



# economic perspective

by Gene Steuerle

## Toying With the Economic Future

If one is a traditional tax reformer, there was much to recommend in the president's initial approach to tax policy. Lowering tax rates is a clean and efficient way to reduce taxes, as opposed simply to hiding more expenditures in the tax system. Reducing marriage penalties and household tax burdens when children are present can also be justified under a number of traditional tax policy principles. Distortions between debt and equity deserve to be removed both for tax and financial reasons, thus giving impetus to proposals to tax corporate income only once. A legitimate fight can be picked over who will pay for these cuts and how they will be paid for given long-term budget shortfalls, but, in truth, a similar fight should be picked over automatic growth in entitlement spending and a lot of increased discretionary spending as well.

As the tax "reform" process has unraveled, however, Congress has twisted various tax bills into budget packages oriented toward meeting some sound bite, such as the size of each package over a limited span of years. Its way of achieving this goal has been to schedule very large tax increases in the future. Some politicians think this is just a nifty way to get even more tax cuts down the road — after all, any future Congress will be scared to let those tax increases occur — but they are playing with economic dynamite for three separate reasons. First, these scheduled tax increases could cause timing shifts in economic behavior large enough to threaten economic growth. Second, they will inevitably distort investment and financing decisions in firms and the capital markets. Finally, they mess up the budget process for the future by making it difficult to know even what the law will be in the future.

Start with the dividend relief. With any temporary provision that might go away, firms would have an enormous incentive to pay out as much as possible in the way of dividends right away. The conference between House and Senate has backed off a Senate proposal that was even more temporary because of the associated revenue cost (understated in preliminary Joint Committee on Taxation estimates), but some portion of these threats and games will remain as firms pay out dividends in anticipation of the end of any relief that is provided. Some firms will simply look at what is happening to the budget and get their relief while they know the "getting" is good. Why wait until some future Congress pulls back on the relief? That is, on an expected value basis, it is still worthwhile to pay

out more dividends up front than otherwise, with a corresponding decline later.

A second set of games will inevitably be played as tax lawyers advise firms and individuals on how to take maximum advantage of a new incentive structure regarding dividends, retained earnings, and capital gains. We have not even begun to see the new options and opportunities that are going to be unveiled. Firms, for instance, will now go through a number of divestitures and mergers to maximize their after-tax income in the new tax world. To the extent relief is temporary, or thought to be temporary, the very nature and pace of reorganization will be affected.

Of course, it's not just dividends and capital gains that force recalculations of when and how to engage in economic activity. The new legislation combines with the laws adopted in 2002 and 2001 to schedule very large tax increases in the future — one for capital investment, the second the alternative minimum tax (AMT). Significant capital investment incentives (writing off a share of physical capital investments) are scheduled to end soon, so firms are not only given an incentive to beef up their investments temporarily, but then to go into a period of slack both because incentives decline and because some investment got shifted forward. (For previous articles on macroeconomic incentives, see Gene Steuerle, "Can Policymakers Time the Ending of Macroeconomic Incentives," (parts 1-3) *Tax Notes*, Apr. 1, 2002, p. 121; Apr. 15, 2002, p. 441, and Apr. 29, 2002, p. 789.) To complicate matters further, a firm now has to figure out how to coordinate two opposite incentives that affect cash flow: the decline in cash that might be occasioned by making additional dividend payments with the additional cash flow needed to shift investment into the incentive period.

Individuals, in turn, must take note of the \$100 billion annual increase in AMT taxes annually that is scheduled to take place through the remainder of this decade — creating its own dampening effect on the economy.

Finally, consider the budget process itself. Traditionally, it has been the mechanism for keeping legislative largess in check enough to avoid unsustainable growth in debt and to provide some budgetary slack, so that future revenues could be allocated to meet future needs not yet anticipated. Now Congress knows even less than ever how to figure out what current law even is and how little slack it has. Which of the many temporary tax cuts and tax relief provisions, for instance, are really temporary? What do CBO calculations under something called "current law" even mean?

## COMMENTARY / ECONOMIC PERSPECTIVE

The tax cutters think that they have beaten this system by putting in the law temporary cuts in dividend taxes, estate taxes, and AMT taxes, along with temporarily generous capital investment write-offs that need to be extended. But no planner can count fully on any of these extensions, especially given the size of the deficits that are coming along. Moreover, budget projections stretching out for 10 years are starting to incorporate years when the decline in the labor force participation of the baby boomers will significantly reduce projected economic growth rates. Thus, at a minimum, taxpayers counting on future Congresses to

defer again the scheduled tax increases face a lot of uncertainty. In this environment, they will be further advised to “get” theirs now — which means that even with an extension down the road, there will still be a future negative impact on the economy from any forward shifting of investment spending and dividend payments.

All this, it seems to me, is toying with the future economy — enough so that Congress and the president may not even get the short-run economic reprieve they want before the tax increases they have scheduled are due to take hold.