

The President's Tax Plan



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The President's Tax Plan

President Bush announced a “jobs and growth” tax-reduction package on January 7, 2003. He made additional tax reduction proposals on February 3. In this presentation, I discuss the president’s overall plan, reflecting both sets of proposals.

In this discussion, I first provide an overview of selected provisions of the plan. I then consider at some length the proposal to integrate the individual and corporate income taxes. (The media generally refer to this proposal as “dividend tax relief,” but, as explained below, that description is incomplete.) I conclude by reviewing the plan’s potential role as a short-run stimulus to aggregate demand, the distribution of its tax savings, and its budgetary impact.

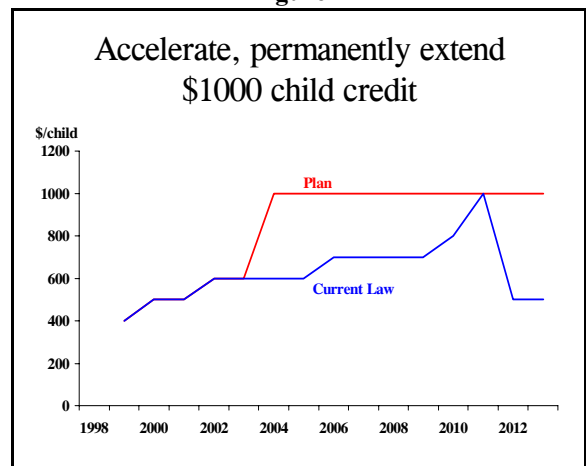
Overview of Selected Provisions

The first provision permanently extends the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), the large tax cut Congress and President Bush adopted in June 2001. Except for one small provision that has already been made permanent, EGTRRA is now scheduled to sunset, or expire, in its entirety on December 31, 2010. The president’s plan would eliminate this sunset. All EGTRRA provisions in effect in 2010 would be made permanent.

Many of the tax cuts made by EGTRRA are currently scheduled to phase in gradually, not taking full effect until 2006, 2008, or 2010. The plan would accelerate some, but not all, of these tax cuts, making them fully effective in 2003.

For example, the child credit, currently \$600, is scheduled to rise gradually, reach \$1,000 in 2010, and then drop back down to \$500 when EGTRRA sunsets (**Figure 1**). Under the plan, the credit would jump immediately to \$1,000 in 2003 and remain at that level permanently. This year’s increase in the child credit would be distributed to qualifying families in the form of \$400-per-child rebate checks.

Figure 1



The plan would also accelerate and make permanent EGTRRA's reduction in marginal tax rates (**Figure 2**). In 2003, the plan would lengthen the 10-percent bracket to cover \$14,000 rather than \$12,000 of taxable income, lengthen the 15-percent bracket (only for married couples), reduce each of the next three brackets by 2 percentage points (from 27 to 25, 30 to 28, and 35 to 33), and make a larger reduction in the top bracket (from 38.6 to 35). The standard deduction for married couples (not shown in the figure) would also be increased. Under the plan, the resulting rate schedule would apply from 2003 onward; under current law, it applies only from 2008 through 2010.

Under the plan, some of the EGTRRA tax cuts would not be accelerated, although they would be made permanent. For example, the estate tax changes would continue to phase in gradually, with full repeal not occurring until 2010. Under the plan, however, the estate tax would not spring back into existence in 2011, as it does under current law.

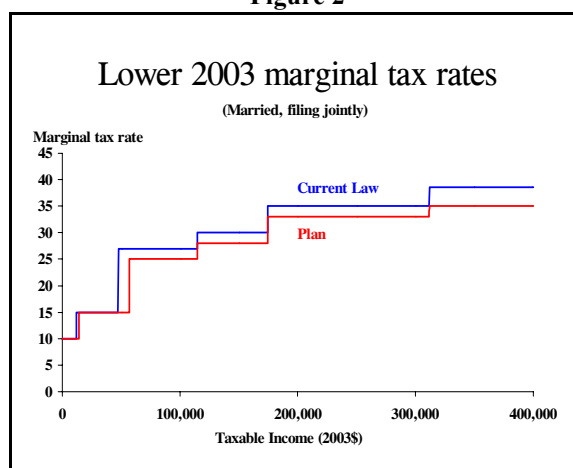
The plan would make permanent the research and experimentation tax credit, which is currently scheduled to expire on June 30, 2004. It would also triple—from \$25,000 to \$75,000—the amount of annual equipment purchases that small firms may expense, or immediately deduct, rather than depreciate over time.

The plan would provide a new tax credit for health insurance premiums paid by low-income people under age 65. This credit would be refundable in cash for those who do not owe income tax. The plan would also offer a new tax deduction for long-term care insurance premiums.

The plan would offer temporary relief from the individual alternative minimum tax (AMT). Even with this relief, however, 40 million taxpayers would still move onto the AMT in the second half of this decade.

One of the plan's more sweeping provisions would expand and revamp individual retirement accounts (IRAs). For future contributions, conventional, Roth, and nondeductible IRAs would be replaced by two new accounts. Each taxpayer could contribute \$7,500 per year to a Lifetime Savings Account (LSA) and (if the taxpayer has at least \$7,500 labor income) another \$7,500 per year to a Retirement Savings Account (RSA). No age or income ceilings would apply. As with Roth IRAs, contributions to these accounts would not be deductible, but withdrawals would be tax-free. Withdrawals from LSAs could be made at any time for any purpose, while tax-free withdrawals from RSAs could be made only after age 58, death, or disability. Taxpayers would be allowed, but not required, to convert existing conventional and nondeductible IRAs to RSAs; if they converted, they would owe the same income tax (but no penalty) that they would have owed if they had withdrawn the IRA balances.

Figure 2

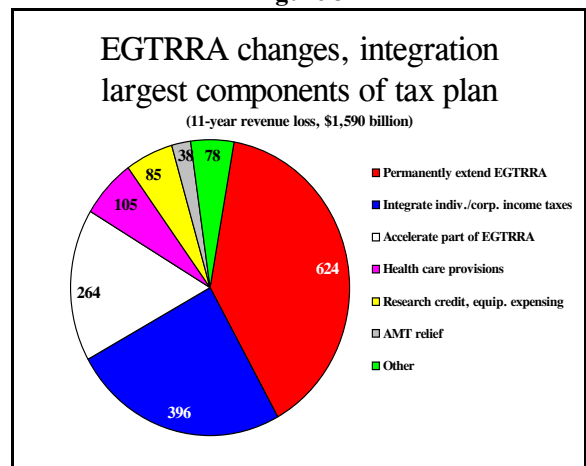


This proposal would greatly expand tax-free saving opportunities, because the new contribution limits would be much higher than current-law IRA contribution limits. Indeed, the overwhelming majority of households could do all of their saving in tax-free form. However, the impact on saving is uncertain. A significant fraction of personal saving may be done by the small number of households who save more than the limits. Those households would presumably take full advantage of the accounts, but the accounts would not give them any incentive to increase their savings. Since they would already be above the maximum, they would receive no tax relief for any *additional* saving. Also, the new accounts might substitute for other tax-preferred savings vehicles, such as employer pensions, tax-deferred annuities, and municipal bonds.

Because the tax break would be provided to withdrawals rather than contributions and because IRA conversions would be taxed, the provision would cause very little net revenue loss over the next decade. The small short-run effect camouflages the large long-run revenue loss that would result from future tax-free withdrawals.

The plan contains dozens of other tax changes, which I do not discuss here.¹ The Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) estimate that the plan's total revenue loss during the 11-year period from fiscal years 2003 through 2013, inclusive, would be \$1,590 billion (**Figure 3**).² The largest component of the 11-year revenue loss, \$624 billion, would arise from the permanent extension of EGTRRA. This extension would continue to reduce revenue by more than \$250 billion per year after 2013. The acceleration of EGTRRA tax cuts would generate an 11-year revenue loss of \$264 billion, but would generate no further losses after 2013. The other large component, which I have not yet discussed, is the proposal to integrate the individual and corporate income taxes. Integration would have an 11-year revenue loss of \$396 billion, with a continuing loss of more than \$60 billion per year after 2013. I now turn to the integration proposal.

Figure 3



¹For a detailed description and analysis of the entire plan, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2004 Budget Proposal* (JCS-7-03), March 2003, <http://www.house.gov/jct/s-7-03.pdf>.

²This \$1,590 billion "revenue loss" includes an increase of \$100 billion in refundable tax credits paid in cash to those who do not owe income tax. The government budget would record this \$100 billion as a spending increase rather than as a revenue reduction.

Integration of Individual and Corporate Income Taxes

I first describe how current law taxes non-corporate and corporate business income and then explain how the president’s proposal would change the tax treatment of corporate income, by integrating the corporate and individual income taxes. I then consider the proposal’s possible effects on investment and other economic incentives.

Current Law

As shown in the first row of the table (**Figure 4**), current law taxes the profits of both corporate and non-corporate firms when earned, regardless of whether the profits are paid out to owners or reinvested in the firm’s operations. Profits of non-corporate firms are taxed at the owners’ regular income tax rates. Profits of corporate firms are subject to a separate corporate income tax, generally at a 35 percent rate.³

As shown in the second row of the table, owners of corporate and non-corporate firms experience sharply different tax treatment when they receive payouts of profits. Owners of non-corporate firms may receive such payouts without further tax. In contrast, corporate stockholders are taxed on dividend payouts at their regular income tax rates, even though the underlying profits have already been subjected to corporate income tax.

As shown in the third row, the tax treatment also differs when the two types of firms reinvest their profits. Such reinvestment increases the value of the firm and generates capital gains for the owners. When owners of non-corporate firms sell their ownership stakes, this component of their capital gain is effectively tax-free. Current law allows the reinvested amount to be subtracted as part of the owner’s “cost basis.” For example, suppose that an individual buys a partnership interest for \$10 and that, during the time that she owns the interest, her share of the partnership’s reinvested profits is \$2. When the individual sells her partnership interest, she pays capital gains tax on her sale proceeds minus \$12. She can deduct not only the \$10 that she initially invested to buy the partnership interest, but also the \$2 that she indirectly reinvested in this interest (the \$2 that the partnership

Figure 4

	Non-Corporate	Corporate
Profits	Owners' regular income tax rates	35% corporate tax rate
Payouts to Owners	Tax-free	Owners' regular income tax rates
Capital Gains due to Reinvestment	Tax-free, add reinvestment to cost basis	Owners' capital gains tax rates

³For this purpose, “non-corporate” firms include sole proprietorships, general and limited partnerships, limited liability companies, S corporations (small corporations that qualify for and elect to be exempt from the corporate income tax), and special entities such as Real Estate Investment Trusts. “Corporate” firms include only C corporations (corporations that do not enjoy S status and therefore are subject to corporate income tax).

reinvested on her behalf). By treating the \$2 as part of the owner's cost basis, current law ensures that the \$2 increase in value due to reinvestment is tax-free.

No similar adjustment is made for corporate stockholders. When they sell their stock, they are taxed on all of their capital gains, including those due to the firm's reinvestment. They do benefit, though, from the fact that capital gains are taxed more lightly than other forms of income. (A special 20 percent maximum tax rate applies to gains on stock held for more than one year, the tax is postponed until the stock is sold, and the tax is forgiven entirely if the stockholder dies before selling).

Current law subjects the profits of corporate firms to both corporate income tax (as shown in the first row of the table) and to individual income tax (as shown in the second and third rows). Many proposals have been made to integrate the two taxes. Most European countries integrate their taxes, although many of them do so partially rather than completely.

Integration Proposal

The president's plan would integrate the corporate and individual income taxes in the following manner. For each \$35 of corporate income tax paid by a corporate firm, its stockholders would be allowed to receive \$65 of income free from individual income tax.⁴ The firm would be deemed to have received \$100 of income that was fully taxed at the 35 percent corporate tax rate. The remaining \$65 would not be taxed again at the individual level.

The tax relief would go to dividends first. If the firm paid an \$80 dividend, \$65 would be tax-free while the \$15 excess would still be taxed. If the firm paid a \$65 dividend, it would be fully tax-free. If the firm paid a \$50 dividend, it would be fully tax-free and stockholders would also be entitled to \$15 of tax-free capital gains. The firm would choose dates during the year on which it would be deemed to pay \$15 of hypothetical dividends. The stockholders would be deemed to use the hypothetical dividends to buy additional hypothetical shares of stock. When the stockholders sell their stock and compute their capital gains, the hypothetical dividends would be subtracted as part of their purchase costs. This "deemed dividend reinvestment" would give corporate stockholders a cost-basis adjustment similar to the one currently enjoyed by owners of non-corporate firms. The adjustment would not be simple, just as the current adjustment for non-corporate owners is not simple.

The media description of the integration proposal as "dividend tax relief" is incomplete. As explained above, the proposal also offers capital gains tax relief on reinvested profits.

⁴Under the proposal, the firm's payment of \$35 foreign corporate income tax (that was credited against the U.S. corporate income tax) would also allow stockholders to receive \$65 of income free from individual income tax.

So, the tax treatment of stockholders would depend on whether the firm pays dividends greater or less than 65/35 of its corporate income tax liability. The proposal would base this determination on a two-year lag of tax liability and would provide an averaging approach for firms with fluctuating dividend-tax ratios.

What's the typical situation? The ratio of aggregate dividends to (two-year-lagged) aggregate corporate income tax liability has consistently been well below the critical 65/35 ratio (**Figure 5**).⁵ This calculation suggests that the average firm's stockholders would receive fully tax-free dividends and would also receive some capital gains relief. (As discussed below, however, the adoption of the integration proposal might cause dividend payments to rise.)

The expanded table (**Figure 6**) shows that the plan would tax corporate firms more similarly to non-corporate firms—owners of both types of firms would enjoy tax-free payouts and reinvestment and thereby face only one level of tax. But, two differences would remain. First, corporate profits would be taxed at the 35 percent corporate rate, while non-corporate profits would still be taxed at the owners' individual income tax rates. Second, tax-free income for corporate stockholders would be subject to the 65/35 limit, while there would continue to be no similar limit for the owners of non-corporate firms. The latter could still enjoy tax-free payouts and reinvestments even if the firm used tax credits or other preferences to avoid tax on some or all of its profits.

Figure 5

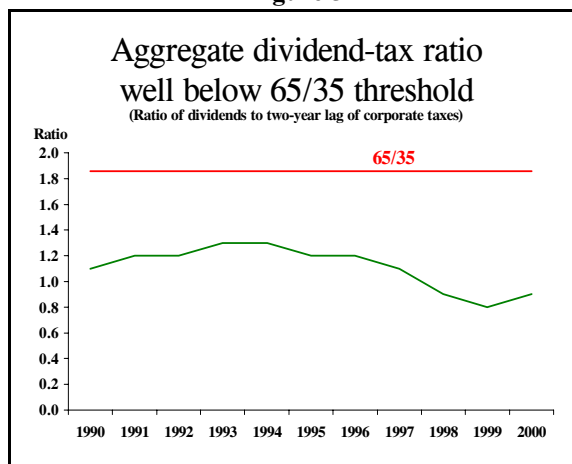


Figure 6

	Non-Corporate	Corporate	Corporate (Proposal)
Profits	Owners' regular income tax rates	35% corporate tax rate	35% corporate tax rate
Payouts to Owners	Tax-free	Owners' regular income tax rates	Tax-free up to 65/35 limit
Capital Gains due to Reinvestment	Tax-free, add reinvestment to cost basis	Owners' capital gains tax rates	Tax-free, add reinvestment to cost basis, up to 65/35 limit

By removing the individual income tax on corporate equity-financed investment, the integration proposal could have a significant impact on investment incentives. However, the impact depends upon exactly what corporations adjust when they decide to undertake a new investment and when they receive profits from that investment.

⁵I exclude dividends paid by S corporations from the dividend series used to compute this ratio, because the current-law corporate income tax and the integration proposal apply only to C corporations (see footnote 3). I include foreign income tax credited against U.S. tax in the tax series used to compute this ratio (see footnote 4).

Economists have adopted two theories about this question—a traditional view and a new view. Because the two views have such different implications, I consider each of them.

Impact on Investment - Traditional View

The traditional view assumes that a firm issues and sells new shares of stock to pay for investment. When the investment yields profits, the firm pays out part of the profits as dividends and reinvests the remainder. The implications of the traditional view are straightforward. After all profits have been subjected to corporate income tax, the portion paid out as dividends is subject to dividend tax and the reinvested portion is subject to capital gains tax. As a result, both dividend taxes and capital gains taxes penalize investment, as does the corporate income tax.

Impact on Investment - New View

The “new” view, developed in the 1970s, assumes that the firm cuts dividends to pay for investments. The firm increases dividends when the investment yields profits. The surprising result, in this case, is that the dividend tax does *not* penalize investment, as long as the tax rate is stable over time.

This conclusion is best illustrated with an example. To isolate the impact of the dividend tax, I assume, for the moment, that there is no corporate income tax and no capital gains tax. Consider an investment that costs \$100. Suppose that stockholders must receive a 5 percent per year after-tax return to be willing to invest—at lower rates of return, they prefer to spend their money or invest it overseas. The relevant question is the minimum annual profitability of the investment that makes it acceptable to stockholders.

First, consider the case in which there is no dividend tax. Since the firm cuts dividends by \$100 to make the investment, stockholders are out-of-pocket \$100 and demand a \$5 per year payoff. So, the minimum acceptable profitability is \$5 per year. Stockholders approve all investments with profits greater than or equal to this amount and veto all investments with lower profits.

Now, consider the case in which there is a dividend tax. The firm cuts dividends by \$100 to make the investment. But, stockholders would never have received this full amount. With a 20 percent dividend tax rate, they would have received only \$80 of the dividend, with the other \$20 going to the government. If the investment is made, stockholders are out-of-pocket only \$80. So, they demand a 5 percent after-tax rate of return only on \$80, not on the full \$100. The investment must provide an after-tax payoff of \$4 per year.

Of course, since profits are paid out as dividends, they are subject to the 20 percent tax. The minimum acceptable profitability is \$5 per year. With this profitability, the dividend tax is \$1 per year, leaving stockholders their required after-tax payoff of \$4 per year. Stockholders approve all investments with profits greater than or equal to \$5 per year and veto all investments with lower profits, the same decisions they made without the tax.

Since stockholders make the same investment decisions with or without the dividend tax, the tax does not penalize new investment. Because the dividend tax applies only to the money that the firm *doesn't* invest, the investment is made with pretax money. The dividend tax merely makes the government a partner in the investment—it picks up 20 percent of the cost and claims 20 percent of the payoff.

Rather than being a penalty on new investment, the dividend tax is a burden on the firm's existing capital. The existence of the dividend tax depresses the price of the firm's stock (in this example, by 20 percent).

However, investment is still penalized, not only by the corporate income tax, but also by the capital gains tax. When the firm reduces current dividends and makes the investment, it increases the value of each share of its stock, triggering capital gains tax.

Traditional vs. New View

Under the traditional view, the integration proposal would provide a substantial boost to new investment by removing the investment penalties currently imposed by both dividend and capital gains taxes (up to the 65/35 limit). The impact on stock prices would be limited, because the main impact would be to spur the formation of new capital rather than to increase the value of existing capital.

Under the new view, the integration proposal would provide a smaller boost to new investment, all of it due to the removal of the capital gains tax. The dividend tax relief would do nothing to boost new investment. On the other hand, the dividend tax relief would cause a large permanent increase in stock prices, reflecting the transfer of wealth from the federal treasury to stockholders. Existing capital would increase in value as the dividend-tax burden is lifted from its shoulders.

Which view (or what mixture of the two views) is most likely to be valid? Start-up firms, for which investment is greater than profits, must issue new shares to finance equity investment. They must, therefore, follow at least part of the traditional view. Mature firms, for which profits are greater than investment, *should* finance investment by cutting dividends, thereby following the new view, if they want to reduce their stockholders' taxes. But, statistical evidence suggests that some mature firms may behave in a manner more similar to that described by the traditional view. Given the conflicts between different strands of evidence and the uncertainty about how to interpret them, I cannot resolve this dispute here.

Other Implications for Investment

By lowering the tax on corporate equity-financed investment, the integration proposal would make the tax playing field less tilted across different forms of investment. But, it would not fully level the field. Corporate equity investment would be taxed only once (like other investment). But, that tax would still be imposed at the 35 percent corporate tax rate, which is generally higher than the average individual income tax rate that applies

to the profits of non-corporate firms. Corporate debt-financed investment would also continue to enjoy a lower average tax burden than corporate equity-financed investment. (It, too, faces only the individual tax, because the firm can deduct its interest payments from the corporate tax.) Still, the disparity would be narrower than under current law.

The integration proposal could cause several changes in the allocation and financing of investment. As equity-financed investment increased in the corporate sector, funds would become scarcer and more expensive in the non-corporate sector, reducing investment there. Costs would similarly be driven up for other borrowers, including state and municipal governments. There might be some contraction among firms that receive non-corporate tax treatment, such as S corporations and real estate investment trusts. With a lower tax burden on equity-financed investment, corporations might use less debt.

The integration proposal would probably cause portfolio shifts. Corporate stock, taxed at a flat 35 percent rate, would tend to concentrate in high tax brackets, while bonds and other assets taxed at individual rates, would tend to concentrate in low brackets, particularly tax-free retirement accounts. The incentive for stock holdings to shift to high brackets would be especially strong on days the stock pays dividends. To combat this incentive, the proposal would reduce the tax savings for stockholders who held the stock for fewer than 45 days around the dividend date.⁶

Other Incentive Effects

The integration proposal would have some other incentive effects. It might discourage firms from engaging in tax avoidance. If a corporation reduced its own tax liability by pursuing tax-preferred activities (such as buying municipal bonds, conducting research, or constructing low-income housing) or by investing in tax shelters, it would automatically increase its stockholders' taxes—they would receive less tax-free income, due to the 65/35 limit. The increase in stockholder taxes might temper the firm's incentive to avoid taxes. Calculations show, however, that the change in incentives would be minor for most firms. No major changes in behavior should be expected.

By taxing dividends more heavily than capital gains, current law penalizes dividend payments. This disparity encourages firms to give cash to stockholders through share repurchases rather than dividends. It also encourages firms to reduce dividends and reinvest profits rather than sell new shares of stock.

⁶The plan also includes a provision that would reduce tax savings for stockholders during the first year they own each stock. However, the IRS would probably establish broad exceptions to this provision.

The integration proposal would largely equalize dividend and capital gains taxes (by removing both of them, up to the 65/35 limit). So, the proposal might reverse the long-term downward trend in the fraction of firms paying dividends (**Figure 7**). Some supporters of the proposal argue that an increase in dividend payments would improve corporate governance. Investors would demand cash dividends, which might give them a better signal of firm finances than earnings reports that can be manipulated. Management would also face more market discipline if it financed investment by selling new shares to outside investors rather than reinvesting internally generated funds.

Other Economic Issues

Returning to the overall plan, I discuss three other economic issues: the potential role of the plan as a short-run stimulus to aggregate demand, the distribution of its tax savings, and its budgetary impact.

Short-Run Stimulus

The president's plan could stimulate aggregate demand, possibly aiding the recovery from the 2001 recession. However, the short-run stimulus would be modest. The tax cut in fiscal 2003 would be only \$39 billion, less than 3 percent of the 11-year tax cut.

The plan is not primarily intended to provide a short-run stimulus to aggregate demand. Its primary goal is to promote long-run growth by reforming the tax code. It should be judged by its success or failure in that regard.

Distribution of Tax Savings

Figure 8 displays information for six income groups, as computed by the Urban-Brookings Tax Policy Center. The green bars show the percentage of the country's tax returns filed by each group, 20 percent for each of the first four groups and 19 percent for the fifth group, with the last group constituting the top 1 percent of the income distribution. The blue bars show the percentage of the country's income tax payments currently made by each group. (Payroll and other taxes are not included.) The bottom two groups pay negative income tax, because refundable credits more than

Figure 7

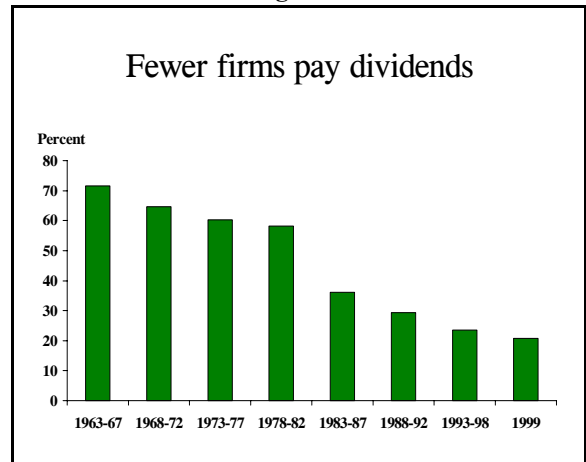
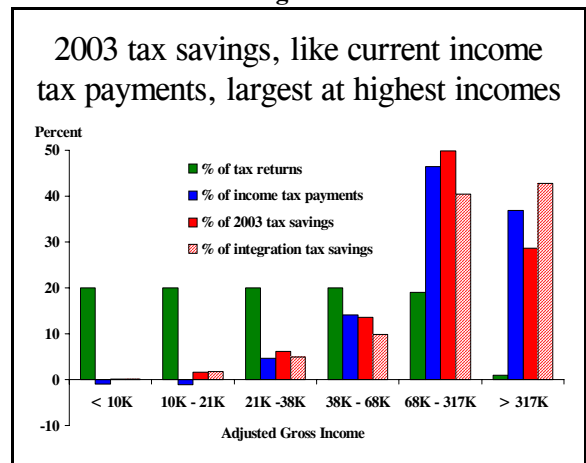


Figure 8



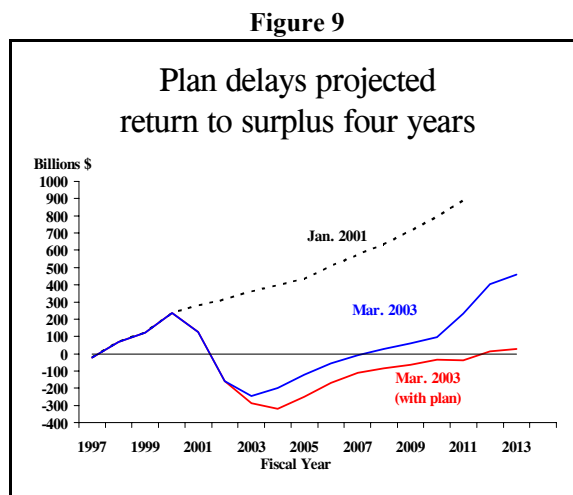
offset the income tax they owe. The top two groups currently bear the bulk of the income tax burden.

The solid red bars show the percentage of the plan's 2003 tax savings that would be received by each income group. (The analysis includes most, but not all, of the provisions that would take effect in 2003.) The top two groups would receive the bulk of the tax savings. Each group's share of the tax savings would be roughly similar to its share of the current-law income tax burden, implying that each group would receive roughly the same proportional reduction in its income tax liability.

The tax savings from the plan's integration proposal are shown by the shaded red bars. The top 1 percent of the income distribution would receive a larger share of the tax savings from integration than from the overall plan, reflecting that group's extensive holdings of corporate stock.

Budgetary Impact

As mentioned above, CBO and JCT estimate that the plan would reduce revenue by a total of \$1,590 billion during fiscal years 2003 through 2013, inclusive.⁷ The plan's 11-year revenue loss would be somewhat larger than that of EGTRRA. The lower revenues might create political pressure for reductions in spending. If spending cuts did not occur, however, the revenue loss would require additional federal borrowing, which would add \$350 billion to the government's interest expense over the 11-year period.



In **Figure 9**, the blue line shows the March 7, 2003 budget projection made by the Congressional Budget Office (CBO). The projection is for the current-law baseline, which assumes no changes in tax or spending laws. The overall budget remains in deficit until fiscal 2008, when it returns to surplus. The red line adds in the plan's estimated revenue loss and interest cost. With no spending changes, the tax plan would increase the current deficits, delay the projected return to surplus until 2012, and lower the subsequent projected surpluses.

As can be seen, the 2003 baseline projection is much less favorable than the baseline projection CBO made in January 2001, before EGTRRA, 9/11, and the recession. Spending increases proposed by the president and Congress could further increase the projected deficits and reduce or eliminate the projected future surpluses.

⁷These revenue estimates do not reflect any macroeconomic behavioral changes, such as changes in saving, investment, or labor supply. They do reflect projected changes in other behavior, such as portfolio decisions.

The change in each year's deficit or surplus would have a cumulative impact on the outstanding government debt. By the end of 2013, the plan would increase the government debt by more than \$1.9 trillion, relative to its projected level under current law (**Figure 10**).

Many economists believe that the increased debt would raise interest rates, which would crowd out private investment. On net, the plan might either raise or lower capital accumulation, depending on whether the crowding-out effect was smaller or larger than the investment boost provided by integration, the expansion of tax-free savings accounts, and other provisions of the plan. Economists do not agree on the magnitude of crowding out.

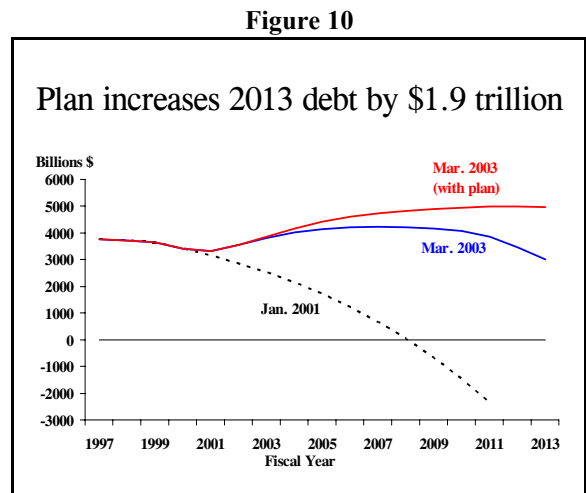
The increase in government debt would also impose future fiscal burdens—eventually, taxes would have to be raised or spending cut to service the extra debt. Of course, if the net effect of the plan were to increase capital accumulation, future taxpayers would enjoy a larger economy and higher wages, which could offset the fiscal burdens.

Conclusion

The plan is primarily intended to promote long-run growth rather than to provide a short-run stimulus to aggregate demand.

Its economic effects are uncertain. They depend, for example, on taxpayers' response to the expanded tax-free savings accounts, on whether the traditional view or the new view better describes corporate investment, and on the extent to which deficits crowd out private investment.

Of course, the final form, if any, in which the plan will be adopted is also uncertain, as it works its way through Congress in accordance with our constitutional system.



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