cut or adopt other budget gimmicks to remain within the $350 billion constraint in the Senate (imposed by the budget resolution before conference and by Senator Grassley's promise after conference). In addition, the partial dividend exclusion proposed in the Senate Finance legislation may facilitate future reductions in dividend taxes, raising the budgetary cost. If the dividend provision were not expanded substantially, the Senate Finance legislation would involve lower long-term costs than the Ways and Means legislation. As Table 2 shows, the Senate Finance plan, if made permanent, would reduce taxes by about 0.25 percent of GDP in the long term without counting its offsets; with the offsets, the revenue effect would be more modest.

A particularly cynical ploy that was in none of the bills at the time of this writing would phase in the administration's dividend tax cut over a few years and

[2]We assume that 70 percent (in present value) of the immediate revenue losses associated with the bonus depreciation and expensing limit provisions would be recaptured through future reductions in depreciation allowances. This calculation is approximate and based on figures in Gravelle (1994). The JCT estimates that the increase in the present value of depreciation deductions would be 15 percent under a 50 percent bonus expensing scheme. Thus, if the scheme were introduced in 2005, the net long-term costs would be 30 percent of the immediate deduction, consistent with our 70 percent figure. We also assume that 90 percent (in present value) of the revenue loss associated with the net operating loss carryback provision would be recaptured through future reductions in loss deductions.

then sunset it. Such a scheme was in the first draft of the Senate Finance Committee mark-up and it continues to have White House support (Weisman 2003). In political terms, this would allow the president to claim victory while masking most of the cost, technically wedging the tax cut into the Senate's budget resolution target. Even abstracting from the dishonest budgeting, this approach would create highly undesirable economic incentives. Phasing in the dividend tax cut would give firms incentives to alter the timing and character of dividend payments. The sunset would also create uncertainty about the tax law, which would diminish investors' willingness to bid up stock prices to reflect the new tax benefits. This would make the proposal an even less effective short-term fiscal stimulus than a more certain dividend tax break.

III. Stimulus and Growth Effects

A. Framework

The short-term stimulus effects of the proposals and their long-term effects on economic growth are often discussed independently, but they are related. An economy operating below capacity can increase output in the short run without an increase in productive capacity, simply by boosting aggregate spending and allowing businesses to increase use of extant capacity. In the long run, however, an economy can grow only by expanding its capacity, which requires an increase in the supply of labor and capital, and improvement in the allocation of labor and capital, or an improvement in technology. As a result, policies that serve to raise consumer spending can raise output in the short term, but if they persist, they will reduce the amount that households save and hence can dampen growth in the long term.

Tax cuts can play important roles in both the short run and the long run. In the short run, most tax cuts will boost aggregate spending simply because consumers have more cash in hand. But as long as taxpayers spend a positive fraction of any tax cut they receive, public saving will fall (from the reduction in tax revenues) by more than the increase in private saving, so national saving will fall and aggregate demand will rise. That is helpful in a stagnant, underutilized short-term economy, but it sows the seeds of a long-term slowdown in economic growth if it is continued over time.

In the long run, tax cuts have potentially offsetting effects on economic growth: while they can stimulate growth through better incentives, they can also reduce growth by generating (a) positive income effects for households, which reduce labor supply, (b) windfall gains for current owners of capital, which reduce current private saving, and (c) increased budget deficits, which reduce national saving (Gale and Orszag 2002). That does not mean that the overall growth effects of tax cuts are necessarily negative, but it does mean that to generate growth, the positive effects of the proposals must be sufficiently large and persistent to offset the fiscal drag and to produce additional gains. The net effect depends on the interaction between these events. The key point for understanding the growth effects of the current proposals is simply that they are not well-designed to maximize the positive effects on growth and minimize the negative effects.

The administration, House, and Senate Finance proposals would boost short-term economic activity. As noted, though, this is not a major accomplishment. Almost any tax cut or spending increase would succeed in boosting a sluggish economy if the Federal Reserve Board follows an accommodative monetary policy (which it would likely do during a recession). *The key question is, therefore, not whether the proposals provide any short-term stimulus, but whether they are the most effective way to provide stimulus.* Here, a relevant point is that, because of growing fiscal concerns, a good proposal would provide a strong short-term stimulus without compounding medium- and longer-term budget problems. By this criterion, the three proposals are poorly designed. The acceleration of EGTRRA provides most of its benefits to high-income households, who would be less likely to spend the additional funds upon receipt; thus, only a relatively small share of the tax cut will appear as immediate spending. The effects of acceleration on long-term growth are negative, since the acceleration would result in higher public debt with no analogous reductions in marginal tax rates after 2006.

> ***A good proposal would provide a strong short-term stimulus without compounding medium- and longer-term budget problems. By this criterion, the three proposals are poorly designed.***

Boosting the stock market — which is often alleged to be one of the goals of dividend and capital gains tax cuts — raises wealth and therefore raises consumption this year and in the future. The expansion in consumption this year is beneficial in spurring short-term growth by bolstering aggregate demand, but the effect is likely to be small relative to other options. For example, consider two policies with a net present value cost of $1. A permanent reduction in dividend taxes that reduces the present value of revenues by $1 would raise the value of the stock market by $1 and, using estimates of the responsiveness of consumption to changes in wealth, would raise current consumption spending by between three and five cents. As an alternative, consider $1 in aid to the states this year. The $1 increase in aid could boost state spending or reduce taxes by $1, relative to what it would otherwise have been, with an immediate effect on the economy that is much larger than 3 to 5 cents. For the same present value cost to the government, aid to the states thus provides much larger immediate stimulus than a dividend tax cut.

A less well-understood point is that because the expansion in consumption due to a permanent rise in the stock market continues in the future, it has an adverse effect on long-term growth. In particular, higher consumption translates into lower national saving. The

Table 3: Effects of the House Plan on Economic Growth (Percent Change in Real GDP relative to baseline)		
	Calendar Years	
	2003-08	2009-13
Neoclassical Growth Model:		
MEG-aggressive Fed reaction	0.2	-0.1
MEG-neutral Fed reaction	0.3	0.0
Econometric Model:		
GI Fed Taylor reaction function	0.9	-0.1
Life cycle Model With Forward Looking Behavior:		
OLG Reduced Government Spending in 2014	0.2	-0.1
OLG Increased Taxes in 2014	0.2	-0.2
Source: JCT estimates as reported in the *Congressional Record,* May 8, 2003.		

reduction in national saving reduces future national income (Gale and Orszag 2002). *The larger the effect on the stock market, the larger the increase in consumption, the larger the reduction in national saving, and the larger the decline in future national income.* A stock market boost due to tax cuts may also raise investment, but if it does, the additional investment will be financed by borrowing from abroad (since private saving and public saving will both have declined). The borrowing will have to be paid back in the future and thus effectively represents a mortgage on the future income produced by the investments.

All of this suggests that designing tax policy to stimulate short-run activity and long-run growth at the same time is difficult within a single set of proposals. As a final example, note that extending "bonus depreciation" provisions (as under the House proposal) would impede short-term growth. Temporary investment incentives provide a stronger motivation for corporations to invest immediately or in the very short term than do permanent incentives, for the simple reason that, to benefit from the temporary subsidy, the firm must make the investment soon. But, by lengthening the period of eligibility, the House proposal would reduce the incentive to invest now. (The proposal also raises the share of investment expenditure that is eligible for immediate write-offs, which would raise the incentive to invest now. It is important, however, to separate the effects of the generosity of the depreciation provision from its timing.)

B. Analyses

A number of recent studies have examined these issues in the context of full-blown macroeconomic models. The CBO (2003a) recently analyzed the impact of the president's overall budget proposals in a series of different models and under varying assumptions. CBO found the effects on growth would generally be small and could be negative. By estimating the combined effects of the president's tax and spending proposals over the next 10 years, however, the analysis does not provide information on (a) what would happen after 10 years or (b) the effects of the tax proposals separately from the spending options.

The effects on the economy after 10 years — that is, the long-term growth effects — can be gleaned from a similar CBO (2002) macroeconomic analysis of tax reform proposals. That study found that tax cuts uniformly reduced long-term GDP (relative to baseline) unless they were offset by sufficient spending cuts to ensure budget neutrality.

Two recent studies examine the administration and House tax proposals in isolation of the spending proposals. Macroeconomic Advisors (2003), the consulting firm that developed the macroeconomic model used by the White House's Council of Economic Advisers, estimated that the president's tax cuts would reduce the size of the economy in the long run.

More recently, the Joint Committee on Taxation estimated the macroeconomic effect of the House plan (Congressional Record 2003). Using a variety of models and assumptions, the JCT results, displayed in Table 3, show that the House plan would boost the economy in the short run but by relatively small amounts. Four of the five models suggest average real GDP effects over the first five years of between 0.2 and 0.3 percent ($18 billion to $27 billion). Given the price tag on the overall House plan, these are miniscule effects.

Most strikingly, the JCT also estimated that the House "Growth and Jobs" plan would end up reducing GDP relative to the baseline in the second half of the decade. Although the JCT does not report results beyond the 10-year window, the language implies that the growth effect would continue to decline.[3]

IV. Distributional Effects

A. By Income Level

Table 4 (next page) lists distributional aspects of the three plans for 2003. (Appendix Table 1 on p. 1098 gives the same information by income percentile.) This comparison omits the dividend cuts in the Senate Finance

[3]For example, after noting that the residential capital stock falls but nonresidential capital rises in the first 10 years (with the overall capital stock falling, as best we can estimate), JCT notes that "The simulations indicate that eventually the effects of the increasing deficit will outweigh the positive effects of the tax policy, and the build up of private nonresidential capital stock will likely decline." Thus, in the longer run, the JCT analysis of the Thomas plan foresees rising deficits, and declining residential and nonresidential capital stocks. Taken together, these imply declining GDP and GNP over time.

Table 4: Distributional Measures of Key Proposals, 2003

AGI Class (thousands of 2002 dollars)	Returns		Percent With Tax Cut			Percent Change in After-Tax Income		
	Number (thousands)	Percent of Total	Administration	House	Senate Finance Committee	Administration	House	Senate Finance Committee
Less than 10	32,978	23.7	0.8	0.7	0.6	*	*	0.1
10-20	23,022	16.6	45.5	45.2	59.8	0.4	0.3	0.6
20-30	18,524	13.3	88.1	87.8	89.4	0.8	0.8	0.9
30-40	13,431	9.7	92.6	92.6	91.5	1.0	1.0	0.9
40-50	10,627	7.6	95.3	95.2	94.1	1.2	1.1	1.0
50-75	18,039	13.0	98.9	98.9	98.5	1.3	1.2	1.1
75-100	9,518	6.8	99.9	99.9	99.7	2.2	2.1	2.0
100-200	9,196	6.6	99.8	99.8	99.7	2.3	2.3	2.0
200-500	2,174	1.6	99.3	99.4	97.2	2.4	2.5	1.9
500-1,000	359	0.3	98.7	98.5	87.0	3.6	3.5	2.7
More than 1,000	184	0.1	98.8	98.7	88.6	4.2	4.4	3.0
All	138,959	100.0	64.0	63.9	66.1	1.8	1.8	1.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

AGI Class (thousands of 2002 dollars)			Percent of Total Income Tax Change			Average Tax Change ($)		
			Administration	House	Senate Finance Committee	Administration	House	Senate Finance Committee
Less than 10			*	*	0.1	-1	-1	-2
10-20			1.3	1.2	2.4	-57	-53	-92
20-30			3.6	3.4	4.5	-199	-189	-213
30-40			4.4	4.3	4.7	-336	-323	-310
40-50			5.0	4.7	5.0	-482	-452	-415
50-75			12.8	12.5	13.3	-734	-705	-648
75-100			15.5	15.2	16.4	-1,676	-1,619	-1,508
100-200			23.6	23.4	24.0	-2,646	-2,589	-2,287
200-500			11.5	12.1	10.5	-5,451	-5,631	-4,232
500-1,000			6.3	6.1	5.5	-18,047	-17,324	-13,378
More than 1,000			16.0	17.0	13.5	-89,509	-93,537	-64,431
All			100.0	100.0	100.0	-742	-731	-631

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

proposal, which do not take effect until 2004. In Table 8 (on p. 1093), however, we report the distributional effects of those tax cuts in 2004 and it is clear that they would not significantly alter our overall conclusions about the Senate Finance proposal on its own or in relation to the other proposals.

Our preferred measure of the distributional burden is the percentage change in after-tax income.[4] A plan that raises after-tax income by the same percentage for each household (or for households in each income group) leaves the overall after-tax distribution of income the same. A plan that raises after-tax income by a greater percentage for higher-income (lower-income) households than for others makes the distribution less equal (more equal).

All of the plans make the distribution of after-tax income less equal. In the administration plan, after-tax

(Text continued on p. 1091.)

[4]Our distributional estimates of capital gains cuts are based on changes in tax burden, not actual tax payments. For example, if capital gains taxes were to rise and people cut back their sales of assets so much that their capital gains tax declined, we would still show them as being worse off from the capital gains tax increase. Likewise, with a capital gains tax cut, the distributional effect shows the effect on taxpayer liability assuming no change in realizations. For a discussion of the distinctions between tax burden and tax realizations, and the various approaches that have been taken, see Bradford (1986), Graetz (1995), and Burman (1999). Relative to the results reported in Table 4, including the induced-realization effect would generate larger gains in after-tax income for high-income households but smaller reductions in overall tax liability.

(Footnote 4 continued in next column.)

Table 5: House Plan Distribution by Size of Tax Cut and Type of Taxpayer, 2003[1]

Income Tax Cut ($)	All Tax Units[2]		Joint Tax Units		Joint With Children[3]		HOH With Children[4]		Elderly[5]		Business Income[6]	
	Percent of Total	Average Tax Cut ($)	Percent of Total	Average Tax Cut ($)	Percent of Total	Average Tax Cut ($)	Percent of Total	Average Tax Cut ($)	Percent of Total	Average Tax Cut ($)	Percent of Total	Average Tax Cut ($)
0	36.1	0	19.5	0	11.5	0	55.5	0	53.1	0	25.1	0
1-100	17.2	-55	4.9	-85	2.4	-85	2.9	-44	9.9	-56	11.1	-61
101-500	18.5	-305	20.9	-306	11.3	-376	29.1	-373	18.9	-273	18.9	-298
501-1,000	9.3	-752	13.8	-766	23.3	-775	9.7	-763	5.2	-713	11.7	-759
1,001-1,200	2.6	-1,118	4.9	-1,120	8.4	-1,126	1.1	-1,161	1.1	-1,096	3.4	-1,114
1,201-2,000	7.3	-1,586	15.6	-1,592	17.1	-1,580	1.1	-1,596	5.0	-1,615	11.2	-1,586
2,001-5,000	7.7	-2,808	17.7	-2,802	23.3	-2,782	0.5	-2,713	5.5	-2,950	14.8	-2,930
5,001-10,000	0.8	-6,617	1.6	-6,582	1.7	-6,502	0.0	-7,378	0.9	-6,763	2.2	-6,684
10,001-50,000	0.4	-19,658	0.9	-19,734	0.9	-19,788	0.0	-19,483	0.4	-18,421	1.4	-19,985
Over 50,000	0.1	-150,928	0.1	-147,881	0.1	-148,365	0.0	-195,601	0.1	-140,568	0.2	-154,067
All	100.0	-731	100.0	-1,458	100.0	-1,740	100.0	-249	100.0	-567	100.0	-1,605

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).
[1]Calendar year. Baseline is current law. Includes the following provisions: increase child tax credit to $1,000; expand size of the 10 percent bracket to $7,000 for singles and $14,000 for married couples; expand 15 percent bracket for married couples to twice that for singles; increase standard deduction for married couples to twice that for singles; reduce top four tax rates to 25, 28, 33, and 35 percent; increase AMT exemption by $15,000 for married couples and $7,500 for others; reduce the tax rate on dividends and long-term capital gains to 15 percent (the rate for individuals in the 10 and 15 percent tax brackets would be 5 percent; preferential rates would not apply to income that, under current law, is reported as dividends on tax returns but represents distributions of interest income from mutual funds; applies to qualifying assets sold on or after May 6, 2003).
[2]Includes both filing and nonfiling tax units. Tax filing units that are dependents of other taxpayers are excluded from the analysis.
[3]Married couples with at least one dependent child living at home.
[4]Head of household units with at least one child living at home.
[5]Individuals age 65 or older; for married couples, at least one spouse is 65 or older.
[6]Tax units claiming income or loss on Schedules C, E, or F.

Table 6: Distributional Effects of Accelerating Parts of EGTRRA in 2003[1]

AGI Class (thousands of 2002 dollars)[2]	Returns[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Income Tax Rate[5]	
	Number (thousands)	On AMT (thousands)	Percent of Total				Current Law	Proposal
Less than 10	32,978	0	23.7	0.0	0.0	-1	-9.7	-9.7
10-20	23,022	3	16.6	0.3	1.3	-47	-3.9	-4.2
20-30	18,524	1	13.3	0.7	3.8	-173	3.5	2.9
30-40	13,431	3	9.7	0.9	4.8	-301	6.9	6.1
40-50	10,627	20	7.6	1.0	5.2	-413	8.6	7.7
50-75	18,039	78	13.0	1.1	13.7	-647	9.9	8.9
75-100	9,518	89	6.8	2.0	16.9	-1,505	12.4	10.6
100-200	9,196	750	6.6	2.0	24.4	-2,256	16.1	14.4
200-500	2,174	1,100	1.6	1.8	10.3	-4,020	23.2	21.8
500-1,000	359	98	0.3	2.7	5.7	-13,372	28.1	26.2
More than 1,000	184	33	0.1	3.0	14.0	-64,429	29.2	27.0
All	138,959	2,179	100.0	1.5	100.0	-611	13.3	12.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
[1]Baseline is current law. Proposal includes ending marriage penalties in the tax brackets and standard deduction, accelerating 2006 rate cuts, increasing the child tax credit to $1,000, increasing the 10 percent bracket, and temporarily increasing the AMT exemption by $10K for couples ($5K for singles). This proposal mirrors the non-dividend, non-capital gains portion of the House Plan.
[2]Returns with negative AGI are excluded from the lowest income class but are included in the totals.
[3]Includes both filing and nonfiling units. Returns of individuals who are dependents of other taxpayers are excluded from the analysis.
[4]After-tax income is AGI less individual income tax net of refundable credits.
[5]Average income tax, net of refundable credits, as a percentage of average AGI.

income would not rise for households with income below $10,000, and would increase by only 0.4 percent for households with income between $10,000 and $20,000. The percentage increase rises as income rises, reaching 4.2 percent for households with income above $1 million. The Thomas plan is actually even more regressive, with an increase of 0.3 percent for households with income between $10,000 and $20,000, rising to 4.4 percent for households with income above $1 million.[5] The Senate plan is somewhat less skewed, but still substantially regressive, providing an increase in after-tax income of 0.6 percent for households between $10,000 and $20,000, rising to 3 percent for households above $1 million.

The table also provides other perspectives on the distributional effects of the tax cuts. The plans would give tax cuts to just under two-thirds of all filing units, including less than 1 percent of those with income below $10,000 and between 40 and 60 percent of those with income between $10,000 and $20,000.

The share of the income tax cut allocated to households with income above $100,000 ranges between 53 and 58 percent. Households with income below $20,000 obtain between 1.2 and 2.5 percent of the tax cuts under the plans.

The administration and House plans would give cuts averaging as much as $90,000 to households with incomes above $1 million, compared to under $500 for households with income between $40,000 and $50,000. The Senate Finance plan gives a tax cut of $63,000 to the top income group, and a cut of about $415 to the middle-income group.

B. By Size of Tax Cut and Type of Taxpayer

Table 5 provides more detail on the distribution of tax cuts in the House plan in 2003. The average tax cut is about $731, but such an average is misleading: It represents the combination of a few people receiving very large tax cuts and a large number of people receiving small cuts. The *typical* tax-return-filing unit would receive a tax cut of between $1 and $100. About 36 percent of filing units would receive no tax cut at all. Many of these do not pay income taxes, and some do not even file income tax returns. But if the goal is to stimulate the economy in the short run, putting money in the hands of people who have low or moderate income (and thus pay little or no income tax) is likely to result in more new spending than is an equivalent amount given to higher-income households.

The data in Table 5 shed light on other claims as well. Some advocates have claimed that the tax cut

[5]For taxpayers in the top tax bracket, the House plan provides larger capital gains tax cuts than the administration plan does and dividend tax cuts that are about the same size as the administration's. For these taxpayers, the House plan provides an effective tax cut on dividends of about 61 percent relative to current law (1-0.15/0.386). The administration's proposal would have exempted all qualified dividends from individual-level taxation; our estimates suggest that about 60 percent of dividends would have qualified in 2003.

Table 7: Distribution of Returns With Small Business Income, 2003						
Tax Bracket	Distribution of All Returns (percent)	Distribution of Returns With Small Business Income (percent)	Cumulative Distribution of Returns With Small Business Income (percent)	Percent of Returns in Bracket With Small Business Income (or Loss)		
				Any Small Business Income	> 25% AGI	> 50% AGI
0%	27.3	20.3	20.3	17	11	9
10%	14.0	12.0	32.3	19	9	6
15%	32.9	30.1	62.5	21	5	3
26%	1.2	2.5	64.9	46	11	6
27%	20.2	25.1	90.1	28	5	3
28%	0.3	1.0	91.0	66	23	15
30%	2.6	4.8	95.8	41	13	8
35%	0.9	2.2	98.0	57	24	17
38.6%	0.6	2.0	100.0	73	36	26
All	100.0	100.0		22	8	6
Source: Urban-Brookings Tax Policy Center Microsimulation Model.						

would be particularly valuable to the elderly, small business, or single parents. In fact, the House bill would provide no tax cut for more than half of all elderly taxpayers, more than half of all single parents, and a quarter of all returns with business income. More than 80 percent of the elderly, 85 percent of single parents, and half of returns with business income would receive tax cuts less than $500. Among the 80 percent of elderly households with the lowest income, the average tax cut would be $70. Among small business owners, the 55 percent of returns with the lowest AGI would receive an average tax cut of $114.

V. Accelerating the EGTRRA Tax Cuts

Accelerating features of the 2001 tax cut has attracted little attention in the current debate but raises a number of important issues. First, the acceleration of marginal tax reductions and other items would be expensive, reducing revenues by $263 billion. Including the costs of the added federal interest payments due to the larger federal debt, the reduction in the 10-year budget surplus (or increase in the deficit) would be in the neighborhood of $400 billion.

Accelerating features of the 2001 tax cut has attracted little attention in the current debate but raises a number of important issues.

Second, acceleration would be regressive. Table 6 shows that accelerating the EGTRRA provisions (and the accompanying AMT changes) in the House bill would increase after-tax income by 3 percent for households with income above $1 million, compared to an average of 0.5 percent for the 85 percent of households with income below $75,000. In dollar terms, taxes would fall by $64,000 for households in the top group, but an average of only $209 for households with income below $75,000. More than half of the tax cut would accrue to households with incomes above $100,000. (Appendix Table 2 on p. 1099 provides similar data by income percentile.)

The distributional effects are not simply a matter of equity. Since higher-income households are less likely to spend additional after-tax income on immediate consumption needs than are households living from paycheck to paycheck, a regressive tax cut is likely to have a lower "bang for the buck" than is a progressive one, other things equal.

Nor is the acceleration likely to provide a serious boost on the supply side. The TPC microsimulation model shows that less than 30 percent of return-filing units will see reductions in marginal tax rates due to the acceleration. Among households with income below $75,000, only about 18 percent would obtain a reduction in marginal tax rates. Thus, the acceleration would produce significant income effects (recall from Table 4 that 64 percent of return-filing units would get a tax cut), which would tend to reduce labor supply, but the substitution effects that would tend to raise labor supply would be small and uneven.

Given that the acceleration of the 2006 EGTRRA provisions would provide ineffective stimulus, could be counterproductive in terms of supply-side effects, and would raise the deficit, there seems little economic justification for them. From a political economy perspective, locking in the scheduled future rate cuts now would make it more difficult to restore fiscal discipline. Recent CBO projections suggest that even in the absence of further tax cuts, the FY 2003 deficit will be more than $300 billion, a figure $50 billion higher than projected as recently as March (CBO 2003b).

Indeed, recalling that Congress did not think that accelerating the tax cut was affordable in 2001, with surpluses as far as the eye can see, it is difficult to see how it is affordable now. A response to that claim is offered by *The Washington Times*: "Congress, knowing then what it now knows about the real condition of the economy in May 2001, would almost certainly have

Table 8: Distributional Measures of Dividends and Capital Gains Proposals, 2004

AGI Class (thousands of 2002 dollars)	Returns		Percent With Tax Cut			Percent Change in After-Tax Income		
	Number (thousands)	Percent of Total	Administration	House	Senate Finance Committee	Administration	House	Senate Finance Committee
Less than 10	33,461	23.7	0.5	0.4	0.3	*	*	*
10-20	23,246	16.5	7.4	6.9	6.4	0.1	*	*
20-30	18,563	13.2	13.8	13.1	12.6	0.1	0.1	*
30-40	13,624	9.7	17.1	16.2	14.5	0.1	0.1	*
40-50	10,550	7.5	22.9	21.4	18.6	0.2	0.1	*
50-75	18,217	12.9	29.6	27.4	23.3	0.2	0.1	*
75-100	9,955	7.1	39.3	36.2	30.4	0.3	0.2	0.1
100-200	9,614	6.8	57.2	53.7	46.7	0.4	0.3	0.1
200-500	2,299	1.6	75.6	71.0	59.0	0.8	0.6	0.1
500-1,000	384	0.3	83.5	80.0	64.3	1.0	1.0	0.1
More than 1,000	200	0.1	85.9	83.3	66.4	1.4	1.9	0.1
All	140,030	100.0	18.6	17.4	15.2	0.4	0.4	0.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

AGI Class (thousands of 2002 dollars)			Percent of Total Income Tax Change			Average Tax Change ($)		
			Administration	House	Senate Finance Committee	Administration	House	Senate Finance Committee
Less than 10			*	*	0.1	**	**	**
10-20			1.1	0.7	2.6	-11	-7	-4
20-30			2.3	1.6	4.8	-29	-18	-9
30-40			2.3	1.6	4.5	-38	-26	-12
40-50			3.7	2.4	6.2	-80	-49	-21
50-75			8.4	6.1	12.8	-106	-72	-25
75-100			8.6	6.4	11.9	-199	-137	-43
100-200			20.1	15.7	23.7	-482	-348	-88
200-500			18.5	15.9	15.4	-1,854	-1,481	-238
500-1,000			8.9	9.6	5.9	-5,309	-5,363	-544
More than 1,000			26.0	39.8	12.2	-29,870	-42,443	-2,180
All			100.0	100.0	100.0	-163	-152	-25

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

provided much more fiscal stimulus, especially over the short term. That is why accelerating the implementation of many of the tax cuts passed in May 2001 makes so much sense today."[6] However, if Congress is going to rethink tax options in light of the decline in the economy and the massive decline in fiscal prospects over the last two years, it should focus on restricting the size of the long-term tax cut passed in 2001.

Another commonly made argument is that acceleration of the EGTRRA tax cuts, especially the cuts in the top rate, would be a great boon to small business. As shown in Table 5, however, even including the dividend and capital gains tax cut in the House package, more than half of all returns with small business income would receive tax cuts of $500 or less, and half of those (a quarter of the total) would receive no tax cut.

That fact notwithstanding, tax cut advocates claim repeatedly that reducing the top rate disproportionately helps small business. Table 7 presents data that can help clarify this discussion. First, the vast majority of small business owners do not face anything approaching high marginal income tax rates. Only about one-third of small business returns are in tax brackets of 26 percent and above, less than 5 percent face rates of 35 percent and above, and only 2 percent are in the top tax bracket. Thus, the claim that cutting the top rate or the top two rates is crucial for small business is misplaced. Roughly 95 percent of small businesses are not affected at all by cuts in the top two tax rates.

[6]*The Washington Times*, May 7, 2003, page A16.

Second, although it is clearly the case that the share of returns that report at least some business income rises as income rises, business income is not the dominant form of income for most of those returns. In the top two brackets more than half of returns have some business income and in the top bracket almost three quarters have some. But much of that business income is not from the taxpayer's primary occupation. For example, a professor's consulting income or an executive's compensation from serving on a board of directors would appear as business income, rather than wages and salaries, on a tax return. Only about one quarter of households in the top bracket and one-sixth in the second bracket have more than half of their income from business income.

VI. Tax Cuts on Dividends and Capital Gains

In the United States, some corporate income is currently taxed twice (once at the corporate level and again when received by shareholders as dividends or capital gains); some is taxed once, at either the corporate or individual level; and some is never taxed. Although precise data are difficult to obtain, it appears that roughly one quarter of corporate income is taxed twice, one quarter is never taxed, and about half is taxed once.[7]

Taxing all corporate income once is a sound idea, other things being equal. To ensure that all corporate income was taxed once, however, would involve both eliminating tax on the doubly taxed portion of corporate income and taxing the currently untaxed portion. Such an objective could be accomplished in a roughly revenue-neutral manner, and indeed the first President Bush's Treasury Department proposed to do just that in 1992.

The proposed reduction in taxes on dividends and capital gains is ostensibly motivated by a desire to tax corporate income once. But none of the dividend and capital gains tax cut proposals under consideration attempt to guarantee that all corporate income is taxed once. Thus, one suspects that current efforts for dividend and capital gains tax cuts have less to do with improving the operation and incentives in the tax system than with other goals, such as providing large tax cuts for high-income households.

Before turning to the individual proposals, we address several issues common to all of them. First, each proposal would boost the stock market, although by differing amounts. It is not clear to us, however, why the government should have a goal of boosting the stock market any more than it should have a goal of boosting, say, the price of steel. Some have claimed that the stock market boost would spur investor confidence. But even the president's proposal (the largest of the three) is likely to increase the stock market by only about 5 percent, and it seems unlikely that an increase of that magnitude would have any appreciable effect on investor confidence in the absence of more fundamental changes in the economic outlook. Furthermore, increases in the current stock market induced by tax cuts will raise consumption, reduce private and public saving, and thus reduce future national income.

Second, it has been claimed, by the president and others, that dividend tax cuts would help the elderly. In fact, the vast majority of elderly would gain little from the dividend tax cut. Less than 4 percent of the total dividend and capital gains tax cut in the administration's proposal would go to elderly households with income below $50,000. And, as Table 5 shows, more than 80 percent of elderly taxpayers would receive tax cuts of less than $500.

Third, as noted above, dividend and capital gains tax cuts are a very inefficient way to stimulate the economy in the short run.

A. President's Proposal

Under the president's proposal, dividends and capital gains realized on corporate stock would be tax-free to the extent that the underlying income had already been fully taxed at the company level. This proposal has several useful features. For corporations that pay corporate income tax, the proposal would reduce or eliminate the tax incentive to retain earnings rather than pay out dividends. It would also improve neutrality between investment in corporate capital and other investments and between debt and equity. However, it would not eliminate incentives or opportunities for corporations to shelter earnings; for those corporations that do shelter earnings, it would not eliminate the incentive to retain earnings (Gale and Orszag 2003).

If the proposal were paid for by closing loopholes — as was originally proposed by the Treasury in 1992 — it could improve economic incentives and boost economic growth (U.S. Department of the Treasury 1992). But as a tax cut rather than a tax reform, the administration's proposal would boost the current stock market, which would raise current consumption, and as explained above, would thus reduce national saving by reducing both private and public saving. The reduction in national saving would either crowd out private capital investment, which would reduce future productivity, or raise borrowing from abroad, which would mortgage future income. As noted above, estimates suggest that deficit-financed dividend relief would on balance produce a long-term drag on the economy.[8]

In addition, the administration's proposal is complex and regressive. Companies would have to follow complicated rules to account for the tax-free dividends and capital gains that they allocate to shareholders. Shareholders would no longer be able to figure the capital gain upon sale by subtracting cost from the net proceeds of sale. The cost basis for stock would be

[7] *See* Gale (2002), who estimates that about half of dividends are not taxed at the shareholder level under current law. The Tax Policy Center estimates that more than one-third of dividends are paid out of corporate earnings that did not face corporate tax. McIntyre (2003) estimates that about half of all corporate earnings are untaxed at the corporate level.

[8] *See also* Gravelle (2003). Burman (2003) provides a proposal for a roughly revenue neutral integration proposal that would likely produce positive economic effects.

adjusted up or down depending on the company's dividend payouts and tax payments for every year between purchase and sale. Shareholders, brokerage firms, and mutual funds would need to report different dividend numbers to state and federal governments if state governments continue to tax all dividends and capital gains, as most do at present.

In the political debate, much of the justification for the president's proposal has been based on notions of fairness. The administration claims it is unfair to tax shareholders when their dividends are already paid out of after-tax corporate income. That is, dividend relief is said to be a matter of horizontal equity. This argument is misguided. It is not unfair to levy a tax that all shareholders knew they would be subject to when they made the investment. A shareholder would have purchased the stock only if she expected the after-tax return to be competitive with competing investments. Indeed, if there is an issue of horizontal equity, it arises from the windfall to existing shareholders from the sudden elimination of the tax. The tax cut would discriminate in favor of those who had invested in corporate stock in the past as compared with investors in other assets, such as bonds or real estate.

Most importantly, the House proposal abandons any notion of dividend tax changes as a way of integrating the corporate and individual taxes.

A second aspect of equity — vertical equity or progressivity — is arguably violated by the president's dividend relief proposal. Table 8 compares the distributional effects of the dividend and capital gains tax cuts for the administration, House, and Senate Finance bills, and focuses on 2004 because the Senate provisions would not take effect until then and the House plan would only partially take effect in 2003.

The table shows that under the administration dividend and capital gains tax cut alone, after-tax income would rise by 1.4 percent for those with income above $1 million compared to 0.2 percent or less for households in income groups below $75,000. About 26 percent of the benefit would go to the 0.1 percent of households with incomes greater than $1 million and three-quarters would go to households with income above $100,000. The bottom 85 percent of households, with incomes of $75,000 or less, would get only about 10 percent of the tax cut. The average tax cut would be almost $30,000 per year for the top 0.1 percent of households, compared to less than $50 for households below $75,000.

B. House Plan

The House plan would reduce the tax rate on dividends to 15 percent (and 5 percent for taxpayers in the lowest two brackets). It would also reduce capital gains tax rates to these levels from the current 20 percent maximum capital gains tax rate (10 percent for lower-income taxpayers). As discussed below, relative to the administration proposal, the House proposal is slightly less expensive, significantly more regressive, and probably less complicated.

Most importantly, however, the House proposal abandons any notion of dividend tax changes as a way of integrating the corporate and individual taxes. First, shareholders would get the benefit of the lower dividend tax rates and lower capital gains on corporate stocks regardless of whether the corporation had paid taxes. Second, taxpayers would benefit from lower capital gains tax rates even if their investment were not in corporate stock. Indeed, about half of capital gains are on assets other than corporate stock (Wilson 2002). Third, the capital gains tax cut provides as much additional incentive to purchase other assets, such as land or small businesses, as it does to purchase corporate shares, and so does not reduce the distortion created by the corporate tax.

Fourth, and of most concern, the proposal could invite a wave of tax shelters for corporations and individuals. One gauge of the potential impact of this problem is that the JCT estimate of the cost of dividend and capital gains tax cuts in the House bill is $276 billion over 10 years. This is on the order of twice the "static" estimate from the TPC microsimulation model. The difference is likely due to the fact that JCT may consider several margins of behavior that the TPC model does not. For example, corporations would become a much more effective tax sheltering device. Under current law, arranging to earn income through a corporate shell subjects the investor to full taxation on dividends plus any tax levied at the corporate level. Under the proposal, if an investor in the top income tax bracket can arrange to channel income through a corporation, which can take advantage of corporate tax shelters to avoid tax, any income distributed to the investor would be taxed at less than half the rate of other income. The fact that the dividend-paying company had paid no income tax would not limit the tax breaks received by shareholders.

In addition, the increase in the capital gains tax differential would likely fuel the growth of individual tax shelters. Virtually all individual income tax shelters exploit the difference between tax rates on capital gains and on ordinary income and deductions. The 15 percent top tax rate on capital gains would be the lowest rate in effect since 1941 (Burman 1999). It would provide massive incentives for any scheme to convert ordinary income into capital gains.

Because the proposal does not effectively integrate the corporate and personal taxes, it does not generate the benefits of reallocating the capital stock from noncorporate to corporate uses (as could result from the administration proposal). In addition, the increase in sheltering and in the national debt would serve to reduce growth. Thus, it is not surprising that, as noted above, the Joint Committee on Taxation concluded that the House plan would reduce economic output over the decade.

Finally, the House proposal is by far the most regressive option for providing relief on capital income because it extends substantial tax breaks to individuals with capital gains. Income from capital gains is much

more skewed than dividends. The 0.1 percent of people with incomes over $1 million will receive a projected 48 percent of realized capital gains in 2003, but only 15 percent of dividends. Taxpayers with incomes over $200,000 will earn 72 percent of capital gains, compared with 36 percent of dividends. Thus, lowering taxes on capital gains is worth much more to those with very high incomes than exempting a portion of dividends. As a result, the House dividend and capital gains proposal would reduce taxes by almost 2 percent of income for taxpayers with incomes over $1 million (Table 8). Such taxpayers will receive nearly 40 percent of the tax benefits from such a scheme.

The House plan would also create substantial complexity for individuals. Taxing dividends at the same fixed rates as capital gains sounds simple, but it is not. The alternate rate schedule that applies to long-term capital gains is extremely complicated. Taxpayers first have to calculate income (including all capital gains) and tax as if the alternative rates did not apply. Then, they must make an adjustment to the extent that their capital gains are taxed at a higher rate than the set maximum. A similar adjustment must be done to compute the alternative minimum tax, if applicable.[9] These adjustments require an entire page each on the schedule D (used to report capital gains) and form 6251 (used to calculate AMT). For taxpayers who carryover AMT credits from one year to the next, the same calculations must be repeated a third time on form 8201. If dividends are taxed the same as long-term capital gains, taxpayers with dividends will have to undertake similar pointlessly complex calculations every year.

C. Senate Finance Proposal

Starting in 2004, the Senate Finance Committee proposal would exclude the first $500 of dividends earned by individuals plus 10 percent of the amount over $500. Starting in 2008, 20 percent of dividends above $500 would be excluded. The proposal would sunset at the end of 2012. It would cost $81 billion over 10 years according to the JCT. The Finance Committee, however, also approved $72 billion of net offsets, including provisions designed to rein in corporate tax shelters.

Like the House version, the Senate Finance plan would apply the dividend exclusion regardless of whether tax had been collected at the corporate level. The anti-corporate-tax-shelter provisions in the Senate proposal, however, would tend to increase the share of company income paid in taxes. The proposal would reduce somewhat the tax bias against corporate investment, and it would reduce the disincentive for corporations to pay dividends, although by less than the other two options. Because of its more modest net revenue cost, this option has the least damaging effect on national saving. It would also slightly improve economic neutrality and close inefficient loopholes, both of which would tend to boost economic efficiency.

This proposal is the least regressive dividend relief package. The dividend exclusion provision itself would add about the same small share of after-tax income for all classes of taxpayers with incomes over $75,000 (about 0.1 percent). Only 12 percent of the benefits would flow to those with incomes over $1 million. About 18 percent would go to those with incomes under $50,000 (Table 8).

For taxpayers with more than $500 of dividends, accounting for dividends would be somewhat more complex than under current law. However, this added complexity pales in comparison to the complexity due to alternate rate calculations (in the House version) or the complex accounting for excludable dividends in the administration's proposal. For taxpayers with less than $500 in dividends, the effect on tax complexity would be mixed.[10]

VII. What's Wrong With This Picture?

The disconnect between the economy's current problems and the proposed tax solutions is striking. The economy is sputtering, and a short-term boost may be helpful. Long-term growth is always beneficial, so policies that boost such growth would be helpful. The budget faces seriously bleak prospects in the not-too-distant future, so fiscal restraint is appropriate, especially in the longer term. One of the major fiscal problems is the need to reform the AMT, repeal of which would cost upwards of $1 trillion over the next decade, with the cost growing with each delay.

> ***The disconnect between the economy's current problems and the proposed tax solutions is striking.***

In this environment, three policies strike us as particularly attractive. The first is substantial assistance to the states. The Senate Finance proposal includes $20 billion in aid to the states. States have already weathered two years of substantial budget deficits and face fiscal shortfalls of more than $75 billion for the upcoming fiscal year. Having largely exhausted the loopholes in their balanced budget rules and drawn down their rainy day funds, the states are being forced

[9]The AMT will apply to one-third of taxpayers, and an even larger share of people with capital gains by 2010 according to TPC projections, so the interaction between capital gains and AMT complexity would be a growing nuisance for taxpayers over time.

[10]The proposal might be simpler than either the administration or the House proposals. Taxpayers with dividends less than $500 would presumably not have to report dividends on their federal income tax returns. More than one-third of taxpayers with dividends are in this category. On the other hand, some taxpayers with dividends less than $500 would still have to tally them on tax returns, though, because the excluded dividends are included in modified AGI for purposes of income phaseouts. This provision, which was presumably included to limit the revenue cost, would add complexity to already unnecessarily complex provisions and might be reconsidered. In addition, if states did not change the treatment of dividends to conform with federal standards, the proposal would not simplify matters at all for most taxpayers.

to raise taxes or cut spending — either of which puts further short-term downward pressure on the economy. In this environment, federal aid to the states would translate into smaller state spending cuts or smaller state tax increases, and so would represent particularly effective short-term stimulus.

Opponents of state fiscal relief make two basic arguments: that the states brought the problem on themselves by irresponsible tax cuts and spending increases during the 1990s; and that state fiscal relief would set a bad precedent and encourage irresponsible behavior on the part of the states during the next business cycle. The first argument reflects a selective reading of the data: many factors contributed to the state fiscal crisis, including an unanticipated and steep decline in revenue associated with the recession and the stock market decline; the deleterious effects of the 2001 and 2002 tax cuts on state finances; and increases in costs in education, health care, and corrections. The second argument has merit at some level, but ignores the fact that moral hazard concerns must be weighed against other objectives. A wide variety of policy interventions are undertaken to cushion the immediate impact of adverse developments despite the potential moral hazard created. (If policymakers were so concerned about moral hazard, they would also eschew bailing out investors through a dividend or capital gain tax break.) Furthermore, state fiscal relief could be designed (in size and structure) to mitigate this concern. For example, aggregate state fiscal relief could be limited to some fraction (say, half) of the projected state deficits for next year. To attenuate the moral hazard concern further, relief should not be allocated in proportion to each state's projected deficit, but rather on the basis of some other factor such as population, income, an estimate of the revenue loss caused by the economic downturn given the structure of the state's tax system, or the share of total federal tax payments made by residents of the state.

The second policy is to extend the unemployment insurance benefit program that is scheduled to lapse in May. In particular, the March 2002 stimulus legislation created the Temporary Extended Unemployment Compensation (TEUC) program. The TEUC program provides extended unemployment benefits to workers who have exhausted their regular, state-funded benefits. The program is scheduled to begin phasing out at the end of May. New applications for unemployment insurance have remained at elevated levels, and the number of those who have exhausted benefits has been rising. In this context, extending the TEUC program would be both fair and sound short-term macroeconomic policy. Unemployment benefits would be quickly spent, spurring demand in the short run (Orszag 2001); they would also cushion the blow of unemployment in a continuing weak labor market.

Finally, if a long-term tax cut were to be enacted, it should be a permanent fix for the alternative minimum tax. The administration, House, and Senate Finance proposals instead defer the AMT problem by addressing it only for a few years. As is increasingly understood, the AMT will represent a growing problem over time (Burman, et al., 2002). Addressing this looming problem on a rolling basis, as appears to be the strategy that policymakers are following, does not reduce its long-term cost. Rather, it merely disguises that cost by spreading it over numerous budget proposals. It would be far better to resolve the uncertainty surrounding the AMT and recognize the costs by enacting a permanent reform to the AMT.

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Appendix Table 1: Distributional Effects of Key Proposals, 2003, by Income Percentile

AGI Quintile	Percent With Tax Cut			Percent Change in After-Tax Income		
	Administration	House	Senate Finance Committee	Administration	House	Senate Finance Committee
Lowest Quintile	0.2	0.1	0.3	*	*	0.1
Second Quintile	34.7	34.4	45.9	0.3	0.3	0.5
Middle Quintile	89.0	88.7	89.9	0.9	0.8	0.9
Fourth Quintile	96.2	96.1	95.2	1.1	1.1	1.0
Next 10 Percent	99.7	99.7	99.5	1.9	1.8	1.7
Next 5 Percent	99.8	99.8	99.8	2.4	2.3	2.1
Next 4 Percent	99.9	99.9	99.6	2.3	2.3	1.9
Top 1 Percent	98.6	98.8	91.2	3.6	3.6	2.6
All	64.0	63.9	66.1	1.8	1.8	1.6

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

AGI Quintile	Percent of Total Income Tax Change			Average Tax Change ($)		
	Administration	House	Senate Finance Committee	Administration	House	Senate Finance Committee
Lowest Quintile	*	*	*	-1	-1	-1
Second Quintile	1.1	1.1	2.2	-41	-38	-68
Middle Quintile	6.1	5.9	7.4	-227	-217	-233
Fourth Quintile	13.7	13.2	14.1	-510	-484	-445
Next 10 Percent	17.8	17.4	18.8	-1,319	-1,275	-1,185
Next 5 Percent	15.0	14.7	15.6	-2,224	-2,151	-1,974
Next 4 Percent	18.2	18.6	17.8	-3,374	-3,398	-2,809
Top 1 Percent	28.0	29.0	24.0	-20,762	-21,177	-15,159
All	100.0	100.0	100.0	-742	-731	-631

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0503-1).

Appendix Table 2: Distributional Effects of Accelerating Parts of EGTRRA in 2003, by Income Percentile[1]

AGI Quintile[2]	Returns[3]			Percent Change in After-Tax Income[4]	Percent of Total Income Tax Change	Average Tax Change ($)	Average Income Tax Rate[5]	
	Number (thousands)	On AMT (thousands)	Percent of Total				Current Law	Proposal
Lowest Quintile	26,884	0	19.3	0.0	0.0	-1	-10.1	-10.2
Second Quintile	27,805	3	20.0	0.2	1.1	-34	-4.9	-5.2
Middle Quintile	27,780	1	20.0	0.8	6.5	-200	4.4	3.7
Fourth Quintile	27,791	65	20.0	1.0	14.5	-443	8.9	8.0
Next 10 Percent	13,898	99	10.0	1.7	19.4	-1,184	11.4	9.9
Next 5 Percent	6,946	206	5.0	2.1	16.1	-1,963	14.2	12.5
Next 4 Percent	5,558	1,188	4.0	1.9	17.8	-2,717	18.6	17.1
Top 1 Percent	1,389	613	1.0	2.6	24.6	-15,027	27.8	25.9
All	138,051	2,175	99.3	1.5	100.0	-611	13.3	12.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model.
[1]Baseline is current law. Proposal includes ending marriage penalities in the tax brackets and standard deduction, accelerating 2006 rate cuts, increasing the child tax credit to $1,000, increasing the 10% bracket, and temporarily increasing the AMT exemption by 10K for couples, (5K for singles). This proposal mirrors the non-dividend, non-capital gains portion of the House plan.
[2]Returns with negative AGI are excluded from the lowest quintile but are included in the totals.
[3]Includes both filing and non-filing units. Returns of individuals who are dependents of other taxpayers are excluded from the analysis.
[4]After-tax income is AGI less individual income tax net of refundable credits.
[5]Average income tax, net of refundable credits, as a percentage of average AGI.