

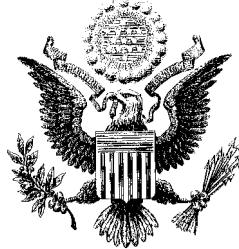
# CORD

## Federal Tax Policy, Near-Term Stimulus, and Long-Term Growth

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# FEDERAL TAX POLICY, NEAR-TERM STIMULUS, AND LONG-TERM GROWTH

## A JOINT ECONOMIC COMMITTEE STUDY



**Vice Chairman Jim Saxton (R-NJ)**

**Joint Economic Committee  
United States Congress**

**March 2003**

### **Executive Summary**

On January 7, 2003, President George W. Bush proposed a *Jobs and Growth Initiative* to stimulate near-term economic growth and support a long-term economic expansion. The findings of this JEC study include:

- By reducing the excess burden of the federal tax system and encouraging economically productive behavior, this initiative would simultaneously provide a near-term stimulus to the U.S. economy and support its long-term economic growth.
- By ameliorating financing constraints among small and medium-sized firms that are organized as proprietorships, partnerships, or S corporations whose income and expenses flow through to their shareholders for federal income tax purposes, accelerating marginal individual federal income tax rate reductions would stimulate not only labor force participation but also aggregate investment during the near term.
- Ending the double taxation of corporate income would reduce agency problems between the executives of publicly held corporations and their shareholders that cause such corporations to make less than efficient investments. Therefore, ending double taxation not only would increase the quantity of aggregate investment but also would improve its quality. Ending double taxation would enhance the efficiency, neutrality, and fairness of the federal tax system and would increase the long-term growth potential for the U.S. economy.
- Because the public generally believes that policymakers will not allow the tax relief provisions of the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) to expire on December 31, 2010, as mandated under current law, failure to make EGTRRA's existing tax relief provisions permanent would invalidate the public's perception of EGTRRA's permanence, cause a negative reaction, and diminish long-term economic growth.

The Council of Economic Advisors (CEA) forecasted this initiative would increase real GDP by 1.7 percent and would create 1.4 million new jobs by the fourth quarter of 2004. This CEA forecast is broadly consistent with estimates of the initiative's near-term growth benefits by private macroeconomic forecasters.

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# FEDERAL TAX POLICY, NEAR-TERM STIMULUS, AND LONG-TERM GROWTH

## TABLE OF CONTENTS

<b>I.</b>	<b>INTRODUCTION .....</b>	<b>1</b>
<b>II.</b>	<b>EGTRRA AND THE JOBS AND GROWTH INITIATIVE .....</b>	<b>2</b>
	A. Economic Growth and Tax Relief Reconciliation Act .....	2
	B. President’s Jobs and Growth Initiative .....	3
<b>III.</b>	<b>JUDGING THE JOBS AND GROWTH INITIATIVE .....</b>	<b>3</b>
<b>IV.</b>	<b>REDUCING THE EXCESS BURDEN OF THE FEDERAL TAX SYSTEM .....</b>	<b>4</b>
	A. What is the Excess Burden of the Federal Tax System .....	4
	1. Administrative Costs.....	4
	2. Compliance Costs .....	4
	3. Deadweight Losses .....	4
	B. Jobs and Growth Initiative Would Reduce the Excess Burden of Taxation .....	5
<b>V.</b>	<b>STIMULATING INVESTMENT THROUGH ACCELERATING MARGINAL INDIVIDUAL FEDERAL INCOME TAX RATE REDUCTIONS.....</b>	<b>5</b>
	A. Recent Empirical Studies Cause a Reevaluation of the Effectiveness of Reducing Marginal Federal Income Tax Rates in Stimulating Investment .....	5
	B. Marginal Individual Federal Income Tax Rates, Financing Constraints, and Investment among Sole Proprietorships, Partnerships, and S Corporations .....	6
	C. Accelerating Marginal Individual Federal Income Tax Rate Reductions and Increasing the Expensing Limit Would Stimulate Investment .....	7
<b>VI.</b>	<b>ENHANCING EFFICIENCY, FAIRNESS, AND NEUTRALITY BY ENDING DOUBLE TAXATION OF CORPORATE INCOME .....</b>	<b>7</b>
	A. What is the Double Taxation of Corporate Income? .....	7
	B. Double Taxation Distorts Economic Decision-Making.....	8
	C. Ending Double Taxation Would Enhance Efficiency, Fairness, and Neutrality.....	9
<b>VII.</b>	<b>IMPORTANCE OF PERMANENCE TO THE STRENGTH OF THE ECONOMIC RESPONSE TO TAX RELIEF .....</b>	<b>9</b>
	A. Modified Life Cycle Permanent Income Hypothesis.....	9
	B. Implications of the Modified Life Cycle Permanent Hypothesis for the Near- Term Effects of Federal Tax Changes on Consumption and Economic Growth.....	10
	C. Jobs and Growth Initiative and Permanence.....	10
	1. Making the Existing Provisions of EGTRRA Permanent.....	10
	2. New Tax Relief Provisions .....	11
<b>VIII.</b>	<b>FORECAST OF THE INITIATIVE’S GROWTH BENEFITS.....</b>	<b>11</b>
<b>IX.</b>	<b>CONCLUSION .....</b>	<b>12</b>

# FEDERAL TAX POLICY, NEAR-TERM STIMULUS, AND LONG-TERM GROWTH

## I. INTRODUCTION

Economic growth decelerated during the second half of 2000. Real gross domestic product (GDP) declined by 0.6 percent in the first quarter of 2001. Subsequently, the Business Cycle Dating Committee of the National Bureau of Economic Research determined that a recession had begun in March 2001. This slowdown prompted Congress to enact the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA). EGTRRA reduces marginal individual federal income tax rates and repeals the federal estate tax. However, EGTRRA's tax relief provisions are currently scheduled to expire on December 31, 2010.

Although real GDP growth resumed in the fourth quarter of 2001, the terrorist attacks on September 11, 2001, increased uncertainty. Higher uncertainty and overinvestment in certain industries depressed aggregate investment. Consequently, real GDP growth remained sluggish through the fourth quarter of 2002.

On January 7, 2003, President George W. Bush proposed a *Job and Growth Initiative* to stimulate near-term economic growth and support a long-term economic expansion. This initiative would:

- Accelerate EGTRRA's marginal individual federal income tax rate reductions,
- Make EGTRRA's tax relief provisions permanent,
- Increase the amount of investment that small firms can expense rather than capitalize and depreciate over time from \$25,000 to \$75,000 and index the amount thereafter, and
- End the double taxation of corporate income at the corporate level as profits and at the individual level as capital gains or dividends.

Based on previous Joint Economic Committee (JEC) studies that had surveyed the empirical literature regarding taxation, this study finds:

- The actual burden of the federal tax system on the U.S. economy is much larger than the federal tax receipts collected from individual and corporate taxpayers. Including administrative costs, compliance costs, and deadweight losses, a reasonable estimate of this excess burden of the federal tax system is \$0.40 per \$1.00 of marginal federal tax receipts. By reducing this excess burden and encouraging economically productive behavior, the *Jobs and Growth Initiative* would simultaneously provide a near-term stimulus to the U.S. economy and support its long-term growth.
- The prevalence of financing constraints among virtually all small firms, most medium-sized firms, and even some large firms in new, rapidly changing industries means that marginal income tax rate reductions are an effective way to stimulate aggregate investment. Marginal individual income tax rate reductions not only promote labor force participation, but also stimulate investment among sole proprietorships, partnerships,<sup>1</sup> and S corporations<sup>2</sup> whose income and

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<sup>1</sup> Partnerships also include limited liability companies (LLCs) and limited liability partnerships (LLPs).

<sup>2</sup> An S corporation is an incorporated entity that retains the main attributes of the traditional C corporation such as limited liability, freely transferable ownership, and unlimited lifespan, but, in exchange for certain limitations, receives the benefits of a flow-through entity for income tax purposes. The election to be treated as an S corporation allows income and expenses to pass through the corporate structure to its shareholders, and any resulting tax liability is the responsibility of its shareholders. This benefit eliminates the double taxation on the corporation's net income and capital gains.

expenses flow through to their shareholders for federal income tax purposes. Accelerating EGTRRA's marginal individual income tax rate reductions would improve the efficiency of the federal tax system. By allowing small firms to avoid the complexity and distortions associated with tax depreciation, increasing the expensing limit not only would improve the efficiency of the federal tax system but also would increase its neutrality and simplicity. Together, accelerating EGTRRA's marginal individual income tax rate reductions and increasing the expensing limit would stimulate aggregate investment during the near term.

- Because the interests of a corporation's executives and its shareholders may diverge, executives may make business decisions that benefit them rather than maximize the wealth of the shareholders. Economists describe this phenomenon as the **agency problem**. Dividends are a market mechanism to overcome the agency problem in publicly held corporations and align the interests of executives and shareholders. By taxing corporate income twice, federal tax policy discourages corporations from paying dividends and contributes to agency problems – excessive management compensation and unwise acquisitions – that became apparent after the stock market bubble collapsed in 2000. Ending double taxation not only would increase the quantity of aggregate investment, but also would improve the quality of aggregate investment by reducing agency problems that prompt corporations to make economically inefficient investments. By enhancing the efficiency, fairness, and neutrality of the federal tax system, ending double taxation would increase the long-term growth potential for the U.S. economy.
- The perceived duration of a tax reduction affects its ability to stimulate consumption and real GDP growth. Because the public perceives that EGTRRA's tax relief provisions are permanent (*i.e.*, policymakers will not allow EGTRRA to expire as currently scheduled on December 31, 2010), making EGTRRA permanent may not stimulate economic growth. However, if policymakers were to reject making EGTRRA permanent, they would invalidate the public's perception of EGTRRA's permanence. Such a rejection would be a negative shock to the U.S. economy that would reduce its long-term growth. Because of the lack of permanence, alternative proposals for a tax rebate or a temporary federal payroll tax reduction would provide less near-term stimulation than the *Jobs and Growth Initiative*. Unlike this initiative, moreover, these alternative proposals would not help to sustain a long-term expansion.

Macroeconomic forecasters have found that significant near-term growth benefits would accrue from the *Jobs and Growth Initiative*. The Council of Economic of Advisors (CEA) forecasted that this initiative would increase real GDP by 1.7 percent and would create 1.4 million new jobs by the fourth quarter of 2004. This CEA forecast is broadly consistent with estimates of the initiative's near-term growth benefits by private macroeconomic forecasters.

## II. EGTRRA AND THE JOBS AND GROWTH INITIATIVE

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

On June 7, 2001, President George W. Bush signed the *Economic Growth and Tax Relief Reconciliation Act of 2001* into law. Among other things:

- **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. President's Jobs and Growth Initiative***

On 7 January 2003, President George W. Bush proposed a *Jobs and Growth Initiative*. Among other things:

- **Marginal individual income tax rate reductions.** The President proposes to accelerate EGTRRA's individual income tax rate reductions scheduled for January 1, 2004, and January 1, 2006, to January 1, 2003.
- **Child tax credit.** The President proposes to accelerate EGTRRA's phased increase in the child tax credit to \$1,000 to January 1, 2003.
- **Marriage penalty relief.** The President proposes to accelerate EGTRRA's phased marriage penalty relief to January 1, 2003.
- **Double taxation of corporate dividends.** The President proposes to end the "double taxation" of corporate dividends 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 sale of corporate equity by the amount of previously-taxed retained earnings per shares.
- **Expensing small business investment.** The President proposes to increase 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.

### **III. JUDGING THE JOBS AND GROWTH INITIATIVE**

This study applies the following well-established economic criteria to evaluate the President's *Jobs and Growth Initiative*:

- **Efficiency.** The federal tax system should minimize any disincentives against individuals and firms from engaging in economically productive behavior.
- **Fairness.** An individual's burden under the federal tax system should be proportional to such individual's economic welfare. Different individuals whose level of economic welfare is the same should pay the same taxes regardless of their source of income.
- **Neutrality.** The federal tax system should not affect relative prices and should not distort the market allocation of resources through the price system.
- **Simplicity.** The federal tax system should be as simple as possible.

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

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

The 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, the economic burden of paying a marginal dollar in taxes to the U.S. government is at least \$1.40.

##### 1. Administrative Costs

The administrative costs are the expenses that 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.<sup>3</sup> This amounts to 0.51 percent of all federal receipts.<sup>4</sup>

##### 2. Compliance Costs

Closely related to administrative costs are compliance costs. Individuals and corporations filed approximately 175 million federal income tax returns during 2002.<sup>5</sup> 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.<sup>6</sup>

##### 3. 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**. Recent empirical studies have found that the deadweight loss imposes a substantial burden on the U.S. economy. For example, Charles L. Ballard,

<sup>3</sup> Interview with U.S. Department of the Treasury, Internal Revenue Service, Congressional Relations Office.

<sup>4</sup> Author's calculations.

<sup>5</sup> Interview with U.S. Department of the Treasury, Internal Revenue Service, Congressional Relations Office.

<sup>6</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.

John B. Shoven, and John Whalley (1985) calculated that the average marginal excess burden for all U.S. taxes was 33.2 percent.

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 %

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:

*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.<sup>8</sup>*

#### **B. Jobs and Growth Initiative Would Reduce the Excess Burden of Taxation**

The *Jobs and Growth Initiative* will significantly improve the efficiency of the federal tax system. By accelerating the reduction of marginal individual federal income tax rates and eliminating the double taxation of corporate income, this initiative 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, this initiative will 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**

Before 1988, aggregate investment models assumed that firms operate in a close approximation of a perfect financial market. In a perfect financial market, outside lenders and investors are willing to supply a firm with whatever debt or equity that a firm needs to invest in any capital asset with positive expected net present value at a competitively determined interest rate that fully reflects the risk inherent in such assets.

In aggregate investment models that assume a close approximation of a perfect financial market, the federal tax policy affects aggregate investment by changing the expected net present value of an investment in a new capital asset; *i.e.* the asset's marginal effective tax rate. Because of the ready availability of outside funds, a firm's cash flow from its portfolio of existing capital assets is irrelevant to its investing decision. In such models, the federal tax policy toward existing capital assets cannot, by definition, affect aggregate investment.

<sup>7</sup> 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.

<sup>8</sup> 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.

Such models led many economists to believe that the most effective way of stimulating aggregate investment was asset-specific tax relief designed to reduce the effective marginal tax rate on a firm's new investment. Asset-specific tax relief includes accelerated depreciation, investment tax credits, and lower differential tax rates on the income from specific capital assets. Economists regarded reducing marginal federal income tax rates as "wasteful" because most of such reductions would lower a firm's average tax rate on its portfolio of existing capital assets while only a small portion would lower a firm's marginal effective tax rate on its investments in new capital assets.

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 significantly improved the performance of pre-1988 aggregate investment models.<sup>9</sup> 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 reevaluate 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. Therefore, marginal income tax rate reductions do not "waste" tax benefits on existing capital assets. Instead, marginal income tax rate reductions empower financing constrained firms to make investment that they would not make with asset-specific tax relief. This is especially true during an economic downturn 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.<sup>10</sup>

Previously, many economists had thought that marginal individual income tax rate reductions (1) mainly affected aggregate labor force participation and (2) only peripherally affected aggregate investment by lowering marginal effective tax rate on investments in new capital assets. However, small

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<sup>9</sup> 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.

<sup>10</sup> Author's calculations from IRS *Statistics of Income Bulletin* data for tax year 1988.

and medium-sized firms (which are generally “flow-through” firms) are more likely to be financing constrained than large firms. These “flow-through” businesses and farms are the least likely to be able to take full advantage of any asset-specific tax relief. For these “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 their investment. Thus, 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.* employed returns that (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. Applying various approaches to model investing behavior in 1988, Carroll *et al.* found that the elasticity of investment was -1.78 for sole proprietorships. 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.<sup>11</sup>

### ***C. Accelerating Marginal Individual Federal Income Tax Rate Reductions and Increasing the Expensing Limit Would Stimulate Investment***

Accelerating EGTRRA’s marginal individual federal income tax reductions 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. Allowing small firms to increase the amount of capital expenditures that such firms can expense rather than capitalize and depreciate over time from \$25,000 to \$75,000 and indexing the amount thereafter would reduce the marginal effective tax rate on investment in new capital assets for such firms. By allowing small firms to avoid the complexities and distortions associated with tax depreciation,<sup>12</sup> increasing the expensing limit would not only would improve efficiency of the federal tax system but also would increase its neutrality and simplicity. Together, accelerating EGTRRA’s marginal individual income tax rate reductions and increasing the expensing limit would stimulate aggregate investment during the near term.

## **VI. ENHANCING EFFICIENCY, FAIRNESS, AND NEUTRALITY BY ENDING DOUBLE TAXATION OF CORPORATE INCOME**

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

An efficient and fair tax income system should tax all income once, but only once. Current federal tax policy deviates from this sound principle through the double taxation of corporate income for all corporations except S corporations. 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

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<sup>11</sup> 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.

<sup>12</sup> Tax depreciation schedules are not adjusted for inflation and the time value of money. Thus, the expected present value of depreciation deductions for a new capital asset is less than its cost. Expensing eliminates this distortion.

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 60.1 percent. If corporations retain a portion of the income that they generate from equity-financed investments, the federal government taxes any stock price appreciation from retained and reinvested earnings as capital gains when individuals sell their shares. For individuals holding their shares for at least five years, the United States taxes these capital gains at a maximum rate of 18 percent. Thus, the maximum effective federal tax rate on retained earnings income from corporate equity-financed investment is 40.9. 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 that corporations generate from debt-financed investments and the income that sole proprietorships, partnerships, and S corporations generate from their investments is 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 corporate income affects the economic decision-making in a number of perverse ways that diminish overall economic welfare.

The double taxation of corporate 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 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.

When making business decisions, corporate executive should seek to maximize the wealth of their shareholders. In large publicly traded corporations, the interests of senior executives inside the corporation and outside shareholders often diverge. Corporate executives may make business decisions that benefit themselves rather than maximize the wealth of shareholders. Economists refer to this phenomenon as the **agency problem**. While a corporation's executives may behave illegally to advantage themselves at the expense of its shareholders, illegal behavior is only a small part of the agency problem. Agency problems encompass many legal but economically inefficient practices such as excessive executive compensation and unwise mergers in which the expected returns from an acquired firm are less than the expected returns that shareholders could achieve investing a diversified portfolio of stocks.

During the last quarter of the 20<sup>th</sup> century, economists published a large body of theoretical and empirical literature on agency problems. Michael C. Jensen (1986) found that agency problems are especially severe among publicly traded corporations that generate a large free cash flow (*i.e.*, cash flow in excess of that required to fund all projects that have positive expected net present value when discounted at the relevant cost of capital). In such corporations, their executives may choose to spend their resources on acquisitions rather than to pay dividends to their shareholders. Many of these acquisitions generate small benefits to shareholders or may even be value-destroying. Jensen found that dividends are a market mechanism for reducing excessive free cash flow and overcoming agency problems between a corporation's executives and its shareholders.<sup>13</sup>

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<sup>13</sup> Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review* 76 (May 1986): 323-329.

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.<sup>14</sup>

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

Ending double taxation would eliminate this incentive to withhold dividends and make federal tax policy neutral as to whether corporations pay dividends to their shareholders or retain such funds for investment. 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. As a result, the quality of corporate investment would improve as executives utilize scarce resources more wisely. Ending 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.

## **VII. IMPORTANCE OF PERMANENCE TO THE STRENGTH OF THE ECONOMIC RESPONSE TO TAX RELIEF**

### ***A. Modified Life Cycle Permanent Income Hypothesis***

Observing that individuals smooth their consumption over their lifetime, Nobel laureate Milton Friedman proposed the **permanent income hypothesis**; *i.e.*, individuals base their consumption during any period upon their current wealth and their expectations for average lifetime after-tax income excluding any one-time gains or losses. Consequently, individuals benefiting from a temporary increase in their after-tax income are likely to save a significant portion of their windfall initially and then to increase their consumption very slowly by drawing on their additional savings in small increments over a long time.

Age also affects individual consumption. When individuals enter the labor market, they frequently consume more than their current after-tax income through borrowing. During their peak earning years, individuals save a significant portion of their income. After retirement, individuals draw upon their savings to maintain their consumption. This is the **life cycle hypothesis**. Because the life cycle hypothesis and the permanent income hypothesis are so closely interrelated, economists usually combined them into a single **life cycle permanent income hypothesis**.

Real world factors may limit the ability of some individuals to smooth their consumption. Some individuals may be liquidity constrained; *i.e.*, they own few assets, they cannot easily or quickly convert assets that they own to cash, or they are unable to borrow because of their poor credit history. Contrary to the life cycle permanent income hypothesis, liquidity constraints may force some individuals to reduce their consumption in response to a decline in their current after-tax income. Because of these limitations, most economists accept a **modified life cycle permanent income hypothesis**; *i.e.*, many individuals (50 percent to 80 percent) smooth their consumption in accord with the life cycle permanent income hypothesis while other individuals (20 percent to 50 percent) suffer from liquidity constraints, myopia, or other limitations and adjust their consumption to reflect changes in their current after-tax income.

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<sup>14</sup> 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 20<sup>th</sup> Century*, prepared for the Joint Economic Committee, 108<sup>th</sup> Cong., 1<sup>st</sup> sess. (forthcoming).

Surveying the empirical literature, a recent JEC study found, “Empirical studies generally support the modified life permanent income hypothesis.”<sup>15</sup>

**B. *Implications of the Modified Life Cycle Permanent Hypothesis for the Near-Term Effects of Federal Tax Changes on Consumption and Economic Growth***

The modified permanent income-life cycle hypothesis has important theoretical implications for federal tax policy. The minority of individuals whose consumption responds to their current after-tax income due to liquidity constraints, myopia, or other limitations will react in the same way to either a permanent or a temporary change in their federal tax liabilities. According to many econometric studies, the majority of individuals whose consumption responds to their permanent income will react differently based upon their perception of whether a federal tax change is either permanent or temporary. Permanent federal tax reductions increase permanent income while temporary federal tax reductions or federal tax rebates do not. For unconstrained individuals, a permanent federal tax reduction will elicit a large and swift increase in their consumption. A temporary federal tax reduction will immediately increase their savings. Unconstrained individuals will draw upon their additional savings very slowly over a long time to increase their consumption gradually. The different response of these two groups of individuals to a one-time change in their current after-tax income under the modified life cycle permanent income hypothesis means that a permanent federal tax reduction should be significantly more effective in stimulating near-term real GDP growth than a temporary federal tax reduction or a federal tax rebate, all other things being equal. However, many econometric models may overstate the near-term stimulative effects of fiscal policy changes because such models do consider the effects of government borrowing on the resources available to the private sector.

Economists have examined the economic effects of major federal tax policy changes including the broadly based income tax rate reductions in *Revenue Act of 1964* and in *Economic Recovery Tax Act of 1981*, the income tax surcharge in the *Revenue and Expenditure Control Act of 1968*, and one-off rebate in the *Tax Reduction Act of 1975*. Consistent with the modified life cycle permanent income hypothesis, numerous empirical studies have found that the duration affects how strongly the economy responds to federal tax reductions. A recent JEC study found:

*From this survey of relevant empirical studies using a variety of statistical models and data sets, it may be reasonably inferred that a permanent federal tax reduction affecting individuals will increase ... GDP twice as much in the first year as a temporary federal tax reduction of the same amount and at least three times as much in the first year as federal tax rebate of the same amount, all other things being equal. Put another way, the first-year revenue loss from a temporary tax reduction affecting individuals would have to be twice as large as the first-year revenue loss from a permanent federal tax reduction to have same near-term effects, all other things being equal. Likewise, the first-year revenue loss from a federal tax rebate to individuals would have to be at least three times as large as the first-year revenue loss from a permanent federal tax reduction to have the same stimulating effects on near-term ... GDP growth, all other things being equal.<sup>16</sup>*

**C. *Jobs and Growth Initiative and Permanence***

**1. *Making the Existing Provisions of EGTRRA Permanent***

Because EGTRRA’s existing tax relief provisions are currently scheduled to expire on 31 December 2010, the strength of the economic response to EGTRRA’s existing tax relief provisions

<sup>15</sup> Robert P. O’Quinn, *The Effects of Duration of Federal Tax Reductions: Examining the Empirical Evidence*, prepared for the Joint Economic Committee, 107<sup>th</sup> Congress, 2<sup>nd</sup> session, February 2002: 3.

<sup>16</sup> O’Quinn (February 2002), 10.

depends largely upon the public's perception of whether policymakers will make EGTRRA permanent in future legislation. In testimony before the Joint Economic Committee on April 17, 2002, Chairman of the Board of Governors of the Federal Reserve System Alan Greenspan said:

*I don't know of any economist who does long-term forecasting and presumes that the tax cuts will fall off the cliff at the end of the period in which they are statutorily in place. So my own impression is that the markets assume that these tax cuts are permanent.*<sup>17</sup>

Given that the public perceives that EGTRRA's existing tax relief provisions as permanent, a rejection of the President's initiative to make EGTRRA permanent would invalidate the public's perception of EGTRRA's permanence. Such a rejection would be a negative shock to the U.S. economy that would reduce long-term growth. In testimony before the Joint Economic Committee on November 13, 2002, Chairman Greenspan said:

*[B]ecause I believe that the markets presume that the tax cuts are permanent and that, as a consequence, making them permanent would therefore have no stimulative effect on the economy, it is also the case that if you were to rescind them, the markets would adjust negatively ...*<sup>18</sup>

## 2. New Tax Relief Provisions

Beyond making EGTRRA's existing tax relief provisions permanent, the President has proposed other permanent changes to federal tax policy including increasing the expensing limit and ending double taxation. Because of the lack of permanence, alternative proposals for tax rebates or temporary federal payroll tax reductions would provide less near-term stimulation than the *Jobs and Growth Initiative*. Unlike this initiative, moreover, these alternative proposals would not help to sustain a long-term expansion.

## VIII. FORECAST OF THE INITIATIVE'S GROWTH BENEFITS

The Council of Economic Advisors forecasted 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 price from ending double taxation, the CEA forecasted 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). Moreover, the unemployment rate would be 0.3 percentage points lower by the fourth quarter of 2003 and 0.8 percentage points lower by the fourth quarter of 2004.<sup>19</sup>

This CEA forecast is broadly consistent with estimates of the initiative's near-term growth benefits by private macroeconomic forecasters. In a study for The Business Roundtable, PriceWaterhouseCoopers found that the President's initiative would increase nominal GDP by \$738 billion from 2003 through 2007 and would decrease the average unemployment rate by 0.8 percentage points during 2003 through 2007.<sup>20</sup>

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<sup>17</sup> U.S. Congress, Joint Economic Committee, *Monetary Policy and the Economic Outlook: Hearing before the Joint Economic Committee Congress of the United States*, 107<sup>th</sup> Cong., 2<sup>nd</sup> sess., April 17, 2002, 10.

<sup>18</sup> U.S. Congress, Joint Economic Committee, *Economic Outlook: Hearing before the Joint Economic Committee Congress of the United States*, 107<sup>th</sup> Cong., 2<sup>nd</sup> sess., November 13, 2002, 20.

<sup>19</sup> Council of Economic Advisors.

<sup>20</sup> Kenneth L. Wertz, PriceWaterhouseCoopers, letter to John J. Castellani, President, The Business Roundtable, January 21, 2003.

## IX. CONCLUSION

Both economic theory and empirical studies suggest that the President's *Jobs and Growth Initiative* would stimulate near-term economic growth and would support a long-term economic expansion. This initiative would enhance economic welfare by reducing the excess burden of federal taxation. Accelerating EGTRRA's marginal individual federal income tax rate reductions would stimulate not only labor force participation but also aggregate investment during the near term. Ending the double taxation of corporate income would ameliorate agency problems between executives at publicly held corporations and their shareholders. Consequently, ending double taxation not only would increase the quantity of aggregate investment but also would improve its quality. Ending double taxation would therefore enhance the efficiency, neutrality, and fairness of the federal tax system and would increase the long-term growth potential for the U.S. economy. Making EGTRRA permanent would avoid a negative shock to the U.S. economy that would reduce long-term growth.

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