Published by

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230 www.aier.org

RESEARCH REPORTS

Vol. LXX No. 3 February 10, 2003

The Bush Tax Plan

The president's tax proposals could change the incentives to work, save, and invest in ways designed to encourage economic growth. However, unless the growth of government spending is slowed, reducing taxes will simply shift the burden of paying for government from current to future taxpayers.

The tax plan outlined by President Bush in his State of the Union speech, and presented to Congress in the Administration's budget for fiscal 2004, includes a number of changes designed to encourage economic growth. These include an acceleration of the tax-rate cuts enacted in 2001. For example, the top marginal tax rate would drop from 39.6 percent to 35 percent as of January 2003 rather than in 2006. It also would give small businesses a bigger tax break on their purchases of equipment. The centerpiece of the plan, however, is the proposal to end the "double taxation" of dividends.

Under current tax law, corporate income is taxed when a corporation makes a profit. When the corporation pays a dividend out of that income, it may also be taxable income to the stockholders. Whether or not this constitutes "double taxation" has been disputed (see box on p. 14), but most analysts believe that it has distorted business decisions. Rather than pay dividends, many managements have retained earnings and used the funds for purposes that have not benefited shareholders. In addition, the tax treatment of dividends may have encouraged over-reliance on debt financing, which has often turned out to be disastrous for stockholders. Interest paid by companies on their debt is a tax-deductible expense to them, whereas the dividends they pay on their stock are not. This makes it appear cheaper for companies to raise funds by borrowing rather than by issuing stock.

There are two ways to eliminate the double taxation of dividends: at the corporate level or at the investor level. The Bush plan would do the latter, by eliminating the personal income tax that shareholders pay on dividends.

Unfortunately, the way in which it would do so is confusing and complicated. The plan calls for dividends to be tax-free only to the extent that companies have paid taxes on their earnings at the corporate level. Because of countless tax breaks (some call them "loopholes") in the corporate income tax, the effective corporate rate is often much less than the 35 percent top corporate rate, sometimes as little as zero.

Under the president's proposal, if a company relies heavily on corporate tax breaks, or simply has no taxable profits, some portion of dividends would be taxable income to its stockholders. In practice, figuring out how much of a dividend is taxable could be messy, because it may not be possible to determine the taxable portion of a given dividend payment until long after it has been made.

The plan also would enable stockholders to increase their tax "basis" (the cost when calculating profit or loss when a holding is sold) by a so-called "deemed dividend." This would be an amount equal to the portion of retained earnings per share on which corporate taxes were paid. The notion seems to be that it is "double taxation" to tax capital gains that represent the accumulation of after-tax retained earnings.

In addition, investors who hold their stocks in IRAs or other tax-deferred plans will not directly benefit from the new exemption, because their dividends are already tax-deferred. Yet it appears that they will still owe tax on all withdrawals they take, including any portion attributable to dividends they have received that would have been non-taxable if received directly. The tax proposal thus would encourage investors to hold dividend-paying stocks outside of these plans and to hold riskier "growth" stocks in their IRAs. Tax policy could make the portion of IRA withdrawals attributable to non-taxable dividends tax-free, but this would create yet another accounting headache.

The president could have made his proposal simpler and fairer, and further reduced the tax distortions that skew corporate financing decisions, by instead making dividends a tax-deductible expense for companies, *i.e.* by having individual taxpayers (rather than the corporation) pay the tax on the share of corporate income they receive as dividends. This would make a company's decision to raise funds by issuing debt or equity "tax neutral," and it would extend the tax savings to all investors, not just those who hold stocks outside of IRAs and other retirement accounts. Apparently this is the main reason that this approach was not taken—it would have too large an impact on Federal receipts.

Also, allowing corporations to deduct dividend payments from their taxable incomes almost certainly would be criticized as an undeserved gift to scandal-ridden corporate America. Right now we suspect most politicians would rather be accused of supporting "tax breaks for the rich" than "tax breaks for greedy corporations."

A Giveaway to the Rich?

Critics have painted the Bush tax plan as a sop to the rich. It will indeed benefit high-income taxpayers the most—but so would virtually any other large income tax cut. The plain fact is that high-income individuals pay most of the income taxes.

The top two percent of taxpayers paid 45 percent of the personal income tax revenue collected in 2000, while the bottom 50 percent paid less than five percent. With so much revenue coming from such a small percentage of taxpayers, it is all but inevitable that any reduction in income tax rates will benefit them the most.

Another idea that has been proposed is to simply give every taxpayer a rebate of $300. This would leave more money in people's pockets, but it would not increase the incentive to work, save, or invest. The Bush tax cut, in contrast, would strengthen these incentives.

More Alternatives

Another idea that has been discussed

but is not part of the Bush plan, is to cut the payroll tax, which falls disportionately on lower-income individuals. Workers and their employers each pay 6.2 percent in Social Security payroll tax on every dollar of wages they earn up to a limit, set at $87,000 in 2003. (Workers and employers each pay another 1.45 percent in Medicare payroll tax without limit on the wages subject to this tax).

A permanent cut in the payroll-tax rate would benefit all workers, but more so low-income workers, who usually pay more in payroll taxes than they do in income taxes. It also would encourage companies to hire more workers, by reducing the amount that each business must spend on each employee.

However, the current proposals to "cut the payroll tax" do not call for a permanent rate cut. For example, Senator John Kerry has proposed a one-year "payroll-tax holiday" on the first $10,000 of wages, which would mean a $765 tax cut for each worker making $10,000 or more. This would provide a short-term boost to spending, but it would not change long-term incentives to hire. Employers would have little reason to hire more workers if they knew that their tax costs were going to increase after a year.

The exemption might actually harm some lower-income workers, because it would make it cheaper to pay two part-time workers $10,000 each than to pay one full-time worker $20,000. It would be better to permanently reduce the payroll tax rate than provide a temporary exemption on the first $10,000 earned.

Alternatively, Congress could end the double taxation of earnings. Currently, workers pay income tax not only on their take-home pay, but on the part of their pay that is withheld as payroll tax. In other words, they pay income tax on their payroll taxes. As far as we are aware, no one has proposed changing this.

Bush critics say that his failure to support any type of payroll-tax cut is yet another indication that he favors the rich. From a political perspective, however, it would seem easier to cut income taxes than payroll taxes. In the entire 66-year history of the Social Security program, Congress has never cut the payroll tax. Any plan to cut its revenue inevitably would stir up complaints about "raiding the Social Security trust fund." In contrast, politicians frequently tinker with the income tax. This is not necessarily a good thing but it does suggest that it offers better prospects for making significant tax cuts. In contrast to proposed income tax "rebates" or other temporary tax breaks, which would provide only a short-term stimulus to spend, the president's income-tax plan would change the incentives built into the tax code.

What About the Deficit?

The other argument against Bush's tax plan is that it will increase the Federal

Who Pays the Corporate Income Tax, and What are Its Effects?

Congress enacted the corporate income tax in 1906. Its rationale was based on the assumption (probably valid at the time) that only the very wealthiest citizens were stockholders of business corporations, so that a tax on corporate profits might accomplish what the Supreme Court had denied the lawmakers when it declared taxes on individuals' incomes to be unconstitutional. The corporate income tax was held to be constitutional (because it was technically levied as an "excise" on the government-granted right to do business as a corporation rather than as a direct tax, which the Court held could only be apportioned among the states according to population). Seven years later the Sixteenth Amendment ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration") became effective.

The corporate income tax has remained in place ever since, long after the incomes of rich people could be taxed directly. Since 1913 the corporate income tax has mainly been justified by arguments such as "corporations have a lot of money" and "the government needs it." Neither justification would seem to be based on economics.

First, where do corporations get their money? The corporate form of organization is simply a way for individuals to organize themselves, and it is individuals that ultimately bear the burden of taxes. As professor Boulding observed, "…the government simply uses the corporation as a tax collector." But from whom is it collecting?

The most obvious answer is that the tax falls on a corporation's stockholders. This view would appear to be behind the notion of the "double taxation" of dividends, first when they are paid out of profits and again when tey are taxed as individual income to shareholders. However this is not the only possible view. Some analysts have concluded that the corporate tax is simply passed on to consumers– *i.e.,* that it is "just another cost." Still others believe that to maintain a competitive return on capital (which can flee), the tax will come out of and reduce the returns to the other factors of production (labor and land).

The late Joseph Pechman of the Brookings Institution observed: "There is no more contentious issue in taxation than the question, 'who bears the corporation income tax.'" The answer probably includes all of the candidates mentioned above in proportions that vary with the stability of the revenues and the nature of the business of a given corporation.

Second, the government always needs money, but a tax of any kind will influence behavior, and whether that influence is for good or ill is, or should be, an important determinant of tax policy. In this regard, and in contrast to the issue of who pays the corporate income tax, there is little dispute concerning its effects on the behavior of corporate officers. First, whatever its validity, the notion that dividends are taxed twice has no doubt caused much capital to be raised in the form to debt instead of equity, rendering corporations more vulnerable to adverse business or financial conditions. From the point of view of a CFO, interest on debt is a tax deduction, while dividends are simply cash out the door. Second, and for the same reason, managements have often pursued expansion by limiting dividends and using retained earnings to expand operations, all too often in ill-conceived projects and acquisitions.

Finally, the very existence of the corporate income tax has led managements to seek special exemptions and favors from Congress. They often get them (just read the "fine print" of any tax bill). In other words, the corporate levy is the subject of much special pleading and lobbying. No doubt the lobbyists are well-attuned to the politicians' need to raise campaign funds. This is probably the main reason the corporate income tax is likely to be around for a long time to come.

CONSUMER PRICE CHANGES IN 2002

The Consumer Price Index for all urban consumers (CPI-U) increased by 2.4 percent last year, up from 1.6 percent the previous year.

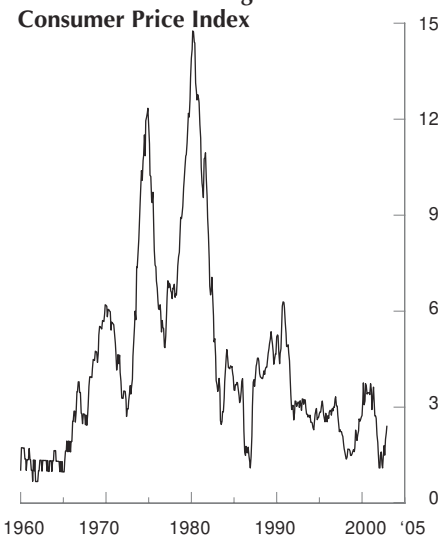
The acceleration in the rate of price inflation mainly reflects higher prices for energy and health care. Energy prices continue to be volatile from one year to the next. The price of fuel oil increased nearly 15 percent in 2002, after falling 27 percent the year before. Gasoline prices increased 25 percent, largely offsetting a 25 percent decrease in 2001. Netting out these swings, most energy prices are still lower than they were in 2000.

Other items that posted large price increases include hospital care (the price of outpatient services increased 12.7 percent, while inpatient services rose 9.4 percent), education (college tuition increased 7 percent), tobacco (higher state excise taxes helped push the price up 9.5 percent) and automobile insurance (up 9 percent). For all the talk of deflation, the prices of most things that consumers buy continue to increase.

The prices of high-tech items continue to fall, however, led last year by personal computers and peripheral equipment (down 22.1 percent), software (-10.7 percent), and televisions (-10.6 percent). The prices of cars and trucks (new and used), long-distance phone service, toys, and clothing also decreased.

Over the long-term, the data on price inflation paint a dismal picture. Since 1980, the general level of consumer prices has more than doubled. It is *ten* times higher than it was at the end of World War II.

Annual Percent Change in the Consumer Price Index



Percent Changes in Selected Consumer Price Indexes

December 2001 – December 2002

Expenditure Category	*Percent Change*
All Items	2.4
Food and Beverages (16% of expenditures)	1.5
Food	1.5
Food at Home	0.8
Breakfast Cereal	0.0
Bread	1.0
Cookies	2.8
Meats	0.2
Beef and Veal	0.6
Pork	-2.3
Bacon, breakfast sausage, and related products	-0.3
Pork Chops	-2.8
Poultry	-0.7
Fish and Seafood	-1.1
Eggs	9.7
Milk	-3.7
Cheese and related products	-2.5
Ice cream and related products	-1.5
Fresh fruits and vegetables	5.5
Apples	6.9
Bananas	0.0
Citrus fruits	9.7
Potatoes	8.3
Lettuce	-5.7
Tomatoes	9.2
Canned fruits and vegetables	3.3
Frozen vegetables	-0.1
Candy and chewing gum	1.6
Butter	-19.4
Salad dressing	-0.6
Peanut butter	0.1
Nonalcoholic beverages	0.9
Juices and carbonated drinks	1.0
Coffee	-0.3
Soup	1.2
Food away from home	2.3
Full service meals and snacks	2.2
Limited service meals and snacks	2.2
Alcoholic beverages at home	1.9
Beer and ale	2.6
Wine	1.4
Distilled spirits	0.2
Housing (40% of expenditures)	2.4
Shelter	3.1
Rent of primary residence	3.1
Owners' equivalent rent of primary residence	3.3
Hotels and motels	0.0
Fuels and utilities	1.4
Fuel oil	14.7
Electricity	-1.9
Utility natural gas service	6.7
Water and sewerage maintenance	3.5
Garbage and trash collection	2.4
Household furnishings and operations	-1.5
Floor coverings	2.0
Window coverings	-3.7
Bedroom furniture	-1.6
Living room, kitchen, and dining room furniture	-1.0
Major appliances	-2.3
Clocks, lamps, and decor items	-5.3
Dishes and flatware	-5.4
Tools, hardware and supplies	-1.6
Outdoor equipment and supplies	-1.3
Housekeeping supplies	-1.1
Household operations	2.3
Gardening and lawncare services	0.1
Repair of household items	4.9
Apparel (4% of expenditures)	-1.8
Men's apparel	-1.0
Suits, coats, and jackets	-0.7
Shirts and sweaters	-1.0
Pants and shorts	-3.2
Boys' apparel	-9.2
Women's apparel	-2.1
Outerwear	0.4
Dresses	1.2
Suits and separates	-2.4
Girls' apparel	1.7
Infants' and toddlers' apparel	-2.5
Watches	-5.3
Jewelry	-3.6
Footwear	0.1
Transportation (18% of expenditures)	3.8
New cars	-2.0
New trucks	-2.2
Used cars and trucks	-5.5
Car and truck rental	0.5
Gasoline	24.8
Motor vehicle maintenance and repair	3.7
Tires	0.1
Motor vehicle insurance	9.0
Motor vehicle fees	3.3
Public transportation	-0.9
Airline fare	-2.4
Ship fare	-1.8
Public transportation within city	1.5
Medical care (6% of expenditures)	5.0
Medical care commodities	3.1
Prescription drugs and medical supplies	4.5
Over-the-counter drugs	0.2
Medical care services	5.6
Physicians' services	3.2
Dental services	4.5
Eye glasses and eye care	-0.3
Inpatient hospital services	9.4
Outpatient hospital services	12.7
Nursing homes and adult daycare	4.4
Recreation (6% of expenditures)	1.1
Video and audio	2.0
Televisions	-10.6
Cable television	7.3
Video cassettes and discs	-0.4
Rental of video tapes and discs	-8.2
Audio equipment	-4.5
Pet food	0.3
Veterinarian services	5.2
Sporting goods	-1.4
Photography	-1.9
Toys	-9.3
Sewing machines, fabric and supplies	-2.2
Music instruments and accessories	-1.2
Recreation services	3.1
Club membership dues and fees	0.6
Admissions	4.9
Fees for lessons or instructions	1.4
Newpapers and magazines	2.2
Recreational books	1.7
Education and communication (5% of expenditures)	2.2
Education	6.6
Educational books and supplies	9.7
College tuition and fees	7.0
Elementary and high school tuition and fees	6.8
Child care and nursery school	4.9
Communication	-1.7
Postage and delivery services	10.4
Telephone services, local charges	5.3
Telephone services, long distance charges	-6.0
Cellular telephone services	0.3
Personal computers and peripheral equipment	-22.1
Computer software and accessories	-10.7
Other goods and services (5% of expenditures)	3.3
Tobacco and smoking products	9.5
Personal care	1.6
Cosmetics and related products	-1.4
Haircuts and other personal care services	1.9
Legal services	4.3
Financial services, incl. tax returns	3.2
Funeral expenses	4.3

budget deficit. The administration has acknowledged that the Federal budget deficit is likely to be $300 billion or more this year, and the president's long-term budget projections show deficits for the next ten years. Critics of the tax plan say that this is no time for a tax cut that will contribute to ballooning deficits.

This criticism ignores the other crucial factor behind budget deficits, which is spending. There were two reasons that the budget deficits of the early 1990s turned into surpluses from 1998 through 2001. First, as shown in the Chart 1, Federal receipts increased to a remarkably high level. The share of Gross Domestic Product paid to the Federal government in 2000 was the highest since World War II. This "revenue bubble" was a product of the strong economy and especially the stock market boom, which generated record taxes tied to capital gains and stock options. But the other factor was that Federal spending decreased as a percentage of GDP. This owed largely to cuts in defense spending, which shrank from a high of 6.2 percent of GDP in 1986 to just 3.0 percent of GDP in the fiscal years 1999-2001–its lowest percentage since the 1930s.

This "peace dividend" is now gone. No one knows how much the war on terrorism will cost. The Administration is projecting that defense outlays will total 3.5 percent of GDP this fiscal year and decline thereafter. If defense outlays increase to, say, *five* percent of GDP (their level during the late 1970s, *before* the buildup under President Reagan), even without tax cuts, other kinds of government spending would have to be cut in order to bring total spending back in line with revenues. With tax cuts, non-defense spending would have to drop even farther to return the budget to balance.

No administration has ever made major cuts in non-defense spending, however. The greatest success of the "Reagan revolution" was reducing tax rates; its greatest failure was that the promised spending cuts never materialized. This was largely because Congress, which was controlled by Democrats during most of Reagan's presidency, consistently rejected his proposed spending cuts. Republicans now control both houses of Congress. If they again fail to cut spending they cannot blame divided government.

Some observers, including Milton Friedman, believe that cutting taxes is a necessary first step toward future cuts in government spending. The notion is that "starving" the government of revenue will create large deficits that will eventually become politically unpopular, forcing Congress to cut spending to keep deficits to a "manageable" level. In this view, perpetual deficits are acceptable, if they are large enough to keep a lid on spending but small enough to keep the national debt (the sum of all the deficits the government has ever run) from growing faster than the economy.

We are skeptical of this scenario. History suggests that today's $300 billion deficit could get much higher, and add much more to the national debt, before political pressures build enough to reduce it. The deficit grew much larger in the 1980s, relative to the size of the economy, than it is now. It was six percent of GDP in 1983. In today's economy, that's the equivalent of $600 billion. As a result of those large deficits in the 1980s, the size of the national debt doubled in relation to GDP.

Those earlier deficits did not spur Congress to make major cuts in domestic programs. They were eliminated through an extraordinary combination of surging tax revenues and sharply reduced defense spending. Under President Bush's plan, these options are not available. Shrinking outlays to match the president's proposed reduction in revenues almost certainly would require targeting the large "middle class" entitlement programs that up to this point have been untouchable. Voters may not want to pay for these entitlements, but so far they have not been willing to give them up. Until this changes, no tax cut will reduce the size of government. It will only shift its source of financing from tax revenues to borrowing, or from current to future taxpayers. ❑

Chart 1
Federal Receipts and Outlays
(Percent of GDP)

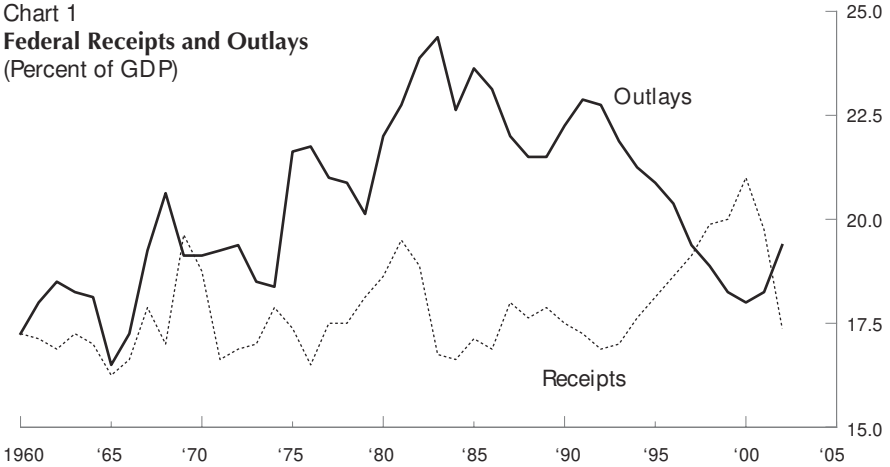
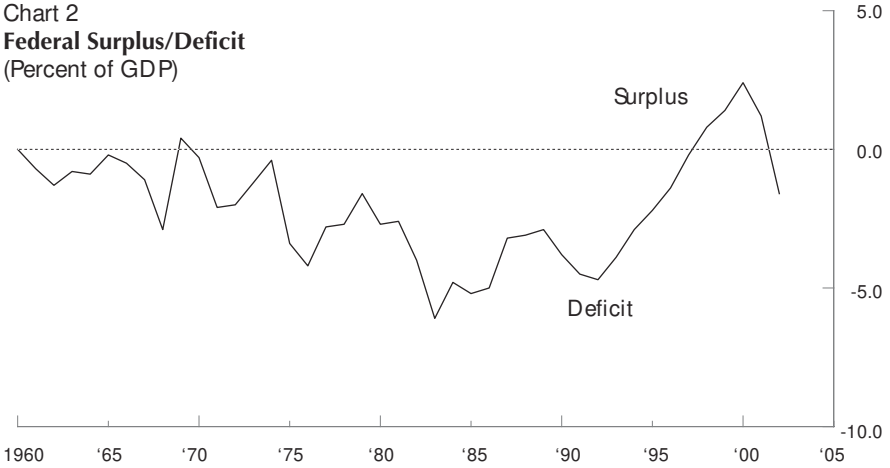


Chart 2
Federal Surplus/Deficit
(Percent of GDP)



PRICE OF GOLD

	2001	*2002*	—— *2003* ——	
	Feb. 8	*Feb. 7*	*Jan. 30*	*Feb. 6*
Final fixing in London	$262.95	$299.50	$367.60	$375.80

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.