Testimony on President Bush's Economic Growth Tax Cut

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President Bush's tax cut has the potential to substantially increase economic growth, boost the stock market, and increase business investment. The jewel of the President's tax plan is the elimination of the dividend tax on individuals. Another key economic growth provision of the tax plan is the acceleration of income tax rate reductions. My estimates are that the tax plan, if fully implemented, would increase stock values immediately by 5% to 15% and would reduce the cost of capital for businesses by 10% - 30%, depending on the industry.

Contrary to concerns that the Bush tax cut is "too big and too bold," I believe that the President's plan would be even more stimulative for economic growth if it were expanded to include several provisions. First, Congress should cut and consolidate income tax rates more than in the President's plan. The income tax rate should be consolidated down to 3 tax rates: 10%, 20%, and 30%. Second, tax free IRA savings accounts should be vastly expanded, in much the same manner as the White House has suggested. Super saver IRA accounts should be established with a cap of $20,000 per year per individual. The money in these funds should not be taxed until it is withdrawn for consumption purposes. Third, the capital gains tax should be lowered to 10% on all new investment.

The President's tax plan has many strengths, but one overriding virtue is this: it moves the federal tax system inexorably toward a single flat rate consumption tax system. Eliminating the double tax on dividends, abolishing the death tax, lowering income tax rates, and expanding tax free savings accounts are all big steps toward the promised land of a flat rate tax system that ends doubled taxation of saving and investment—the building blocks of a rapidly growing economy. Whatever modifications or additions to the Bush tax cut that Congress enacts should be consistent with the principles of a tax system that taxes all income at the same rate, once, and only once.

Myths About the President's Tax Plan

1. The Bush tax cut "benefits only the rich."

The media continues to report, as The New York Times has, that "90% of Americans…will get little or nothing from the dividend tax cut." Wrong. The Tax Foundation's recent examination of IRS tax return data finds just the opposite. Fully 34 million American tax filers reported some dividend income in 2000 and these returns represent 71 million people. That is a whole lot more than 10% of the population who will directly benefit.

The income tax cuts are even more widely distributed. Anyone who pays income taxes and dreads the coming of April 15th will get an income tax cut under the Bush plan. The typical working family with 2 incomes and an income of $60,000—and I suspect very few of these households regard themselves as "rich"—would get a $1,200 a year tax

cut from the Bush plan. If the income is $40,000 the family gets a $600 tax cut —and not just for one year, as under the Democratic alternative plan, but forever.

Proportionately, the rich get a smaller share of the Bush tax cut pie, not a bigger slice than the middle class. For example, the Treasury Department reports that for Americans who make more than $100,000 a year, the share of all federal income taxes paid would rise from 74% to 75%. For those who make less than a six-figure income a year, their overall share of the tax load goes down.

2. The Bush tax cut will blow a hole in the deficit.

The Bush tax cut provides $670 billion in tax relief for Americans over the next 10 years. This will hardly bankrupt the federal treasury. Over the next ten years the IRS will collect some $25 trillion in taxes from Americans. So the tax cut comes to less than 3 cents on the dollar, hardly a massive giveaway.

Nor is it accurate to say that the national debt will rise by the amount of the tax cut, unless one believes that tax cuts result in absolutely zero change in economic behavior. The truth is that for every action in the economy, as in physics, there is a reaction. If we cut income tax rates and eliminate the double tax on dividends, surely workers, and businesses, and investors will behave differently. If the tax on work and hiring goes down, surely we will get more of both. If the tax on investment goes down and the after-tax rate of return goes up, surely we will get more of that too. If the tax on dividends is eliminated and the capital gains tax falls as well, surely we will get more business investment and higher stock values.

Opponents of the tax cut continue to tout the results of economic models that have a perfect batting record of being wrong in predicting the future. For example, in 1997,when the capital gains tax rate was cut from 28% to 20%, the crystal ball gazers inside and outside government predicted a multi-billion dollar "cost" to the Treasury. In fact, the capital gains receipts doubled in 4 years. These are precisely the same defective models that are now telling us the Bush tax cut will lead the nation into bankruptcy.

Bill Beach, the economist and forecaster at the Heritage Foundation, reports that the dividend tax cut alone is such potent medication for the economy that the Treasury Department should recapture about 50 to 70% of the supposed tax revenue loss from the tax cut. Beach finds that the real world cost to the government of the Bush tax cut is probably at most half the reported "cost." I'd put my money on Beach's estimates, which have a far more accurate track record of accuracy.

But let us assume the worst-case scenario: no economic response from the Bush tax cut whatsoever. We could still have the Bush tax cuts and a balanced budget. If Congress were to modestly control its appetite for new spending, the tax plan could be implemented fully and the budget returned to balance by 2006. In a study for the Cato Institute I found that if overall federal spending were restrained to 2% annual growth over the next four years (which shouldn't be too difficult in this era of almost no inflation), the

federal government would start running surpluses by 2006 even if we assume that the Bush tax cut incited no economic feedback and we include the costs of the war. If the tax cuts do generate growth, the budget would be balanced by 2005 or sooner.

Another reason to suspect that the Bush tax cut will not run up the deficit is that if the taxes aren't cut, it is much more likely that Congress will spend the money than save it. In other words, taxes cause spending, and the lack of taxes impose at least some spending discipline. Ohio University economist Richard Vedder has documented this relationship between tax revenues and spending and has found that each additional dollar of taxes available for Congress to spend leads to nearly a dollar of added spending. Nobel prize winner Milton Friedman notes that one of the strongest arguments for the Bush tax cut is that it will discourage a stampede of congressional spending over the next several years.

3. The Bush tax cut won't stimulate economic growth or jobs.

All we can really rely upon to judge the economic value of tax rate reductions is the economic reaction to tax cuts in the past. Fortunately, Bush has history firmly on his side. The 1962 Kennedy income tax rate reductions spurred a bull market expansion and balanced budgets through the mid-1960s. The 1981 Reagan tax cuts ushered in 7 consecutive years of prosperity and 15 million new jobs. The 1997 capital gains cut corresponded with a bull market rally in the stock market and a surge of investment spending and venture capital funding for new businesses.

The critics argue that the 2001 Bush tax cut has failed to provide any juice for the economy. But there's a good reason for that. Seventy percent of the tax cuts haven't taken effect yet. All the more compelling reason to speed up the tax cuts so they can provide immediate economic aid. Especially critical is to chop the highest and most economically punitive tax rates. Roughly two-of-every-three Americans who pay the top income tax rate are business owners or sole proprietors. If you want jobs, you need financially healthy and confident employers with dollars to invest.

The dividend tax cut will have the same salutary effect on larger businesses. For example, John Rutledge, a respected Wall Street economist, has estimated that ending the double tax on dividends increases stock values by roughly 10% or an $800 billion increase in wealth, reduces businesses cost of raising investment capital by 25%, and helps stimulate a recovery in the battered high technology and telecom industries most. Many stock analysts, including economist John Rutledge of Kudlow and Co., believe that passing the dividend tax exemption and the acceleration of income tax rate reductions could add another 5 - 10% or so to equity values. That's the equivalent of a $500 billion to $1 trillion instant boost in wealth.

Clearly, even Americans who do own stocks that do not pay dividends or who own stocks in tax free 401k plans or IRAs will benefit from the dividend tax cut because of the increase in the valuation of stocks.

The Case for Growing the Bush Tax Cut

To maximize the positive job and wealth-creating impact of the Bush tax plan, it should not be shrunk, as some in the House suggest, it should be expanded to perhaps twice the size that the White House has recommended. I am pleased that Rep.s Paul Ryan of Wisconsin and Pat Toomey of Pennsylvania have teamed up to craft such a plan.

President Bush's plan will incentivize supply side growth by eliminating the dividend tax elimination and speeding up income tax rate cuts. But it omits tax policy changes that would improve the tax code, help the economy immediately, and cost the Treasury little or nothing in terms of lost revenues. This strategy would lift the tax drag that is still impeding growth and hasten the economy's recovery to the 4% to 5% real GDP growth that the United States is uniquely capable of achieving. It is worth reminding the members of the Committee that even in the first year of the plan, the tax cut amounts to less than 1% of the entire GDP. The Reagan tax cuts of 1981 and the John F. Kennedy tax cuts of 1964 were about 3 to 4 times larger in size than what President Bush has proposed.

Growth is the key to balancing the budget. A balanced budget will require at least a 3% to 4% economic growth rate to generate the revenues to pay for expected federal spending over the next decade. Every 1 percentage point increase in sustained economic growth generates an extra $1 trillion of tax receipts over ten years. The best way to produce tax receipts is to put people back to work; to get the stock market growing again; and to return American businesses to robust profitability. Tax cuts aren't then only way to make higher growth achievable, but history repeatedly shows they can sure help.

As such, here are the additions to the Bush tax plan that are worth consideration:

1) Consolidate the income tax rates down to three: 10, 20, and 30. Getting the top tax rate down to 35% is good, but 30% would be even better. For those who argue that this would lower the top tax rate too much, we would remind critics that in the late 1990s Reagan got the top tax rate down to 28%. Lowering the top income tax rate back down to 30% would help attract trillions of dollars of foreign investment capital back to the U.S. and would help reverse the decline in the dollar. Also, because 2 of every 3 taxpayers in the highest tax bracket today is a sole proprietor of a small business, lower tax rates will mean more business expansion and more jobs.

2) Cut the capital gains tax to 10% on all new investment. The last capital gains tax cit in 1997 increased stock values, increased business investment and venture capital funding, and helped spur a huge stock market rally. That has been the economic reaction to virtually every capital gains tax cut over the past 40 years. The capital gains tax cut is the goose that lays the golden eggs. Keep cutting until we eventually get down to zero.

3) Expand tax free IRAs and 401k super-saver accounts. This will help create larger individual pools of household savings and wealth accumulation. The latest Fed report shows that 52% of households now own stock and that this mass democratization of the U.S stock market has caused impressive increases in average household wealth in the U.S. – from $50,000 on average in the mid 1980s to almost $75,000 today (adjusted for inflation). IRAs and 401ks help build financial self-sufficiency and less reliance on the government programs. Moreover, we should stop double-taxing Americans' savings. IRAs and 401k's should be dramatically liberalized by raising limits by $5,000 per year. The goal should be to eventually create unlimited supersaver IRAs, where any money that is saved out of income is not taxed, until the funds are taken out of the savings account to be spent. The income limits for IRAs should be repealed too.

One last, but crucial point. Republicans need to adopt dynamic, real-world scoring of tax policy changes. Stop using a tax referee that is biased against the President's program and that consistently produces discredited predictions of the future. For 30 years economic models in Washington have over-estimate the revenue gains from tax hikes, and overstated the tax losses from tax rate cuts.

President Bush deserves great credit for proposing a tax plan that has the potential to increase economic growth and create jobs. The economy needs a jolt of tax cut adrenaline given the recent discouraging financial numbers that have been released. The fact that we are on the eve of war, is an argument for revving up our economic engine of industrial might, not hindering its productive capacity with a dysfunctional tax system.