

# TAX POLICY FOR ECONOMIC GROWTH



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**Joint Economic Committee**  
**United States Congress**  
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## Executive Summary

The ongoing economic slowdown, exacerbated by the terrorist attacks of September 11, makes changes in economic policy necessary. While there is bipartisan agreement on the desirability of tax relief, the composition and scale of tax legislation are both matters of contention. This paper examines current economic conditions, the primary features of several options for tax relief under consideration in Congress, and their potential effects on the economy.

Current and ongoing Joint Economic Committee (JEC) research on major tax issues indicates that measures to reduce income tax rates and reduce the cost of capital would have positive short- and long-term effects on the economy. This study is divided into several sections: the economic impact of taxation, the recent historical record, and certain major provisions for tax relief under consideration. Among the findings are the following:

- The economy has been in an economic slowdown since the middle of 2000, led by a sharp decline in investment growth. The rebound previously projected by many macroeconomic forecasters for the last half of 2001 will probably be delayed or undermined by the terrorist attacks of September 11, 2001. Tax incentives for capital formation are especially appropriate given the important leading role of weakening investment in the economic slump.
- After the attacks, the extra security costs in the short run as well as in the long run will have effects similar to imposing a “security tax” on an already vulnerable economy. This security tax should be offset by tax policy, such as the relief provided under several core components of the *Economic Security and Recovery Act of 2001* (H.R. 3090).
- The current tax code penalizes work, saving, investment, and entrepreneurship. Tax changes that reduce these penalties will improve long-term economic growth.
- According to an important and growing body of economic research, the current level of taxation imposes a large excess burden at the margin; 40 cents in lost economic welfare per dollar of tax would be a reasonable estimate. There is no reason for policymakers to accept such counterproductive results.
- If the tax bill increases the GDP growth rate by only one-tenth of one percentage point annually, it would produce enough additional revenue over 10 years to offset a significant portion of the estimated static revenue losses.
- The dynamic economic impact of properly designed tax legislation, and the high degree of income mobility in the United States, lead to broadly shared economic benefits that are often ignored in conventional revenue and distributional analysis.

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## II. WHY CERTAIN TAX CHANGES CAN AFFECT THE ECONOMY

In a market economy, resources are allocated by the forces of supply and demand. Producers of goods and services expand production to the point where the cost of producing the last unit is covered by the price that can be obtained in the market.

The quantity of inputs to the production process – labor services and capital – is also influenced by changes in market prices. All other things equal, a rise in wage rates, for example, tends to attract new potential workers and expand the labor force. An increase in the rate of return on saving and investment tends to elicit more saving and investment. Thus, changes in prices can affect the quantity of inputs used in production.

Current and especially future prices and costs must be discovered through the market process. Market participants have differing views of future market conditions and their current implications, and these views are tested by the market process over time. Entrepreneurs whose expectations are especially prescient and accurate are rewarded, while those who are not lose their command of productive resources. The entrepreneurial function is the nerve center of the market economy because foresight and the ability to use knowledge productively underlie all the valid assumptions made about costs and prices.

Our economy is not a pure free market economy as in an abstract model. The U.S. economy is a market-based system in which market forces allocate resources, but government is also present. Market costs and relative prices are influenced by government taxation and regulation. The general effect of taxes and regulations is to increase production costs. This effect may or may not be offset by other gains, but an increase in cost or a reduction in the return to a factor of production tends to reduce the supply available. This imposes costs on the economy, withdraws resources from production, and lowers economic growth. The result is economic losses (known as excess burdens) for consumers and producers.

An ideal tax is one that interferes as little as possible with the market allocation of resources. The current tax system is not consistent with this criterion because it is biased against saving and investment, which are taxed more heavily than consumption. In addition, current tax policy also has the effect of discouraging work effort.

Furthermore, given the current level of taxation, the costs imposed are excessive in relation to the revenue raised. The excess burden of taxation is estimated at about 40% of revenues raised at the margin.

Tax legislation that removes some of the bias against work, saving, and investment, would tend to lower barriers to resources flowing into production. Tax legislation that blunts tax provisions that undermine entrepreneurship and innovation would also tend to facilitate the dynamism and flexibility conducive to economic growth. These positive economic effects can be seen during periods when broad-based tax incentives are in place.

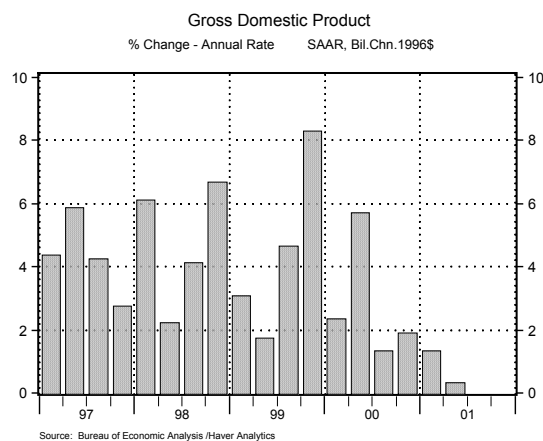
Such measures would work to increase incentives and lower production costs, also improving the cash flow of firms. Improved investment would also increase labor productivity and output, and could bolster demand for labor services that are complementary to capital. Since firms are employers, the reduction in costs and enhancement of labor productivity would work to help firms maintain employment levels and avert pressure to reduce variable costs by discharging as many workers in an economic slowdown. Economic losses incurred by employers and exacerbated by high security, tax and other costs are not in the interest of employers or employees. In sum, a balance in economic policy is needed whereby monetary policy increases aggregate spending, and changes in tax policy are geared to enhancing investment, efficiency, and expansion of output.

### III. ECONOMIC STIMULUS THROUGH TAX RELIEF

Prior to the terrorist attack on September 11, most economic indicators suggested the U.S. economy was experiencing a significant economic slowdown, which began in mid-year 2000. Despite this widespread slowdown, the consensus view among economists at the time was that a near-term economic rebound was at hand for a number of important reasons. The terrorist attack of September 11, however, dramatically changed this by altering consumer and business behavior in both the short and long run; the attack embodies important short- and long-run effects. As a consequence of these effects, prospects for the economic outlook have changed dramatically. The expected near-term economic rebound is now in doubt and the likelihood is that added security expenditures and a “security tax” will adversely effect productivity growth in a longer-term horizon. The economic outlook, however, will importantly depend on the macroeconomic policy response of both monetary and fiscal policy. This analysis explains why an appropriate fiscal response should emphasize tax relief rather than additional government spending and develops a number of alternative tax options.

#### Some Background

Prior to the terrorist attack on September 11, the economy was experiencing a significant slowdown, which began in mid-year 2000. In fact, the macroeconomy was quite weak. Real GDP growth in the second quarter of 2001 was revised down to a low but positive rate. Investment growth had fallen. Manufacturing activity was especially weak with little sign of an imminent rebound. While consumption growth had slowed, it (along with housing strength) was



sufficient to keep the economy out of outright recession. The labor market had softened as employment growth deteriorated and the unemployment rate increased. Broad measures of inflation as well as forward-looking inflation indicators suggested no resurgence of inflation was imminent.

Despite this somber pre-attack picture, at the time it was reasonable to expect that a near-term economic rebound was in the works. With an inventory correction near completion, a retreat of energy prices, a substantial Federal Reserve easing of monetary policy in the pipeline, a tax-cut program in place, and a perception that the stock market had stabilized, consensus projections of an imminent rebound in economic activity appeared quite plausible. These arguments were buttressed by data emerging in the period immediately preceding September 11. Consumer spending, for example, moved higher in August and was maintained in early September. Auto sales were running close to August levels. Purchasing managers reported an improved orders picture in August, and the profit decline was slowing. All of this suggested that a near-term economic turnaround as embodied in consensus forecasts was at hand.

### **The Effects of the September 11 Terrorist Attack**

The terrorist attack of September 11 changed the economic outlook in several important ways. In the short-term, the attack increased uncertainty and apprehension in financial markets. Such increased uncertainty usually increases market volatility, thereby boosting risk premiums. It normally induces investors to move out of riskier assets (such as stocks) and into safer, more liquid, and shorter-term assets (such as short-term U.S. Treasury securities, gold, and cash). This tends to adversely impact the stock market as well as commitments for long-term investments and purchases and to boost demand for short-term liquidity, which works to lower aggregate demand (spending).

This increased uncertainty has negative impacts on consumption and investment as consumer and business confidence deteriorate. Discretionary consumer purchases (such as consumer durables, i.e. cars, major appliances, etc.) and long-term business commitments are often postponed or canceled as purchasers retrench and aggregate demand contracts. Additionally, related stock market declines reduce consumption (via negative wealth effects) and investment (via higher cost of capital).

The terrorist attacks had immediate impacts on certain industries, most notably airlines, aerospace, travel, insurance, hotels, and related areas. The negative impact on these industries, however, likely will spread to other sectors as the negative effects on consumption and investment manifest themselves.

There will be long-term effects of the terrorist attacks as well. The economic costs of a permanently increased terrorist threat will likely bring major changes to our way of life. This will, for example, entail an increased cost of security; in effect, an added "security tax."<sup>2</sup> Such a "tax" will take the form of travel delays, additional security

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<sup>2</sup> See Robert Keleher, "Current Economic Conditions and Outlook," Joint Economic Committee, September 28, 2001. p 2.

checks, longer cross-border transfers, higher insurance costs, additional identification requirements, higher shipping costs, more regulation, immigration restrictions, and other added inconveniences. It will involve spending money on new security guards and buying metal detectors, which do nothing to increase the quantity or quality of goods or services provided. This “tax” will raise the cost of doing business, stifle gains from free exchange, add inefficiencies, and hence constitute a negative supply-side shock or added tax on the economy. Consequently, it will adversely impact both productivity growth and the economy’s long-term potential growth rate.

Similarly, while the attacks will spawn near-term investment and defense spending to repair and replace buildings and shore-up our security, intelligence, and defenses, the total private capital stock will be less than it would otherwise have been. The so-called “peace dividend” – a dividend that freed up resources for growth – is lessened. Monies for a necessary military/security buildup to some extent crowd out private investment. Thus, the attacks will adversely affect aggregate supply and the longer-term potential growth rate of the economy.

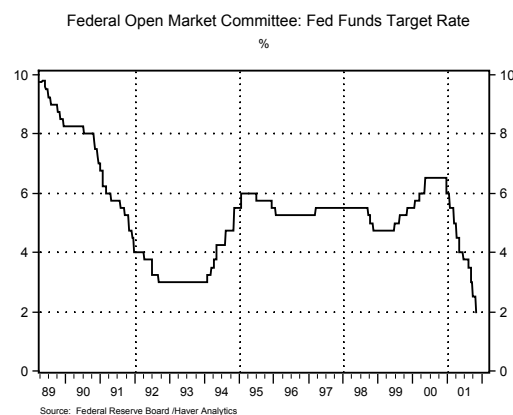
### The Consequences of the Attack

As a consequence of these effects of September 11, the prospects for the economic outlook have changed substantially. These changes relate to the adverse effects to both aggregate demand and aggregate supply. The expected near-term economic rebound, for example, is now in doubt. Real GDP growth is expected to contract in the near-term as a consequence of the events surrounding September 11. According to this scenario, as confidence wanes, unemployment increases, and a weak stock market adversely impacts wealth positions, consumption growth may slow as consumers postpone discretionary purchases, repair their weakened balance sheets, and increase their saving. With such uncertain prospects and the added “security tax” adversely affecting profits, investment growth could remain weak. This is occurring at the same time as a global slowdown and hence weak export growth. The depth and duration of the retrenchment will depend in part on the extent of the damage to business, consumer, and investor confidence. But the near-term may be associated with recessionary conditions and a now weaker recovery may be pushed back into 2002.

### The Macroeconomic Policy Response

The full economic impact of recent events, however, will depend in part on the economic policy response. This response includes monetary policy, which should focus on aggregate demand, and fiscal policy, which should be oriented to aggregate supply:

Monetary policy: The Federal Reserve lowered short-term



interest rates by 50 basis points on September 17, another 50 basis points on October 2, and an additional 50 basis points on November 6. These were the Fed's eighth, ninth and tenth interest rate reductions this year, lowering the fed funds rate by 450 basis points to 2.0 percent (from 6.5 percent in early January). In addition, the Fed has provided a substantial amount of liquidity to the markets to satisfy increased liquidity demands.

Despite these moves, however, there is little economic evidence suggesting that monetary policy is "easy." Jointly assessed forward-looking market price indicators suggest inflation remains dormant and is not a significant problem. Commodity prices remain weak, the foreign exchange rate value of the dollar remains firm, and long-term interest rates recently have fallen. Evidence from key transmission paths or channels of monetary policy also indicates that the stance of policy is not easy. Bank lending has been weak, and stock market values are off considerably. All of this suggests that current monetary policy may not be as "easy" as the recent lowered fed funds rate has led some to believe. Despite Fed efforts to stimulate the economy, more needs to be done to stimulate aggregate demand. An easier Federal Reserve policy stance may be in order.

Fiscal policy: The Congress has already approved a \$55 billion emergency spending package to aid in cleaning up, rebuilding, fighting terrorism, increasing security, and aiding the airline industry. Some additional government spending for these purposes may occur. However, the effectiveness of these measures in stimulating the economy is doubtful. Further measures to bolster the economy will be needed. It is essential that such measures address the weakness in investment that has led the economic slowdown. Such proposals also should include tax relief to bolster the economy by affecting aggregate supply in order to offset the adverse effects of the "security tax" described above. These may include, for example, accelerated depreciation allowances, liberalized expensing provisions, and front-loading scheduled tax rate cuts, among other proposals. Consideration of tax relief for mutual fund shareholders, such as provided in H.R. 168, would be appropriate in this environment. Several of these alternative fiscal proposals will be examined in detail below, and some have already been passed by the U.S. House of Representatives as components of H.R. 3090.

Aggressive monetary and fiscal policy responses will cushion but not fully offset the anticipated adverse consequences of September 11. Such action would foster a shallower and shorter downturn as well as a stronger recovery than otherwise would be the case.

#### **IV. REDUCING THE TAX BURDEN**

As noted in the previous discussion, the additional security costs associated with the terrorist attacks will impose extra costs on the economy analogous to a security tax. Unfortunately, this tax burden is being imposed at a time of considerable domestic and international economic weakness. While the attacks' impact on demand should be

addressed through monetary policy, their impact on supply should be addressed through tax policy, not additional federal spending. Tax relief can reduce some of the extra associated security costs, while increased federal spending will tend to drive them higher. In addition, it is also essential to address the security tax in ways that also lessen the structural bias against saving and investment in the income tax over the long run.

The additional security costs imposed on producers will increase the cost of production, constraining output and future economic growth. Tax policies that would offset some of this extra security tax burden on producers would reduce this negative impact and help increase production, employment, and economic growth in the short run, and even more noticeably in the long run.

Increases in federal spending designed to stimulate the economy, on the other hand, would be ineffective. Federal resources cannot be raised without cost. The resources for additional federal spending must first be drawn from the private sector, so what is given from one hand has been taken from the other. New federal spending generally will not provide a *net* stimulus to the economy.

Moreover, additional federal spending would ultimately be reflected in higher taxes than would otherwise be necessary. The total cost of these taxes must be considered in evaluating the costs and benefits of higher expenditures. The current level of federal taxes imposes high additional costs, including the excess burden economists refer to as “deadweight losses.” Consequently, each additional dollar of federal spending must provide far more than a dollar of benefit to provide net benefits. Economic research suggests that justification of additional federal expenditure requires surmounting a very high hurdle of associated costs.

Each tax dollar taken from individuals or businesses costs the U.S. economy far more than one dollar. Additional burdens stem from administrative costs, compliance costs, and deadweight losses. In fiscal year 2001, the Internal Revenue Service spent \$8.6 billion to administer the U.S. tax code.<sup>3</sup> That amounts to 0.7 percent of federal income tax collections. Closely related to administrative costs, individuals and businesses spent an additional \$100 billion or about 10 percent of federal income tax collections to comply with the U.S. tax code in 1999.<sup>4</sup>

However, the deadweight losses from the U.S. tax code dwarf its administrative and compliance costs. Taxes create disincentives that discourage individuals and firms from undertaking economically productive activities such as work, saving, or investment. Taxes alter the economic behavior of individuals and firms in ways that reduce economic welfare. Deadweight losses represent this loss of economic welfare due to taxes.

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<sup>3</sup> Executive Office of the President, Office of Management and Budget, *Budget of the United States, Fiscal Year 2002, Appendix*, vol. 2. (Washington, D.C.: Government Printing Office, 2001): 2-861.

<sup>4</sup> 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.



Deadweight losses are quite substantial. In 1999, a Joint Economic Committee study reviewed the empirical literature and found that the average among all deadweight loss estimates in these studies was 40 cents for every dollar collected in federal taxes.<sup>5</sup> High marginal federal income tax rates are particularly damaging. Deadweight losses increase more than proportionately to any increase in marginal income tax rates.

Reducing deadweight losses is closely related to increasing economic growth. Both the Organization for Economic Cooperation and Development (OECD) and the World Bank have published cross-country studies linking lower tax rates to higher rates of economic growth.<sup>6</sup>

The challenge before policymakers is to craft tax policy in such a way as to offset the security “tax,” while addressing the structural bias against work, saving and investment in the tax code over the long run. The alternative approach, which would attempt to manage demand through spending increases, would not only be ineffective but also wasteful and costly as well. Monetary policy is a much more effective tool to bolster demand in a weak or deflationary economic environment.

In sum, the choice confronting policymakers is between increasing the costs of production, or reducing them in order to stimulate economic growth. Tax reduction coupled with fiscal restraint would work to lower production costs, while federal spending increases generally would increase costs and the burden of taxation on the economy. The following sections examine a number of viable tax policy options currently available to policymakers. These include: accelerating individual income tax rate cuts; reducing long-term capital gains tax rates accelerated depreciation; eliminating the corporate AMT; and changing the tax treatment of mutual fund investors.

### **Accelerating EGTRA Individual Income Tax Rate Cuts**

On June 7, 2001, the *Economic Growth and Tax Relief Act* (EGTRA) became law. Among its major provisions, EGTRA reduced marginal federal individual income tax rates in four stages from 2001, 2002-2003, 2004-2005, and 2006 and beyond. Accelerating the effective dates of the legally mandated federal individual income tax rate reductions would be an effective way to stimulate an economic recovery.

Lower marginal federal individual income tax rates would accelerate economic growth in five ways:

- **Labor supply.** Empirical studies show cutting individual income tax will cause a modest rise in overall labor supply. Higher-income taxpayers, who

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<sup>5</sup> Richard K. Vedder and Lowell E. Gallaway, *Tax Reduction and Economic Welfare*, Prepared for the Joint Economic Committee, 106th Congress, 1st Session, April 1999: 6.

<sup>6</sup> Willi Leibfritz, John Thornton, and Alexandra Bibbee, *Taxation and Economic Performance* (Paris: Organization for Economic Cooperation and Development, 1997); and Keith Marsden, *Links between Taxes and Economic Growth: Some Empirical Evidence*, World Bank Staff Working Paper 605 (Washington, D.C.: World Bank, 1983).

experience the largest deadweight losses, are likely to show the largest labor supply response to a reduction in marginal federal individual income tax rates.<sup>7</sup>

- **Saving supply.** It is widely recognized that the current U.S. tax code is biased against saving. Lower marginal federal individual income tax rates will partially alleviate this bias.<sup>8</sup>
- **Entrepreneurial activity.** More than 20 million small businesses and farms are subject to the federal individual income tax. Of the individual tax filers with an adjusted gross income above \$200,000 in 1998, IRS data shows that 27 percent reported sole proprietor income and 49 percent reported partnership or “S” corporation income.<sup>9</sup> Cutting marginal federal individual income tax rates affects large numbers of small business people, not just high-salaried executives or those living off investment income. Empirical studies demonstrate that lower federal marginal individual income tax rates help to stimulate small business revenue growth, investment, and employment. One study found a 5-percentage point reduction in marginal federal individual income tax rates would cause a 10 percent increase in small business investment.<sup>10</sup> Another study found that a tax cut that boosts after-tax income by 10 percent would increase a small business’s likelihood of hiring by 12 percent.<sup>11</sup>
- **Production and consumption efficiency.** Higher marginal federal individual income tax rates cause individuals and businesses to make production and consumption decisions on the basis of the tax code. That causes widespread production and consumption inefficiencies and slows economic growth. Cutting marginal federal individual income tax rates reduces the value of tax deductions and exemptions and encourages individuals and businesses to make economically sound decisions about consumption and production rather than to game the tax system. The resulting efficiency gains will accelerate economic growth.<sup>12</sup>
- **Tax avoidance.** Higher-income taxpayers usually have more ability to minimize their tax burdens than other taxpayers. Lowering marginal federal individual income tax rates will encourage higher-income taxpayers to move their funds from unproductive tax shelters to more productive, but taxable investments.<sup>13</sup>

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<sup>7</sup> Chris Edwards, *Economic Benefits of Personal Income Tax Rate Reductions*, Joint Economic Committee, 107<sup>th</sup> Congress, 1<sup>st</sup> Session, April 2001: 5-6.

<sup>8</sup> Edwards (2001): 6-7.

<sup>9</sup> Internal Revenue Service, *Statistics of Income Bulletin* (Washington, D.C.: Government Printing Office, Fall 2000).

<sup>10</sup> Robert Carroll et al., “Entrepreneurs, Income Taxes, and Investment,” in *Does Atlas Shrug?*, Joel Slemrod, ed. (April 2000).

<sup>11</sup> Robert Carroll et al., “Income Taxes and Entrepreneurs’ Use of Labor,” *Journal of Labor Economics* (April 2000).

<sup>12</sup> Edwards (2001): 8-9.

<sup>13</sup> Edwards (2001): 9.

Accelerating already enacted marginal federal individual income tax rate cuts has another advantage – its long-term effects on the federal budget are minimized. Its budgetary effects would be limited to fiscal year 2002 through 2006 with most of its budgetary effects concentrated in fiscal years 2002 through 2004, when fiscal stimulus is needed the most. Unlike other proposals (such as cutting federal corporate income tax rates or reducing federal capital gains taxes), accelerating marginal federal individual income tax rate reductions already enacted in EGTRA would not represent a new and permanent change to the U.S. tax code. The *Economic Security and Recovery Act* would effect an important acceleration of tax relief by reducing the 27 percent tax rate to 25 percent in 2002. Separately, the bill also expands benefits for some tax filers.

### **Reducing Capital Gains Tax Rates**

The U.S. tax code regards assets held longer than 12 months as long-term assets and assets held less than 12 months as short-term assets. Capital gains on short-term assets are taxed at regular income tax rates. Following the enactment of the *Taxpayer Relief Act of 1997*, capital gains on long-term assets held for one to five years are taxed at a maximum tax rate of 20 percent (10 percent for taxpayers in the 15 percent marginal tax rate bracket). Capital gains from the sale of assets held for more than five years are taxed at a maximum tax rate of 18 percent (8 percent for taxpayers in the 15 percent tax rate bracket). One way to stimulate the economy would be to reduce the tax rates on all capital gains. Another approach would be to standardize capital gains tax rates so that the tax rates on capital gains on assets held one to five years would be the same as those held more than five years. In other words, the maximum tax rate on all long-term capital gains would become 18 percent (8 percent for taxpayers in the 15 percent tax rate bracket). This approach has been included in the *Economic Security and Recovery Act*. Deeper reductions in the capital gains tax rate would also be desirable.

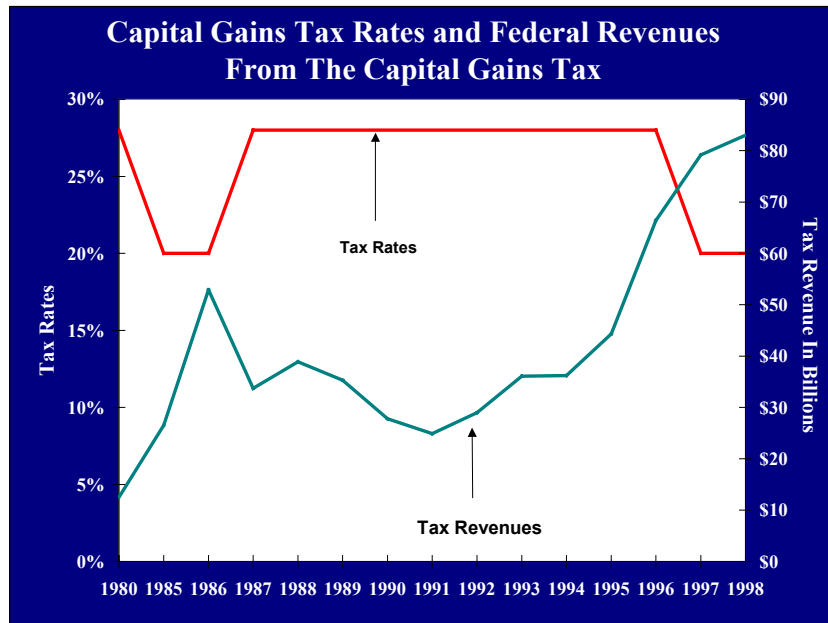
**Macroeconomic benefits.** Capital investment accelerates economic growth by simultaneously increasing the quantity of capital available and the productivity of labor. Reducing the capital gains tax rate stimulates capital investment. Thus, lowering the capital gains tax rate is likely to boost economic growth. Various empirical studies confirm an inverse relationship between the capital gains tax rate and the real GDP growth rate.<sup>14</sup>

The benefits of reducing capital gains tax rates are concentrated among small businesses. Private individuals provide the venture capital that is the major source for investment in most small businesses. Capital gains taxes directly affect the after-tax return that such venture capitalists expect to earn on their equity investments in small businesses. Reducing the capital gains tax rate stimulates entrepreneurial risk-taking by increasing the supply of venture capital available to small businesses.

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<sup>14</sup> DRI/McGraw Hill, “The Capital Gains Tax: Its Investment, Stimulus, and Revenue Feedbacks,” (April 1997), and Shahira Knight, “The Economic Effects of Capital Gains Taxation,” Joint Economic Committee, June 1997.

**Tax revenue.** Historically, capital gains tax revenues have increased when capital gains tax rates are lowered; *e.g.*, 1978, 1981, and 1997. Capital gains tax revenues have decreased when capital gains tax rates have been raised, as in the 1986 tax bill. This may seem counterintuitive because a static analysis implies that capital gains tax revenues should fall when the same level of capital gains realizations are taxed at a lower rate. However, one must remember that capital gains realizations are largely discretionary: many taxpayers can control when assets are sold. If capital gains tax rates are high, then taxpayers will defer selling assets. This is known as the “lock-in effect.” Lowering capital gains tax rates diminishes the lock-in effect and increases capital gains realizations.



In addition to unlocking effects, capital gains tax rate reductions stimulates a rise in asset prices in two ways. First, modern finance demonstrates that the price of an asset is its net present value; *i.e.*, the sum of its discounted future cash flow. Consequently, there is a tax capitalization effect; *i.e.*, a capital gains tax rate increase (decrease) causes asset prices to fall (rise) generally. Second, reducing capital gains tax rates tend to stimulate economic growth. Higher economic growth implies larger cash flows from business and consequently higher asset prices. This is the macroeconomic effect.

Together, the lock-in effect, the tax capitalization effect, and the macroeconomic effect contribute to higher capital gains tax revenue when capital gains tax rates are lowered.

**Simplification.** The difference in the capital gains tax rates on assets held between one and five years and assets held five years or longer is a needless complexity in the U.S. tax code that lacks any economic justification. By standardizing capital gains tax rates at 18 percent and 8 percent, Congress could take an important step toward federal tax simplification.

## Accelerated Depreciation and Expensing

Business income taxes are levied on the difference between the revenues that firms earn and the costs they incur for inputs. Firms earn revenue by selling goods and services to consumers. When producing goods and services firms incur costs. Some of these costs, such as wages and salaries of workers or the cost of raw materials, are generally incurred during the same year in which the income they helped to produce is generated. Other costs, such as investments in plant and equipment, help to produce income over multiple years.

When calculating taxable income, the first type of cost is simply subtracted from the revenue generated that year. Inclusion of the second type of cost, however, is a bit more complicated. Under current law, firms generally apportion the cost of capital assets over a number of years. Such attribution varies by asset type and is governed by a set of depreciation tables produced by the Treasury Department. Under certain circumstances, smaller firms are permitted immediate deductions for investment known as expensing.

Depreciation rates help to determine the cost of capital investment.<sup>15</sup> As a result, they play a crucial role in determining how much investment will take place in a society. If firms are allowed to deduct their expenditures on capital assets quickly, the relative cost of such investment will be low. This will cause the level of capital investment to be relatively high. If, on the other hand, firms are required to deduct their capital expenditures over a longer horizon, the relative cost of such investment will be high. This, in turn, will cause the level of capital investment to be relatively low.

The relationship between depreciation rates and capital investment suggests that accelerating depreciation schedules will increase investment. Empirical studies of investment decisions tend to support this notion and generally show a strong relationship between depreciation rates and investment.<sup>16</sup> By allowing 30 percent expensing for newly purchased equipment with tax lives of 20 years or less and software during the next three years, the *Economic Security and Recovery Act* effectively accelerates depreciation schedules. This would lower the cost of capital and stimulate investment. The *Act* also expands expensing for small businesses, which would have similar economic effects.

## Eliminating the Corporate AMT

The corporate Alternative Minimum Tax (AMT) was passed as part of the *Tax Reform Act of 1986*. Its passage was driven by the perception that complex tax planning allowed some large corporations to pay little or no corporate income taxes. In order to prevent this, Congress created what is essentially a parallel tax system. Under current

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<sup>15</sup> See Dale W. Jorgenson, "Capital Theory and Investment Behavior," *American Economic Review* 53, no. 2 (May 1963), pp. 247-59.

<sup>16</sup> See, for example, Robert S. Chirinko, Steven M. Fazzari, and Andrew P. Meyer, "How Responsive is Business Capital Formation to IT User Cost? An Exploration With Micro Data," *Journal of Public Economics* 31 (December 1993), pp. 1875-911.

law, corporations are required to calculate their tax liabilities under both the regular and alternative minimum tax systems. They are then required to pay the greater of the two liabilities.

The corporate AMT has been criticized on many grounds. Many observers have argued that the complexity generated by the need to calculate a company's tax burden under two tax systems is reason enough to eliminate it. Public finance economists, however, have tended to focus on the role that the corporate AMT plays in determining the cost of capital investment. By its nature, the corporate AMT increases the effective tax rates of those firms subject to it.

Evidence suggests that the corporate AMT increases the cost of capital for firms that invest in equipment and intangible assets such as research and development.<sup>17</sup> Studies also suggest that the elimination of the corporate AMT could increase investment by as much as 7.9 percent over 10 years.<sup>18</sup> Such a rise in investment, coupled with the resulting increase in labor productivity, could be expected to boost the gross domestic product by as much as 1.6 percent over 10 years.<sup>19</sup> The *Economic Security and Recovery Act* contains a corporate AMT repeal provision that would provide needed relief and increase tax incentives for economic growth.

## V. TAXES AND TAXPAYERS

In the debate of tax relief proposals, sometimes it is contended that tax reduction unduly favors the affluent. This point of view is often based on statistical sketches of tax changes in which the benefits appear skewed toward higher-income taxpayers, but in reality only reflect the current pattern of tax payments taken out of context. Very often this kind of information allocating the benefits of tax changes is circulated without any mention of the share of tax payments of each income group before and after the effects of the tax cut legislation are taken into effect.

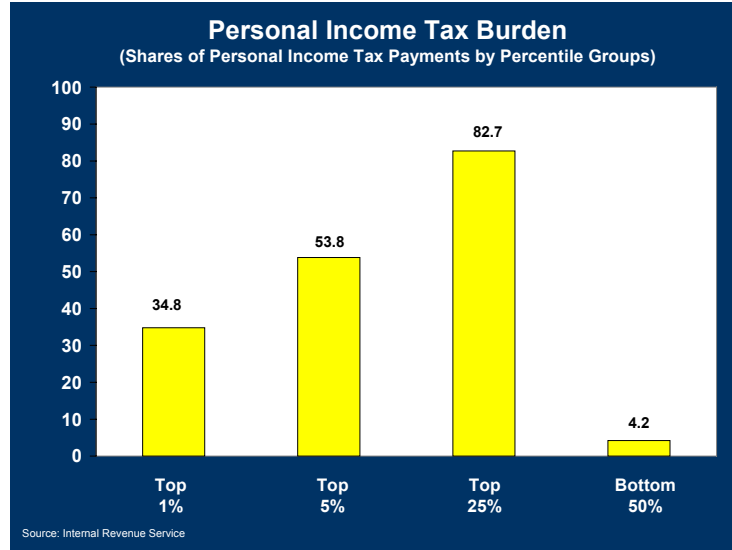
According to a different set of data prepared by the Internal Revenue Service (IRS), the top one percent of filers pays 34.8 percent of the personal income taxes. The IRS data show that the income tax share of the top 5 percent is 53.8 percent, and that of the top 25 percent is 82.7 percent. Filers in the bottom 50 percent paid 4.2 percent of personal income taxes. Incidentally, the taxpayers in the top quarter of taxpayers qualified by earning more than only \$50,607 in 1998. The shares of personal income tax payments are displayed in the graph below.

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<sup>17</sup> See Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington, D.C.: 1997), pp. 77-97.

<sup>18</sup> See DRI, McGraw-Hill, "Report on the Macroeconomic Impact of the House and Senate Proposals Regarding the Corporate Alternative Minimum Tax," August 1995.

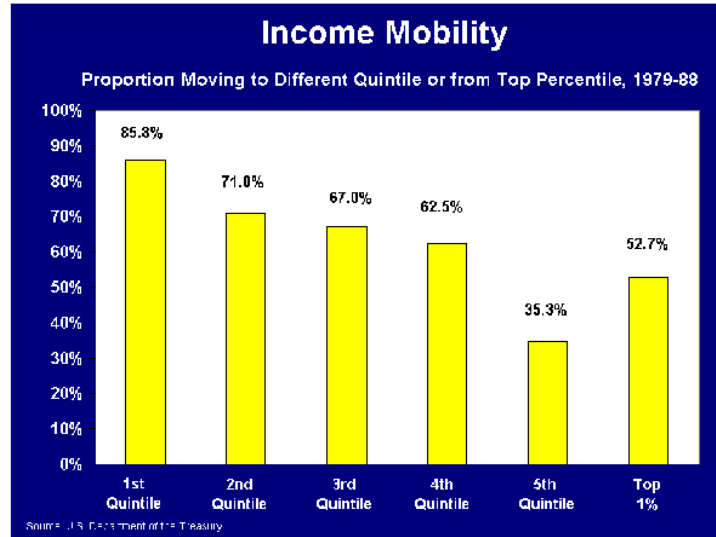
<sup>19</sup> Ibid.



Another serious problem regarding the analysis of the tax changes on taxpayers at various income levels is that those households are not necessarily cemented into specific income classes for extended periods of time. The United States has a dynamic economy in which there are remarkable degrees of income mobility. Over extended periods, many if not most of those in a particular income strata move up or down. Thus, statements based on the assumption that taxpayers are confined to a particular income class over time are inaccurate.

For example, according to tax return data, 85.8 percent of filers in the bottom 5th in 1979 had exited this quintile by 1988. The corresponding mobility rates were 71.0 percent for the second lowest quintile, 67.0 percent for the middle quintile, 62.5 percent for the fourth quintile, and 35.3 percent for the top quintile.<sup>20</sup> The long-run impact of tax policy on most taxpayers depends on their tax situations and incomes in the future, not the present. The graph below displays the high degree of income mobility in the U.S. over one ten-year period.

<sup>20</sup> See Christopher Frenze, *Income Mobility and Economic Opportunity*, Joint Economic Committee, June 1992.



As can be seen, America is a fluid and dynamic society, not a caste system. The portrayal of the American economy as a rigid class system is contradicted by the statistical evidence. Therefore, tax reduction has broader-based benefits than some critics seem to realize.

## VI. CONCLUSION

The economic slowdown that began in the middle of 2000 continues to reflect economic weakness. The prospect of a near-term economic rebound previously forecast by many economists has been jeopardized by the events of September 11, 2001. As a result of the terrorist attacks, significant and pervasive additional security costs will burden the economy in a manner similar to the imposition of a “security tax.” Tax policy should attempt to offset these additional costs to facilitate economic growth over the short as well as long term.

There are other long-term structural problems with the U.S. income tax system. The current tax system is counterproductive and biased against saving and investment. Economic stimulus legislation can effectively address the weakness in investment, which has contributed to the economic slowdown. The tax system imposes large losses on the economy that reduce the economic welfare of households and businesses.

In considering alternative fiscal policies, it must be recalled that the current level of taxation imposes additional costs of about 40 cents at the margin for each dollar collected in revenue. A reduction in this burden imposed by the tax system would make a significant improvement in the economic well-being of American households.

The challenge to policy is to address the “security tax” issue in a manner that also addresses the long-term structural problems with the income tax. The additional economic costs imposed by the terrorist attacks should be alleviated by tax policy, and at the same time some of the structural biases against work, saving and investment in the



current income tax system should be corrected. Tax policy should increase economic incentives, reduce deadweight losses, provide broad-based relief to households subjected to excessive income taxation, and improve the prospects for economic growth.