Testimony on the Administration's Tax Proposals

Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow in Economic Studies
Co-Director, Tax Policy Center
The Brookings Institution

Testimony before the Committee on Financial Services
Subcommittee on Oversight and Investigations
United States House of Representatives
March 18, 2003

Chairman Kelly, Ranking Member Gutierrez, and Members of the Committee, it is an honor to appear before you to discuss proposals for economic growth and job creation.

My testimony argues that the Administration's tax proposals are not well-designed for boosting economic growth in either the short run or the long run:

- In the short run, the key to economic growth is expanded demand for the goods and services firms could produce given current capacity.

- In the long run, a key to economic growth is higher national saving, which finances ongoing expansions in capacity over time.

Yet the Administration's proposals would have only modest effects on demand in 2003 and would expand budget deficits in the long run. All else being equal, the expanded budget deficits would reduce national saving in the long run, exactly the opposite of what would be needed to boost long-term economic performance. Furthermore, the proposals would exacerbate after-tax inequality of income in the United States.

It is also important to put the current proposals in context. The first wave of baby boomers will become eligible for retirement benefits under Social Security in 2008; they will become eligible for Medicare in 2011. As the baby boomers begin to retire, the Federal budget will come under increasing pressure.[2] Given that budgetary outlook, policies that significantly exacerbate long-term deficits seem especially reckless. As a recent report from the Committee for Economic Development, a leading organization of business leaders and educators, put it: "The first step in climbing out of a hole is to stop digging. We cannot afford economic policy decisions today that further raise deficits tomorrow."[3]

---

[1] Peter R. Orszag is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution and a Co-Director of the Tax Policy Center. Much of this testimony draws upon joint work with William Gale. I thank Henry Aaron, Robert Cumby, Robert Greenstein, and Jonathan Orszag for helpful discussions and comments, and Jennifer Derstine, David Gunter, and Matt Hall for excellent research assistance. The views in this testimony are those of the author alone, and should not be attributed to the staff, officers, or trustees of the Brookings Institution or the Tax Policy Center.

[2] For specific estimates of the long-term budget imbalance, see See Alan J. Auerbach, William G. Gale, Peter R. Orszag, and Samara Potter, "Budget Blues: The Fiscal Outlook and Options for Reform," in Henry Aaron, James Lindsay, and Pietro Nivola, *Agenda for the Nation* (Washington: Brookings Institution, forthcoming).

[3] Committee for Economic Development, "Exploding Deficits, Declining Growth," March 2003.

Especially in the face of significant uncertainties involving the war on terrorism, it is difficult for me to see the wisdom in a set of policies that would expand the long-term budget deficit; have at best a minimal positive effect on economic activity, and more likely a negative effect; and widen income inequalities.

Administration's tax proposals

The Administration has proposed two sets of tax cuts: those included in its growth package and other tax cuts included in the budget. The growth package would, along with other smaller changes, accelerate the 2001 tax cuts and exclude dividends and some capital gains from taxation at the individual level. A letter released in January that was signed by 10 Nobel Prize winners in economics, along with more than 400 other economists (including myself), emphasized:[4]

> "…The tax cut plan proposed by President Bush is not the answer to these problems. Regardless of how one views the specifics of the Bush plan, there is wide agreement that its purpose is a permanent change in the tax structure and not the creation of jobs and growth in the near-term. The permanent dividend tax cut, in particular, is not credible as a short-term stimulus. As tax reform, the dividend tax cut is misdirected in that it targets individuals rather than corporations, is overly complex, and could be, but is not, part of a revenue-neutral tax reform effort.
>
> Passing these tax cuts will worsen the long-term budget outlook, adding to the nation's projected chronic deficits. This fiscal deterioration will reduce the capacity of the government to finance Social Security and Medicare benefits as well as investments in schools, health, infrastructure, and basic research. Moreover, the proposed tax cuts will generate further inequalities in after-tax income…"

That letter was written primarily in response to the Administration's growth package, which was announced on January 7th.[5] The additional tax cuts in the budget include, most prominently, substantially expanded tax-preferred savings accounts and the removal of the sunsets on the 2001 tax legislation. These proposals also do not seem well-designed for either the short run or the long run, since they would fail to do much to boost demand in 2003 and would expand budget deficits in the long run.[6]

Economic effects of deficit-financed tax cuts

An important aspect of all the Administration's tax proposals -- including making the 2001 tax cuts permanent, the new dividend proposal, and the new savings account proposal -- is that they are effectively deficit-financed. (It should be noted that the House budget resolution may effectively finance the tax proposals in a different manner than the Administration's budget.)

---

[4] See http://www.epinet.org/stmt/2003/statement_signed.pdf.
[5] For further analysis of the dividend proposal, see William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," The Brookings Institution, January 13, 2003; and William G. Gale and Peter R. Orszag, "The President's Tax Proposals: Second Thoughts," *Tax Notes*, January 27, 2003.
[6] For an analysis of the savings proposals, see Leonard E. Burman, William G. Gale, and Peter R. Orszag, "The Administration's New Tax-Free Saving Proposals: A Preliminary Analysis," *Tax Notes,* March 3, 2003.

Deficit-financed tax cuts are unlikely to have significant positive effects on economic growth in the long-term, and may well reduce it. A full analysis of tax cuts that result in larger budget deficits needs to take into account (1) the direct effects of the policy in question, ignoring any change in the deficit; and (2) the decline in national saving caused by the expanded budget deficit.

The most recent prominent example of the tradeoffs involved is the 2001 tax cut. The net effect of the 2001 tax cut on growth is the sum of its (possibly positive) effect from changes in incentives and its (negative) effect through increases in the budget deficit. Given the structure of the 2001 tax cut, researchers have generally found that the negative effects of the tax cuts via expanded budget deficits (and reduced national) saving offset and potentially outweigh any positive effects on future output from the impact of reduced marginal tax rates.[7] Similarly, an analysis of the new tax cuts proposed by the Administration needs to account for any positive incentive effects from reduced taxes *and* negative effects from expansions of the deficit and reduced national saving. Over the long-term, the result is likely at best to be a modest gain, and may well be negative.[8]

Effect on budget

The revenue losses from the Administration's proposals are substantial: The tax cuts would amount to approximately 1.8 percent of GDP in FY 2013, for example.[9] That 1.8 percent of GDP figure may understate the permanent cost of the Administration's tax proposals, since it is artificially restrained by failing to address the looming alternative minimum tax problem and since it does not fully reflect the long-term cost of the proposed savings accounts.

To put the size of the tax cuts even after 2013 in perspective, it may be helpful to compare the fiscal dimensions of two major items: the projected long-term actuarial deficit in Social Security and the long-term cost of the Administration's tax cuts. As Table 1 shows, *the*

[7] See Alan J. Auerbach, "The Bush Tax Cut and National Saving," Prepared for the 2002 Spring Symposium of the National Tax Association, May 2002; Congressional Budget Office, *The Budget and Economic Outlook: An Update*, August 2001; Douglas W. Elmendorf, and David L. Reifschneider, "Short-Run Effects of Fiscal Policy with Forward-Looking Financial Markets," Prepared for the National Tax Association's 2002 Spring Symposium; and William G. Gale, and Samara R. Potter. 2002, "An Economic Evaluation of the Economic Growth and Tax Relief and Reconciliation Act of 2001," *National Tax Journal* Vol. LV, No. 1 (March): 133-186. One reason for the tepid estimated response to the 2001 tax cut is that 64 percent of filers, accounting for 38 percent of taxable income, would receive no reduction in marginal tax rates, according to Treasury estimates (Donald Kiefer, et al., "The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers," *National Tax Journal* Vol. LV, No. 1 (March 2002): 89-117.).

[8] For an example of a quantitative analysis of the Administration's growth package finding a negative long-term effect, see Macroeconomic Advisers, LLC, "A Preliminary Analysis of the President's Jobs and Growth Proposals," January 10, 2003. The report does find a significant increase in demand in the short run, but also finds that the proposals would reduce potential GDP in the long-term: "Initially the plan would stimulate aggregate demand significantly by raising disposable income, boosting equity values, and reducing the cost of capital. However, the tax cut also reduces national saving directly while offering little new, permanent incentive for either private saving or labor supply. Therefore, unless it is paid for with a reduction in federal outlays, the plan will raise equilibrium real interest rates, crowd out private-sector investment, and eventually undermine potential GDP."

[9] According to the Congressional Budget Office and Joint Committee on Taxation, the revenue loss in FY 2013 is $324 billion. The CBO forecast of GDP in FY 2013 is $17,851 billion. The tax cut is thus 1.8 percent of GDP in FY 2013. See Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," March 2003.

long-term cost of the Administration's tax cuts is more than three times the entire long-term Social Security shortfall. The Administration's tax cuts would cost between 2.3 percent and 2.7 percent of Gross Domestic Product (GDP) over the next 75 years; the Social Security deficit amounts to 0.7 percent of GDP.[10]

Table 1: Administration tax cuts and Social Security deficit over next 75 years

	Present value over the next 75 years, % of GDP	Present value over the next 75 years*, $ trillion
2001 tax cut if made permanent	1.5% to 1.9%	$7.7 trillion to $9.8 trillion
Dividend / capital gains proposal	0.3%	$1.5 trillion
Tax-free savings accounts	0.3%	$1.5 trillion
Other proposed tax cuts	0.2%	$1.0 trillion
Total, Administration tax cuts	***2.3% to 2.7%***	***$11.8 trillion to $13.9 trillion***
Social Security actuarial deficit*	0.72%	$3.7 trillion
Medicare Hospital Insurance actuarial deficit*	0.96%	$5.0 trillion
Combined Social Security and Medicare HI deficit*	***1.67%***	***$8.7 trillion***

* Assumes level of GDP and interest rates projected by the Social Security actuaries. Based on 2002 Trustees Report, which was the most recent available when this testimony was written. The 2003 Trustees Report was scheduled to be released on March 17, 2003.

The bottom line is that, especially in the face of substantial projected budget deficits, enacting large, permanent tax cuts must mean some combination of: (1) shifting tax burdens to future generations, which will already be facing higher taxes based on current projections; (2) reneging on government promises in some form; or (3) running substantial budget deficits that would likely become unsustainable.

Distributional effects

Many Administration officials have been advertising the "growth" package as providing an average tax cut of $1,083, suggesting to many Americans that they would receive a tax cut of this size.[11] Other officials have been highlighting the fact that the tax cut provided to the top 1 percent of tax filers in 2003 is smaller than the share of income taxes they pay. Finally, the White House claims that the proposed tax cut will provide benefits to "everyone who pays taxes -- especially middle-income Americans."[12] These claims raise three important issues.

[10] For further details, see Peter Orszag, Richard Kogan, and Robert Greenstein, "The Administration's Tax Cuts and the Long-Term Budget Outlook," Center on Budget and Policy Priorities, March 2003.
[11] See, for example, "Taking Action to Strengthen America's Economy," Chicago, Illinois, January 7, 2003, available at www.whitehouse.gov.
[12] http://www.whitehouse.gov/infocus/economy/

First, the use of averages can be misleading. As Robert Reich is fond of pointing out, the average of himself and Shaquille O'Neal is a man about 6 feet tall. Averages are also misleading with regard to the Administration's proposal. Under that proposal, 78.4 percent of income tax filers and 71.1 percent of income tax payers would receive less than $1,000 (see Table 2). By contrast, the average tax cut in 2003 for those filers earning more than $1 million would amount to $90,222.

Table 2: Size of tax cut under Administration's "growth" proposal

Size of tax cut received, 2003	Percent of income taxpayers	Percent of income tax filers
$100 or less	37.5%	49.3%
$500 or less	60.0%	68.6%
$1,000 or less	71.1%	78.4%

Source: Urban-Brookings Tax Policy Center and author's calculations

Second, comparing the share of the tax cut received to the share of income tax paid in 2003 is problematic for three reasons:

- It is misleading to examine only the share of income taxes paid, since the top 1 percent pays a significantly smaller share of all Federal taxes than its share of income taxes. In 2003, the top 1 percent of tax filers would pay 36.7 percent of income taxes, but only 24.8 percent of all Federal taxes in the absence of the Administration's growth proposal (Table 3). Since the top 1 percent would receive 28.8 percent of the Administration's proposed tax cut in 2003, it would receive a larger share of the tax cut than its share of Federal taxes paid. As a result, the share of total Federal taxes paid by the top 1 percent would decline if the Administration's proposal were enacted.

- The Administration's proposal becomes more regressive over time, since the provisions primarily affecting the middle class are overwhelmingly temporary (reflecting merely the acceleration of several provisions from the 2001 tax cut) whereas the major provision primarily affecting higher earners (the dividend tax proposal) would be permanent. For example, in 2010, the top 1 percent of tax filers would enjoy 44 percent of the tax cut – almost twice their share of Federal taxes paid and substantially more than their share of income taxes paid. Focusing solely on 2003 is misleading.

- Finally, measuring the progressivity (or lack thereof) of a tax cut by comparing the share of the tax cut to the share of taxes paid is a flawed approach when the proposal is changing the level of overall revenue and the tax system is progressive. To see why, consider the elimination of a progressive tax system. By definition, since taxes would be eliminated, everyone would receive a share of the tax cut equal to his or her share of taxes paid. The net result, however, would be to make the after-tax distribution of income more unequal – since the tax system would no longer be partially offsetting the inequality in pre-tax income. The most insightful measure of the progressivity of a tax cut is therefore the percentage change in after-tax income. If higher earners enjoy a larger percentage increase in after-tax income than lower earners, then the change is regressive. As Table 3 shows, the top 1 percent would experience a 3.7 percent increase in after-tax income in 2003; the bottom 80 percent would experience a 1.0 percent increase. The proposal is thus very regressive even in 2003 – and more so in 2010.

Table 3: Distributional implications of Administration "growth" package

	Share of income taxes paid, 2003	Share of total Federal taxes paid, 2003	Share of Admin. tax cut, 2003	Share of Admin. tax cut, 2010	Change in after-tax income, 2003
Bottom 80 percent	16.8%	30.5%	21.3%	15.5%	+1.0%
Top 1 percent	36.7%	24.8%	28.8%	44.2%	+3.7%

Source: Urban-Brookings Tax Policy Center and author's calculations

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

- More than two-thirds of elderly tax filers (67.3 percent) would receive a tax cut of $500 or less.

- More than half (51.6 percent) of tax returns with small business income would receive a tax cut of $500 or less.[13]

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

Some Administration officials have argued that examining the distribution of benefits based on the flow of taxable dividends presents an incomplete picture, since the elimination of dividends may boost the stock market and therefore provide benefits to all households owning stocks. Such arguments then typically provide a statistic regarding the share of households at different income levels who own stocks. The problem with that type of statistic, for the purposes of examining the distributional consequences of the proposal, is that a household with $1 in stocks is treated equivalently to a household with $10 million in stocks. Table 4 provides a more useful perspective: It shows the distribution of the value of stock holdings among different types of households, according to the 2001 Survey of Consumer Finances (SCF). As the table shows, the top 10 percent of households ranked by income own more than 60 percent of the aggregate stock owned (either in taxable or tax-preferred accounts) by households. Another perspective on the same point is that the SCF data suggest that households with incomes below $75,000 represent about 60 percent of stock owners, but only about 20 percent of the value of stocks owned.

Table 4: Distribution of equity holdings

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

	Percentage of total equity holdings, by type of holding			
	All equity holdings	Held directly or through mutual fund	Held in retirement account	Held in other account/trust
Percentiles of income				
Less than 20	1.3	1.0	1.1	3.2
20-39.9	2.8	2.7	2.3	4.6
40-59.9	6.9	5.4	9.0	8.0
60-79.9	14.2	11.3	19.4	13.0
80-89.9	12.7	9.6	18.0	12.3
90-100	62.0	69.9	50.1	58.8
Age of head (years)				
Less than 35	5.0	5.6	4.0	4.6
35-44	12.8	10.7	17.8	8.4
45-54	26.5	24.5	34.1	14.4
55-64	25.3	24.2	25.0	30.9
65-74	17.3	18.0	13.9	23.2
75 or more	13.2	17.0	5.2	18.5

Source: Analysis of the 2001 Survey of Consumer Finances.

The taxation of corporate income once and only once

My final topic focuses specifically on the dividend tax proposal that is intended to tax corporate income once and only once.[14] Three points are important to emphasize about this proposal:[15]

- First, most corporate income in the United States is not taxed twice. A substantial share of corporate income is not taxed at the corporate level, due to shelters, corporate tax subsidies and other factors.[16] Recent evidence suggests growing use of corporate tax shelters.[17] Furthermore, half or more of dividends are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and non-profits.[18] Although data

[14] The provision would represent a significant tax cut for both dividends and capital gains on corporate stocks. In simplest terms, under the Administration's proposal, dividends paid out of corporate earnings that were already taxed at the corporate level would not be subject to the individual income tax. In addition, earnings that were already taxed at the corporate level and that were retained by the corporation would generate a basis adjustment for shareholders. Such a basis adjustment means that, when the stock is ultimately sold, the increase in stock price due to retained earnings taxed at the corporate level would not generate a capital gains tax liability at the individual level.

[15] This section draws heavily on William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.

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

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

[18] William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes*, November 11, 2002. Although taxes are due on pensions and 401(k) plans when the funds are paid out or withdrawn, the effective tax rate on the return to saving in such accounts is typically zero or negative because the present value of the tax saving due to the deduction that accompanies the original contribution is typically at least as large as the present value of the tax liability that accompanies

limitations make definitive judgments difficult, the component of corporate income that is not taxed (or is preferentially taxed) appears to be at least as large as the component that is subject to double taxation. That is, the non-taxation or preferred taxation of corporate income is arguably at least as big of a concern as double taxation.

- Second, under the Administration proposal, firms would maximize shareholders' after-tax returns by sheltering corporate income from taxation and then retaining the earnings -- the same strategy that maximizes shareholders' after-tax returns under current law.[19] The proposal therefore does not eliminate the incentives that exist under the current tax system to shelter corporate income from taxation and then to retain the earnings; the degree to which it reduces such incentives will depend on a variety of firm-specific factors.

- Third, the Administration's proposal does the "easy" part of tax reform: it cuts taxes. It fails, however, to do the difficult part of any serious tax reform effort: broadening the tax base and eliminating the share of corporate income that is never taxed (or taxed at preferential rates). That difference is what distinguishes "tax reform" from "tax cuts." The approach proposed by the Administration would undermine the political viability of true corporate tax reform. Any such reform would have to combine the "carrot" of addressing the double taxation of dividends with the "stick" of closing corporate loopholes and preferential tax provisions, but the Administration's proposal simply gives the carrot away. Burman (2003) and Gale and Orszag (2003) discuss modifications to the Administration's proposal that would represent a more balanced approach to changing the system of taxing corporate income.[20]

Conclusion

The economic challenges facing the nation differ significantly depending on the time horizon. In the short run, a key challenge is to boost spending (to expand demand for the capacity we have available to produce goods and services). In the long run, a key challenge is to boost saving (to finance expansions in capacity over time). Unfortunately, the Administration's proposals seem poorly designed to meet either challenge. They would expand the long-term deficit and exacerbate income inequality. A better package would combine targeted short-term stimulus (limited to 2003 alone) with long-term fiscal discipline (to boost national saving).

---

the withdrawal. Also note that a substantial share of capital gains on corporate stocks is never taxed because of the basis step-up at death.

[19] See William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.

[20] Leonard E. Burman, "Taxing Capital Income Once," Urban-Brookings Tax Policy Center, January 2003, and William G. Gale and Peter R. Orszag, "The Administration's Proposal to Cut Dividend and Capital Gains Taxes," *Tax Notes*, January 20, 2003.