# NEAR-TERM STIMULUS AND LONG-TERM GROWTH

## A JOINT ECONOMIC COMMITTEE STUDY


**Jim Saxton (R-NJ), Vice Chairman**
**Joint Economic Committee**
**United States Congress**

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**Executive Summary**

The *Jobs and Growth Tax Reconciliation Act of 2003* (H.R. 2) is a balanced tax relief bill that would improve incentives for work, saving, and investment. This legislation addresses the weakness in business investment that has undermined the pace of the current economic expansion. This weakness in business investment followed the bursting of the stock market bubble in the first quarter of 2000, and a subsequent liquidation of capital investment especially evident in the high technology sector. As New York Federal Reserve Bank President William J. McDonough noted, "The effects of the bursting of the stock market have proved to be far more long term and pervasive than expected."

Among other things, H.R. 2 would:

- **Accelerate marginal individual income tax rate reductions**. H.R. 2 would accelerate the individual income tax rate reductions scheduled for January 1, 2004 and January 1, 2006 to January 1, 2003.
- **Reduce double taxation of dividend income**. H.R. 2 would reduce the individual federal income tax rate on dividends to 15 percent for individuals in the 25 percent, 38 percent, 33 percent, and 35 percent brackets and 5 percent for individuals in the 10 percent and 15 percent brackets.
- **Reduce the tax rate on capital gains**. H.R. 2 would reduce the individual federal income tax rate on capital gains to 15 percent for individuals in the 25 percent, 38 percent, 33 percent, and 35 percent brackets and 5 percent for individuals in the 10 percent and 15 percent brackets.
- **Increase and extend bonus depreciation for equipment investments**. H.R. 2 would increase the depreciation bonus enacted in 2002 from 30 percent to 50 percent and would extend this bonus from September 11, 2004 to December 31, 2005.
- **Expand expensing for small businesses**. H.R. 2 would increase the expensing limit for investments from $25,000 to $100,000 and would increase the annual aggregate investment threshold for phasing out expensing from $200,000 to $400,000 through December 31, 2007.

H.R. 2 would boost business investment by lowering the cost of and increasing the after-tax return from investing in capital assets and would thereby provide a much-needed near-term stimulus to the U.S. economy. The reduction in tax rates on both capital gains and dividends would help investors rebuild their portfolios in the wake of the bursting of the stock market bubble of the late 1990s. Faster economic growth would expand employment as well. Moreover, H.R. 2 would lower the excess burden of federal taxation and help to sustain a long-term economic expansion by increasing the efficiency, fairness, and neutrality of the federal income tax system.



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# NEAR-TERM STIMULUS AND LONG-TERM GROWTH

The economy was slipping into recession even before Bush took office, and the corporate scandals that are rocking America began much earlier.

*Joseph E. Stiglitz*
*Chairman of the Council of Economic Advisers (June 1995 – February 1997)*[1]

The effects of the bursting of the stock market have proven to be far more long term and pervasive than expected.

*William J. McDonough*
*President, Federal Reserve Bank of New York*[2]

## I. INTRODUCTION

The economic growth of the last half of the 1990s included a stock market bubble that exploded in the first quarter of 2000. After the stock market bubble burst, overinvestment and malinvestment, particularly in information technology and telecommunications, became apparent. Falling business investment engendered an economic slowdown in the middle of 2000, culminating in a recession. Increased uncertainty after the 9/11 attack depressed business investment, hindering an economic recovery.

Such economic weakness prompted Congress to enact the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTTRA), which provides for a phased reduction of marginal individual federal income tax rates. Congress also enacted the *Job Creation and Worker Assistance Act of 2002* (JCWAA), which accelerates depreciation for investments in equipment by allowing firms to take a 30 percent depreciation bonus in the year when such equipment comes into service. This depreciation bonus expires on September 11, 2004.

On January 7, 2003, President George W. Bush proposed a *Jobs and Growth Initiative*, which would have provided $726 billion of tax relief over eleven fiscal years. On April 11, 2003, Congress approved a budget resolution for fiscal year 2004 allowing for $550 billion of tax relief over eleven fiscal years. To implement this budget resolution, the Committee on Ways and Means marked up H.R. 2 – *Jobs and Growth Tax Reconciliation Act of 2003* – on May 7, 2003 and sent it the full House of Representatives. Among other things, H.R. 2 would:

- **Accelerate marginal individual income tax rate reductions**. H.R. 2 would accelerate EGTRRA's individual income tax rate reductions scheduled for January 1, 2004 and January 1, 2006 to January 1, 2003.
- **Reduce double taxation of dividend income**. H.R. 2 would reduce the individual federal income tax rate applied to dividends to 15 percent for individuals in the 25 percent, 38 percent, 33 percent, and 35 percent brackets and 5 percent for individuals in the 10 percent and 15 percent brackets.[3]

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[1] Joseph E. Stiglitz, "The Roaring Nineties," *Atlantic Monthly* (October 2002), found at http://www.theatlantic.com/issues/2002/10/stiglitz.htm.
[2] William J. McDonough, "Remarks," (Speech at the Annual Financial Services Forum of the New York State Bankers Association, New York, N.Y., March 20, 2003).
[3] The bill as currently drafted limits the lower tax rate on dividends to dividends from domestic corporations. This may be changed in the legislative process.

- **Reduce the tax rate on capital gains.** H.R. 2 would reduce the individual federal income tax rate on capital gains to 15 percent for individuals in the 25 percent, 38 percent, 33 percent, and 35 percent brackets and 5 percent for individuals in the 10 percent and 15 percent brackets.
- **Increase and extend bonus depreciation for equipment investments**. H.R. 2 would increase JCWAA's depreciation bonus from 30 percent to 50 percent and would extend this bonus from September 11, 2004 to December 31, 2005.
- **Expand expensing for small businesses**. H.R. 2 would increase the expensing limit for investments from $25,000 to $100,000 and would increase the annual aggregate investment threshold for phasing out expensing from $200,000 to $400,000 through December 31, 2007.

Based on previous Joint Economic Committee (JEC) studies of investment and federal taxation, this study concludes that H.R. 2 would significantly boost business investment, provide a much-needed near-term stimulus to the U.S. economy, and help to sustain long-term economic growth. By accelerating EGTRRA's marginal individual federal income tax rate reductions, expanding and extending JCWAA's bonus depreciation, reducing the double taxation of dividend income, and lowering the tax rates on capital gains, this bill will reduce the excess burden of federal taxation and improve the incentives for individuals and firms to engage in economically productive behavior.

Accelerating marginal individual federal income tax rate reductions would alleviate financing constraints that inhibit investment among small- and medium-sized firms. Reducing the federal tax rates on capital gains and dividends would significantly improve the efficiency and fairness of the federal tax system. Increasing and extending bonus depreciation would significantly reduce the cost of and increase the expected return from investing in new equipment among all firms. Likewise, expanding the expensing of investments would also reduce the cost of and improve the expected return from investing among small businesses. Increasing and extending bonus depreciation as well as expanding expensing would encourage additional business investment, sparking a more vigorous economic recovery.

## II. WHY IS ECONOMIC GROWTH SO SLOW?

As the decade of the 1990s ended, economic and financial uncertainty increased. After the stock market bubble burst in first quarter of 2000, widespread overinvestment and malinvestment, especially in information technology and telecommunications, became apparent. Consequently, an economic slowdown began in the middle of 2000, culminating in a recession as noted by former Chairman of the Council of Economic Advisers Joseph Stiglitz.

This recession was fundamentally different from other post-World War II recessions. As Federal Reserve Governor Ben S. Bernanke observed:

> Typically, U.S. recessions have featured downturns in household spending, with housing and consumer durables being the most severely affected, and with business spending on capital goods playing a secondary and reactive role. In the recent episode, by contrast, business fixed investment began to weaken well before the official peak of the business cycle, contracting in real terms from the fourth quarter of 2000 through the third quarter of last year. ... Meanwhile, completing the role reversal, households maintained their spending remarkably well, particularly on new homes and automobiles.[4]

[4] Ben S. Bernanke, "Will Business Investment Bounce Back?" (Speech before the Forecasters Club, New York, NY, April 24, 2003).

Unlike other post-World War II recessions, consumer spending has been remarkably stable during the March 2001 recession and subsequent recovery. Consumer expenditures on durable goods rose from an annualized low of 8.01 percent of GDP in the fourth quarter of 2000 to an annualized high of 8.55 percent of GDP in the third quarter of 2002.[5] New single-family residence sales rose from 880,000 in 2000 to 977,000 in 2002. In contrast, business investment declined sharply during the recession and the recovery. Business investment fell from an annualized high of 13.00 percent of GDP in the third quarter of 2000 to an annualized low of 10.55 percent of GDP in the fourth quarter of 2002. Information technology investment decreased from an annualized high of 4.59 percent of GDP in the third quarter of 2000 to an annualized low 3.77 percent of GDP in the first quarter of 2002.

The excessive accumulation of capital assets in some sectors during the 1990s may have significant persistent negative effects on the U.S. economy. Overcapacity, especially in information technology and telecommunications industries, may take years to liquidate. Consequently, business investment may be subdued, and economic growth may remain moderate during the near term.

To increase their investment substantially, firms must perceive that the after-tax returns from their existing and prospective investments in capital assets are increasing. In this economic environment, tax reductions that alleviate financing constraints among small- and medium-sized firms and increase the expected after-tax returns from investing will stimulate business investment.[6]

## III. H.R. 2 – *JOBS AND GROWTH TAX RECONCILIATION ACT OF 2003*

In response to the economic slowdown in the second half of 2000 and the subsequent recession, the 107th Congress enacted two bills to reduce federal taxes: *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) and *Job Creation and Worker Assistance Act of 2002* (JCWAA). Dissatisfied with the slow pace of economic recovery from the recession, President George W. Bush proposed additional tax relief totaling $726 billion over eleven fiscal years in a *Jobs and Growth Initiative* on January 7, 2003.[7] Responding to the President's initiative, Congress adopted a fiscal year 2004 budget resolution (H.Con.Res. 95, H. Rept. 108-71) on April 11, 2003 that allowed for $550 billion in tax relief over eleven fiscal years.[8] In accordance with this budget resolution, House Committee on Ways and Means Chairman Bill Thomas introduced a substitute for the President's original proposal, H.R. 2 – *Jobs and Growth Tax Reconciliation Act of 2003*. The Committee on Ways and Means reported this bill to the full House on May 6, 2003. Among other things, H.R. 2 would:

- **Accelerate marginal individual income tax rate reductions**. H.R. 2 would accelerate EGTRRA's individual income tax rate reductions scheduled for January 1, 2004 and January 1, 2006 to January 1, 2003.
- **Reduce double taxation of dividend income**. H.R. 2 would reduce the individual federal income tax rate applied on dividends to 15 percent for individuals in the 25 percent, 38 percent, 33 percent, and 35 percent brackets and to 5 percent for individuals in the 10 percent and 15 percent brackets.[9]

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[5] Although real GDP has grown in each quarter since the fourth quarter of 2001, the Business Cycle Dating Committee of the National Bureau of Economic Research has not officially declared an end to the recession.
[6] Robert P. O'Quinn, *Federal Individual Income Taxes and Investment: Examining the Empirical Evidence*, prepared for the Joint Economic Committee, 107th Cong., 2nd sess., June 2002.
[7] See appendix for details.
[8] H.Con.Res. 95 allows a point of order in the Senate against any reconciliation bill that provides tax relief in excess of $350 billion over eleven fiscal years. However, H.Con.Res. 95 does not allow for a similar point of order in the Senate against a conference report on a reconciliation bill that provides tax relief in excess of $350 billion but less than $550 billion over eleven fiscal years.
[9] The bill as currently drafted is limits the lower tax rate on dividends to dividends from domestic corporations. This may be changed in the legislative process.

- **Reduce the tax rate on capital gains.** H.R. 2 would reduce the individual federal income tax rate on capital gains to 15 percent for individuals in the 25 percent, 38 percent, 33 percent, and 35 percent brackets and 5 percent for individuals in the 10 percent and 15 percent brackets.
- **Increase and expand bonus depreciation**. H.R. 2 would increase JCWAA's depreciation bonus for equipment investments from 30 percent to 50 percent and would extend this bonus from September 11, 2004 to December 31, 2005.
- **Increase the expensing limit for small business**. H.R. 2 would increase the expensing limit for investments from $25,000 to $100,000 and would increase the annual aggregate investment threshold for phasing out expensing from $200,000 to $400,000 through December 31, 2007.

## IV. REDUCING THE EXCESS BURDEN OF THE FEDERAL TAX SYSTEM

### *A. What is the Excess Burden of the Federal Tax System?*

The marginal excess burden of the federal tax system upon the U.S. economy is significantly larger than the amount of tax revenue that the federal government collects each year from individuals and firms. Because of administrative costs, compliance costs, and deadweight losses, a midpoint estimate of the economic burden of paying a marginal dollar in taxes to the U.S. government is $1.40.

#### 1. Deadweight Losses

Economic activity depends upon voluntary exchange among individuals and firms. Taxation discourages individuals and firms from undertaking economic activities that they would otherwise undertake in the absence of such taxation. By creating disincentives toward economically productive behavior such as work, savings, or investment, taxation alters the economic behavior of individuals and firms in ways that reduce overall economic welfare. Economists refer to this reduction as the **deadweight loss from taxation** or the **marginal excess burden of taxation**. Empirical studies have found that the deadweight loss imposes a substantial burden on the U.S. economy. For example, Charles L. Ballard, John B. Shoven, and John Whalley (1985) calculated that the average marginal excess burden for all U.S. taxes was 33.2 percent.[10]

| TABLE 1 -MARGINAL EXCESS BURDEN FROM RAISING EXTRA REVENUE FROM SPECIFIC PORTIONS OF THE U.S. TAX SYSTEM | |
|---|---|
| All Taxes | 33.2 % |
| Capital Taxes at Industry Level including Corporate Income and Property Taxes | 46.3 % |
| Labor Taxes at Industry Level including Payroll Taxes | 23.0 % |
| Consumer Sales Taxes including Alcoholic Beverages, Tobacco Products, and Motor Vehicle Fuels | 38.8 % |
| Consumer Sales Taxes excluding Alcoholic Beverages, Tobacco Products, and Motor Vehicle Fuels | 11.5 % |
| Personal Income Taxes | 31.4 % |
| Output Taxes including Excise Taxes and Other Indirect Business Taxes | 27.9 % |
| Source: Ballard, Shoven, and Whalley (1985) | |

Other empirical studies have found even higher values for the marginal excess burden of federal taxation. Reviewing the empirical literature regarding deadweight losses from taxation, Richard K. Vedder and Lowell E. Gallaway (1999) concluded:

[10] Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review* 75 (March 1985): 136.

> To be sure, there are still higher estimates … as well as lower ones, but the 40-cent estimate is probably approximately a midpoint estimate of the many serious studies performed. It is important to note all the studies show some deadweight loss from taxation … the 40-cent welfare loss per tax dollar estimate is a reasonable midrange evaluation of studies of the issues using different methodologies, data sets, and time periods.[11]

#### 2. Administrative Costs

The administrative costs are the expenses that the federal government incurs in devising, administering, and enforcing its tax laws. U.S. taxpayers pay these administrative expenses indirectly through higher federal taxes or lower federal spending on other activities or programs. During fiscal year 2002, the IRS spent $9.4 billion to administer federal tax laws.[12] This amounts to 0.51 percent of all federal receipts.[13]

#### 3. Compliance Costs

Closely related to administrative costs are compliance costs. Both individual and business taxpayers must bear the burden of filing these returns and complying with federal law directly. Compliance costs includes the value of the time and out-of-pocket costs of learning tax requirements, record keeping, tax preparation, accounting, legal, and other professional fees, and responding to audits and enforcement proceedings. Surveying and synthesizing the empirical research on compliance costs, Joel Slemrod and Jon Bakija (2000) estimated the compliance cost of the federal income tax was about $100 billion or an amount equal to 10 percent of federal income tax receipts in 1999.[14]

### *B. H.R. 2 Would Reduce the Excess Burden of Taxation*

H.R. 2 would significantly improve the efficiency of the federal tax system. By accelerating EGTRRA's marginal individual federal income tax rate reductions, accelerating JCWAA's bonus depreciation, and reducing the double taxation of corporate income by lowering the tax rates applied to capital gains and dividends, this bill will reduce excess burden of federal taxation and improve the incentives for individuals and firms to engage in economically productive behavior. During the near term, H.R. 2 would stimulate work, saving, and investment. Such additional productive economic activities should help to sustain an economic expansion over the long term.

## V. STIMULATING INVESTMENT THROUGH ACCELERATING MARGINAL INDIVIDUAL FEDERAL INCOME TAX RATE REDUCTIONS

### *A. Recent Empirical Studies Cause a Reevaluation of the Effectiveness of Reducing Marginal Federal Income Tax Rates in Stimulating Investment*

In 1988, Steven M. Fazzari, future Chairman of the Council of Economic Advisers R. Glenn Hubbard, and Bruce C. Petersen found that virtually all small firms, most medium-sized firms, and even some large firms in new rapidly changing industries forego making investments in new capital assets with a positive expected net present value because of their inability to incur additional debt or raise additional equity funds from financial markets. Economists describe this inability as a **financing constraint**. By including cash flow as a proxy variable for financing constraints, Fazzari, Hubbard, and Petersen

[11] Richard K. Vedder and Lowell E. Gallaway, *Tax Reduction and Economic Welfare*, prepared for the Joint Economic Committee, 106th Cong., 1st sess., April 1999: 6.
[12] Interview with U.S. Department of the Treasury, Internal Revenue Service, Congressional Relations Office.
[13] Author's calculations.
[14] Joel Slemrod and Jon Bakija, *Taxing Ourselves: A Citizen's Guide to the Great Debate over Tax Reform* (Cambridge, Massachusetts: The MIT Press, 2000): 137.

significantly improved the performance of pre-1988 aggregate investment models.[15] Subsequent empirical studies have confirmed the findings of Fazzari, Hubbard, and Petersen regarding aggregate investment and financing constraints.

The recognition of the prevalence and importance of financing constraints in post-1988 aggregate investment models has prompted economists to revaluate the effectiveness of reducing marginal federal income tax rates in stimulating aggregate investment. By lowering the average tax burden on the income from existing capital assets, marginal federal income tax rate reductions augment the cash flow of existing capital assets and alleviate financing constraints. Higher investment among financing constrained firms stimulates aggregate investment.

In contrast, asset-specific tax relief cannot augment a financing constrained firm's cash flow from existing capital assets even if asset-specific tax relief were to reduce the marginal effective tax rate on a newly acquired capital asset to zero. Asset-specific tax relief will elicit a smaller investment response among financing constrained firms than among non-constrained firms. Marginal income tax rate reductions empower financing constrained firms to make investments that they would not make with asset-specific tax relief. This is especially true during an economic slowdown when financing constraints are more likely to be binding on financing constrained firms.

### *B. Marginal Individual Federal Income Tax Rates, Financing Constraints, and Investment among Sole Proprietorships, Partnerships, and S Corporations*

Marginal individual federal income tax rate reductions are especially effective in stimulating investment among small- and medium-sized firms. Small- and medium-sized businesses and farms are likely to be organized as sole proprietorships, partnerships, or S corporations whose income and expenses flow-through to their shareholders for federal income tax purposes. These "flow-through" businesses and farms are significant contributors to the U.S. economy. In tax year 1998, there were 17.4 million sole proprietorships, 1.9 million partnerships, and 2.6 million subchapter S corporations compared to 2.2 million corporate tax filings. These "flow-through" firms accounted for 28.1 percent of reported business receipts and 41.9 percent of reported net income.[16]

Previously, many economists had thought that marginal individual income tax rate reductions (1) mainly affected aggregate consumption and labor force participation and (2) only peripherally affected aggregate investment by lowering marginal effective tax rate on investments in new capital assets. However, small and medium-sized firms (which are generally "flow-through" firms) are more likely to be financing constrained than large firms. "Flow-through" businesses and farms are the least likely to be able to take full advantage of any asset-specific tax relief. For "flow-through" businesses and farms, reducing marginal individual income tax rates improves their cash flow from existing capital assets, which is the critical factor in determining investment. Recent empirical progress in aggregate investment modeling demonstrates that marginal individual income tax rate reductions promote not only labor force participation but also aggregate investment.

Robert Carroll, future Congressional Budget Office Director Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen (2000) analyzed the investing behavior of sole proprietorships, a group of firms that *a priori* are likely to be financing constrained. From the *Statistics of Income Individual Income Tax Returns* files for tax years 1985 and 1988, Carroll *et al*. examined returns whose filers (1) had filed as a sole proprietorship in 1985, (2) were ages 25 to 55, (3) had not received an earned income tax credit in either 1985 or 1988, and (4) had not been subject to the alternative minimum tax in either 1985 or 1988.

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[15] Steven M. Fazzari, R. Glenn Hubbard, and Bruce C. Petersen, "Financing Constraints and Corporate Investment," in *Brooking Papers on Economic Activity 1*, ed. William C. Brainard and George L. Perry (Washington, D.C.: Brookings Institution, 1988): 141-204.
[16] Author's calculations from IRS *Statistics of Income Bulletin* data for tax year 1988.

Applying various approaches to model investing behavior in 1988, Carroll *et al.* found that the elasticity of investment was -1.78 for sole proprietorships.[17] This is significantly higher than the range of -0.25 to -1.0 for the elasticity of investment that previous empirical studies had found for corporations. Carroll *et al*. attributed this difference to financing constraints among sole proprietorships. Carroll *et al.* calculated that a five-percentage-point increase in marginal individual income tax rates would reduce the proportion of sole proprietorships that would invest in new capital by 10.4 percent and would lower average investment in new capital among sole proprietorships by 9.9 percent.[18]

### *C. Accelerating Marginal Individual Federal Income Tax Rate Reductions Would Stimulate Investment*

By accelerating EGTRRA's marginal individual federal income tax reductions, H.R. 2 would alleviate financing constraints among small- to medium-sized firms that are proprietorship, partnerships, and S corporations. Therefore, such marginal individual federal income tax rate reductions are not only a stimulus to consumption and labor force participation but also a very effective means of promoting investment particularly among such firms. Accelerating EGTRRA's marginal individual federal income tax reductions would therefore improve the efficiency of the federal tax system.

## VI. STIMULATING INVESTMENT BY REDUCING THE DOUBLE TAXATION OF DIVIDEND INCOME

### *A. What is the Double Taxation of Dividend Income?*

An efficient and fair tax federal income system should tax all income once, but only once. Current federal tax policy deviates from this sound principle through the double taxation of dividend income for all corporations except S corporations. Under current law, the federal government taxes the income that corporations generate from equity-financed investments at the corporate level at a maximum rate of 35 percent. If corporations use a portion of their income remaining after paying corporate federal income taxes to disburse dividends to their shareholders, the federal government taxes these dividends again through individual federal income taxes at a maximum rate of 38.6 percent. Thus, the maximum effective federal tax rate on the dividend income from corporate equity-financed investments is currently 60.1 percent. Because interest payments are deductible under the corporate federal income tax, the federal government taxes the income that corporations generate from debt-financed investments only at the individual level. Likewise, the federal government allows the income that sole proprietorships, partnerships, and S corporations generate from their investments to pass through the firm and taxes such income at the individual level. Thus, the maximum effective federal tax rate on income from both debt-financed corporate investments and all investments of sole proprietorships, partnerships, and S corporations is currently 38.6 percent.

### *B. Double Taxation Distorts Economic Decision-Making*

A neutral tax system should affect the economic decision-making of individuals and firms as little as possible. Economists recognize that the double taxation of dividend income affects economic decision-making in a number of perverse ways that diminish overall economic welfare.

The double taxation of dividend income encourages corporations to finance their investments through debt rather than equity. Because of this incentive, such corporations incur a heavier debt burden and have a higher debt-to-equity ratio than they otherwise would. Unlike dividends, corporations cannot skip interest payments. Consequently, double taxation makes corporations more likely to suffer financial distress and declare bankruptcy during a recession.

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[17] The elasticity of investment refers to how investment responds to changes in income tax rates.

[18] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," in *Does Atlas Shrug?* ed. Joel Slemrod (Cambridge, Massachusetts: Harvard University Press, 2000): 427-455.

Despite the importance of dividends in promoting good corporate governance, double taxation discourages corporations from paying dividends to their shareholders. Because of double taxation, shareholders may prefer to take their portion of corporate profits in the form of capital gains rather than dividends. As a result, corporate dividend payout ratios fell during the second half of the last century. For the Standard and Poor's Composite 500 Index, the dividend yield has declined steadily from 7.42 percent in the fourth quarter of 1950 to an all-time low of 1.11 percent in the third quarter of 2000 before rising slightly to 1.81 percent in the fourth quarter of 2002.[19]

### *C. Reducing Double Taxation Would Enhance Efficiency, Fairness, and Neutrality*

Because the fiscal year 2004 budget resolution permitted only $550 billion in tax relief over eleven fiscal years rather than the $726 billion over eleven fiscal years envisioned in the President Bush's *Jobs and Growth Initiative*, the Committee on Ways and Means could not simultaneously eliminate the double taxation of dividend income and accelerate all of the provisions of EGTRRA. The Committee chose to reduce the double taxation of dividend income by lowering the tax rate applied to dividend income to 15 percent for most individual taxpayers. H.R. 2 would lower the maximum effective tax rate on dividend income from equity-financed corporate investments from 60.1 percent to 44.8 percent. By comparison, H.R. 2 would lower the maximum effective federal tax rate on income from both debt-financed corporate investments and all investments of sole proprietorships, partnerships, and S corporations from 38.6 percent to 35.0 percent. Under H.R. 2, the effective "double taxation penalty" on dividend income (maximum effective tax rate on dividend income from equity-financed corporate investments less the maximum effective tax rate on income from debt-financed corporate investments and from all investments of sole proprietorships, partnerships, and S corporations) falls by more than one-half from 21.5 percentage points to 9.8 percentage points.

Reducing double taxation would diminish the incentive for large publicly traded corporations to withhold dividends. As a result, shareholders would likely press corporate executives to increase dividend payouts when the expected returns from a highly diversified portfolio of stocks exceed the expected returns from internal investments. Corporations would become less likely to undertake investments that do not maximize expected shareholder wealth. Moreover, the quality of corporate investment would improve as executives utilize scarce resources more wisely. Reducing the double taxation would therefore enhance the efficiency, fairness, and neutrality of the federal tax system and increase the long-term growth potential for the U.S. economy.

### *D. Reducing the Maximum Capital Gains Tax Rate Would Boost Long-Term Economic Growth*

H.R. 2 would lower the tax rate applied to not only to dividend income but also to long-term capital gains to 15 percent for most individual taxpayers. According to a previous JEC study:

> The point that a revenue-maximizing rate is highly inefficient cannot be stressed too much. When higher tax rates shrink the tax base so much that they raise little or no additional revenue, this means that they are eliminating a large value of mutually advantageous trades. Production is reduced and resources are used less efficiently than would otherwise be the case … Many asset owners are continuing to hold assets that they would otherwise like to sell to others who value them more. No doubt, the potential new owners believe they can employ the assets more effectively; this is why they are willing to pay more than the current owners' value of the assets. But these mutually advantageous exchanges

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[19] Robert P. O'Quinn, *Did a Stock Market Bubble Develop between 1995 and 2000? A Survey of Financial Economics and Stock Market History During the 20th Century*, prepared for the Joint Economic Committee, 108th Cong., 1st sess. (forthcoming).

> and the accompanying movements to more efficient uses do not occur because of tax implications.[20]

Thus, H.R. 2 would promote the efficient allocation of capital resources, leading to a long-term increase in the growth potential of the U.S. economy. The reduction in tax rates on both capital gains and dividends would help investors rebuild their portfolios in the wake of the bursting of the stock market bubble of the late 1990s. Many economists, including Chairman of the Board of Governors of the Federal Reserve System Alan Greenspan, have observed that the appropriate capital gains tax rate is zero.

## VII. STIMULATING INVESTMENT BY ACCELERATING DEPRECIATION

An efficient and fair federal income tax system would allow firms to deduct all of their expenses related to earning their income before calculating their income taxes. While current federal income tax law allows firms to deduct the expenses for labor, raw materials, or supplies used in producing goods and services, current federal income tax law requires most firms to capitalize the purchase price of most capital assets used to produce goods and services and depreciate such assets over time. Although the purchase price of a capital asset and the sum of its future depreciation deductions are nominally equal, the real value of future depreciation deductions for a capital asset is typically less than its purchase price because of future inflation and the time value of money. To deduct the full cost of new capital assets, federal income tax law should allow firms to either (1) expense such assets (*i.e.*; deduct entire purchase price for capital assets in the year in which firms put such assets into service) or (2) increase their future depreciation deductions by inflation and interest rate factors so that the present value of future depreciation deductions for capital assets equals their purchase price. Although functionally equivalent, expensing is clearly simpler than adjusting depreciation schedules for inflation and the time value of money.[21]

By preventing firms from deducting the full expense of their investments in capital assets, current federal income tax law artificially increases the taxes on income earned from investing in capital assets. Current federal income tax law raises the cost of and reduces the after-tax return from investing in capital assets. This bias in the federal tax code causes firms to invest in fewer capital assets than firms would if federal income tax were unbiased.

H.R. 2 would significantly reduce this bias against investing in capital assets in two ways. First, H.R. 2 would increase the depreciation bonus for investing in equipment from 30 percent to 50 percent. For all business regardless of size, H.R. 2 would mean that one-half of the cost of making an equipment investment would be expensed while the remaining half would be depreciated over time as provided under the modified accelerated cost recovery system. Increasing the depreciation bonus would clearly reduce the cost of and increase the expected after-tax return from investing in equipment. Consequently, this provision should encourage firms to increase their investment in equipment.

Second, H.R. 2 would increase the expensing limit for all investments by small businesses from $25,000 per year to $100,000 and would increase the annual aggregate investment threshold for phasing-out expensing from $200,000 to $400,000. For qualifying small businesses, H.R. 2 would eliminate the bias against investing in current federal income tax law. By reducing the cost of, and increasing the after-tax return from investing, increasing the expensing limit should significantly increase investment among small businesses.

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[20] James D. Gwartney and Randall G. Holcombe, *Optimal Capital Gains Tax Policy: Lessons from the 1970s, 1980s, and 1990s*, prepared for the Joint Economic Committee, 106th Cong., 1st sess. (June 1997): 18.

[21] A comprehensive tax reform that incorporates full expensing may have to address the tax treatment of interest payments.

## VIII. INVESTMENT AND EMPLOYMENT

The Council of Economic Advisers had forecast the likely growth benefits from the President's initiative. Assuming no effect on labor supply from accelerating the reduction in marginal individual federal income tax rates and no effect on stock prices from ending double taxation, the CEA had projected that real GDP growth (fourth quarter to fourth quarter) would be 1.0 percent higher in 2003 and 0.8 percent higher in 2004 for a total increase in real GDP of 1.7 percent by the fourth quarter of 2004. Employment would rise by 510,000 jobs in 2003 and by an additional 891,000 jobs in 2004 (a total of 1.4 million new jobs by the end of 2004).[22] A reasonable estimate of job growth under H.R. 2 would be over 1 million new jobs by the end of 2004.

## IX. CONCLUSION

The *Jobs and Growth Tax Reconciliation Act of 2003* (H.R. 2) is a balanced tax relief bill that would improve incentives for work, saving, and investment. This legislation addresses the weakness in business investment that has undermined the pace of the current economic expansion. This weakness in business investment followed the bursting of the stock market bubble in the first quarter of 2000, and a subsequent liquidation of capital investment especially evident in the high technology sector.

The major provisions of H.R. 2 would boost business investment by lowering the cost of and increasing the after-tax return from investing in capital assets and would thereby provide a much-needed near-term stimulus to the U.S. economy. The reduction in tax rates on both capital gains and dividends would help investors rebuild their portfolios in the wake of the bursting of the stock market bubble of the late 1990s. Faster economic growth would expand employment as well. Moreover, H.R. 2 would lower the excess burden of federal taxation and help to sustain a long-term economic expansion by increasing the efficiency, fairness, and neutrality of the federal income tax system.

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## APPENDIX - TAX ACTS AND TAX PROPOSALS

### *A. Economic Growth and Tax Relief Reconciliation Act of 2001*

On June 7, 2001, President George W. Bush signed the *Economic Growth and Tax Relief Reconciliation Act of 2001* into law. Major provisions of EGTRRA include:

- **Marginal individual income tax rate reductions**. EGTRRA lowers individual federal income tax rates from 15 percent, 28 percent, 31 percent, 36 percent and 39.6 percent in 2000 to 10 percent, 15 percent, 27 percent, 30 percent, 35 percent, and 38.6 percent effective January 1, 2001, to 10 percent, 15 percent, 26 percent, 34 percent, and 37.6 percent effective January 1, 2004, and to 10 percent, 15 percent, 25 percent, 33 percent, and 35 percent effective January 1, 2006. EGTRRA raises the threshold for the 15 percent bracket from $6,000 for single filers, $10,000 for head of household filers, and $12,000 for joint filers to $7,000, $10,000, and $14,000, respectively, effective January 1, 2008, and indexes the threshold thereafter.
- **Child tax credit increase**. EGTRRA increases the child tax credit from $500 to $600 effective January 1, 2001, $700 effective January 1, 2005, $800 effective January 1, 2009, and $1,000 effective January 1, 2010.
- **Marriage penalty relief**. EGTRRA increases the standard deduction for married filers to twice the standard deduction for single filers over five years beginning on January 1, 2005 and increases the taxable income threshold for the 25 percent rate bracket for married filers to twice the threshold for single filers over four years beginning on January 1, 2005.
- **Education IRAs**. EGTRRA increases the annual contribution limit from $500 to $2,000 effective January 1, 2002.
- **Traditional and Roth IRAs**. EGTRRA increases in the annual contribution limits for both traditional and Roth IRAs from $2,000 to $3,000 effective January 1, 2002, to $4,000 effective January 1, 2005 and to $5,000 effective January 1, 2008 and indexes the limits thereafter.
- **Defined contribution pension plans**. EGTRRA increases the annual contribution limit to $11,000 effective January 1, 2002, $12,000 effective January 1, 2003, $13,000 effective January 1, 2004, $14,000 effective January 1, 2005, and $15,000 effective January 1, 2006 and indexes the limit thereafter.
- **Estate tax repeal**. EGTRRA provides a phased elimination of the federal estate tax.

Because of Senate rules limiting what may be included in a reconciliation bill, all of EGTRRA's tax provisions are currently scheduled to expire on December 31, 2010.

### *B. Job Creation and Worker Assistance Act of 2002*

On March 9, 2002, President George W. Bush signed the *Job Creation and Worker Assistance Act* into law. Major provisions of JCWAA include:

- **Bonus depreciation for equipment investments**. JCWAA allows firms to expense 30 percent of their equipment investments in the year in which a firm puts such equipment into service through a depreciation bonus. Firms depreciate the balance of their equipment investments as provided under the modified accelerated cost recovery system. This provision expires on September 10, 2004.

- **Loss carry-back extension**. JCWAA temporarily extends the net operating loss carry-back period for businesses from 2 years to 5 years.

### *C. President's Jobs and Growth Initiative*

On 7 January 2003, President George W. Bush proposed a *Jobs and Growth Initiative*. Major provisions of this initiative include:

- **Acceleration of marginal individual income tax rate reductions**. The President proposed accelerating EGTRRA's individual income tax rate reductions scheduled for January 1, 2004, and January 1, 2006, to January 1, 2003.
- **Acceleration of child tax credit increase**. The President proposed accelerating EGTRRA's phased increase in the child tax credit to $1,000 to January 1, 2003.
- **Acceleration of marriage penalty relief**. The President proposed accelerating EGTRRA's phased marriage penalty relief to January 1, 2003.
- **Double taxation of corporate income**. The President proposed to end the "double taxation" of corporate income by excluding previously taxed corporate income from an individual's taxable income when paid out to individuals as dividends and by increasing the basis for calculating taxable capital gains on the sale of corporate equity by the amount of previously taxed retained earnings per shares.
- **Expensing small business investment**. The President proposed increasing the amount of capital expenditures that small businesses can expense rather than capitalize and depreciate over time from $25,000 to $75,000 and to index the amount thereafter.

Additionally, the President proposes to make all of EGTRRA's tax provisions permanent.

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