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NICKLES DIVIDEND AMENDMENT RELIES ON BUDGET GIMMICKS, WOULD BALLOON ULTIMATE COST OF SENATE PACKAGE TO ABOUT $660 BILLION

By Joel Friedman and Robert Greenstein

Senator Don Nickles plans to offer an amendment on May 15 that would rely on massive budget gimmicks to squeeze a larger dividend tax cut into the $350 billion Senate Finance Committee tax-cut package the Senate is considering. According to a statement that Senator Nickles made on the Senate floor May 14, the amendment would exempt 50 percent of dividend income from taxation in 2003, with the exemption rising to 100 percent of dividend income in 2004. The exclusion would then expire at the end of 2006.

Even with this artificial sunset, the provision would cost significantly more than the dividend tax cut in the Finance Committee bill. As a result, the Nickles amendment is reported to include proposals to offset these higher costs, primarily or entirely by artificially sunsetting after a few years one or more of the other provisions in the bill as well. It is highly unlikely, however, that any of these tax cuts will be allowed to expire; the intention clearly is that the artificial sunsets never take effect and that the provisions all be extended. As a result, once these gimmicks are stripped away (and the reasonable assumption is made that the tax cuts will not be allowed to expire), the ultimate cost of the Senate Finance bill with the Nickles amendment is sure to be more than $660 billion through 2013.

High Cost When Gimmicks Are Removed

The Nickles amendment resorts to the same strategy as the tax-cut package that recently passed the House — relying on phony sunsets. They are phony because everyone knows the intent is to have these tax cuts extended permanently. Regarding the expirations of popular family tax breaks in the House bill, Ways and Means Chairman William Thomas was quoted in the *Los Angeles Times* on May 2 as stating, “No one believes there will be any difficulty in extending them.” The phony sunsets in the Nickles amendment reduce its “official” cost, allowing the Senate bill technically to meet its $350 billion cost limit. Once these tax cuts are extended, however, the long-term cost rises substantially.

- Assuming that the tax cut for dividend income is extended and not allowed to expire after 2006 — which is clearly what its supporters intend — the cost of this proposal soars to at least $380 billion through 2013, or about $300 billion more than the $81 billion cost of the dividend provision in the Finance bill.

- Furthermore, one of the “offsets” that Senator Nickles is reportedly considering would replace the Senate version of the tax break for small business investment with the provision in the House-passed bill. The Senate Finance provision costs $23 billion through 2013, while the House provision costs only $3 billion. Yet the House proposal actually provides a bigger tax break for small businesses than the Senate proposal; the House measure relies on an artificial sunset to hold down its cost.[1] If the House provisions that Senator Nickles may use as an offset is extended through 2013, as likely would be the case, it would cost *$12 billion more* than the provision already in the Finance bill, not $20 billion less.

- The other "offset" that Senator Nickles reportedly may use is to sunset prematurely the provision in the Senate Finance bill that accelerates tax relief for married couples that was enacted in 2001. Again, there is no real intention to end this tax cut early. Rather, the goal of this gimmick is to create the appearance of lowering the cost relative to the Finance bill. In fact, this proposal represents no real savings once one assumes that the marriage penalty relief will not be allowed to expire.

- Assuming that all of these tax breaks do not sunset artificially and instead are extended, the $350 billion cost of the Senate package rises to about $660 billion. Furthermore, holding the cost to $660 billion rather than a still-higher level assumes that the tax increases that the Senate Finance Committee placed in the package as offsets actually are enacted. By all indications, Senate leaders are looking to drop many of these offsets — particularly the $35 billion tax increase on U.S. citizens living and working overseas — when the Senate and House meet in conference to resolve the differences between their two bills. The Senate bill with the Nickles amendment thus could ultimately cost even more than $660 billion.

Little Economic Benefit

Although supporters of a costly 100 percent exclusion for dividend income argue that a full exclusion is needed for this tax cut to yield its full beneficial effects on the economy, those positive impacts are greatly exaggerated. In the short term, a dividend tax cut does little to boost the economy and create jobs.

- Economy.com found that it offers the lowest "bang for the buck" of any of the Administration's tax-cut proposals, generating only nine cents of economic activity in the year ahead per dollar of cost to the Treasury.

- In a recent analysis, the Wall Street investment firm Goldman Sachs also concluded that the costly dividend tax cut would be a wasteful way to try to boost the economy now; Goldman Sachs stated: "The dividend tax exclusion looks especially ineffective as a stimulative measure, providing only 8 cents on the dollar...."[2]

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[1] Robert Greenstein, Richard Kogan, and Andrew Lee, "Tax Policy Center And CBPP Analyses Show That Thomas Tax Plan Would Be More Tilted Toward The Very Wealthy — And More Expensive — Than Bush Plan," May 7, 2003.

[2] Goldman Sachs, "Fiscal Policy – In Search of Balance, Creativity, and Grit," May 2, 2003.

- Supporters suggest that a dividend tax cut would help the economy by boosting the stock market. But the Goldman Sachs analysis found that "there is little reason to expect more than a modest increase in stock prices." Similarly, a recent analysis by the McKinsey and Company consulting firm found that a dividend tax cut "when viewed with an understanding of the shareholder makeup and share price movements of U.S. companies, seems unlikely to have a significant or lasting effect on U.S. share prices….What little impact the proposal may have was probably reflected in the 2.2 percent gain in the S&P 500 the day before it was announced."[3]

- Moreover, since the dividend tax cut under the Nickles amendment would be a partial rather than a full exclusion of dividend income in 2003, the short-term effect would likely be even smaller than these analyses have suggested.

The value of the Nickles dividend amendment as short-term aid to the economy is further eroded because it would have the effect of reducing state revenues. Currently facing their worst fiscal crisis in 50 years, states are placing a drag on the economy as they cut spending and raise taxes to meet their balanced budget requirements. Because of the linkages between state and federal revenues, states would begin to lose revenues immediately as a result of the Nickles dividend tax cut, with the revenue loss rising to $4 billion a year when the proposal is fully in effect. Assuming the proposal is extended, states could lose about $40 billion through 2013, or twice the $20 billion of fiscal assistance provided to the states in the bill.

Recent "dynamic" analyses by both the Congressional Budget Office and the Joint Committee on Taxation also show that a tax-cut package that reflects the Administration's priorities, including a sizable dividend tax cut, would have only a small impact on the economy over the *long run*.

- The Joint Committee on Taxation report analyzing the House bill concludes that its modest short-term stimulus wanes over the long term as "the positive business investment incentives arising from the tax policy are eventually likely to be outweighted by the reduction in national savings due to increasing Federal government deficits."[4] The Joint Committee finds that the $550 billion House plan would actually result in a "small decrease" in the size of the economy during the second five years, from 2009 to 2013.

- In its review of the President's budget proposals, the Congressional Budget Office found that "the net effect on output through long-term changes to the supply side of the economy — including fundamental 'inputs' such as labor supply or the stock of capital — would probably be small. Under most assumptions, the proposals' supply-

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[3] Timothy M. Koller and Susan L. Nolen Foushee, "Much Ado About Dividends," The McKinsey Quarterly, 2003 Number 2.

[4] The Joint Committee on Taxation report was printed in the *Congressional Record* on May 8, 2003, pages H3829-H3832.

side effects would raise or lower the level of output by less than a percentage point, on average, from 2004 to 2013."[5]

Further, even if one did have a more sanguine view of the long-term impact of a dividend tax cut, the design of the Nickles amendment — with its phase-ins and phase-outs — would undermine any positive effects. In an analysis of the type of provision proposed by Senator Nickles, American Enterprise Institute economist Kevin Hassett — a strong supporter of dividend tax cuts — concluded that "[i]t would be hard to imagine that this would be good for the stock market or the economy."[6] He finds if the dividend tax cut were to phase in and then expire, "firms will have difficulties setting dividends and shareholders will have even more difficulties figuring out what current dividends signal about future prospects. Since the elimination of dividend taxes is only temporary, investors must evaluate the risk that dividend taxes will come back. If they do, then the cash flows to investors from owning stock will plummet, as will the value of shares. Under such circumstances, it is undeniable that government policy significantly increases the fundamental risk of stocks."

Skewed Distribution

In its analysis of the various dividend and capital gains provisions — the one proposed by the Administration, and those included in the House-passed and Senate Finance bills — the Urban-Brookings Tax Policy Center concluded that a common feature of all the proposals is that "they would represent large, regressive tax cuts."[7] This is not surprising given that the top five percent of households receive a majority of all taxable dividend income.

Of the various proposals, the Senate Finance dividend measure is the least regressive, with 12 percent of its benefits flowing to households with income over $1 million and about one-third going to households with income over $200,000. The Administration's plan, by comparison, would direct 26 percent of the benefits to "millionaires," and more than half would go those with incomes over $200,000. Because the Nickles amendment follows the Administration's approach, it would make the Senate bill significantly more regressive.

Conclusion

The Nickles amendment should be seen for what it is — a gimmick to circumvent the $350 billion limit imposed on the Senate tax-cut bill in order to increase sharply the size of the tax cut for dividend income. This gimmick is being advanced despite new CBO estimates of revenue collections, issued May 9, that show revenues falling well below CBO projections of just two months ago. As a result, federal revenues are expected to be much lower as a share of

[5] Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2004," March 2003.

[6] Kevin Hassett, "The Dividend Fiasco," American Enterprise Institute, May 14, 2003. http://www.aei.org/news/newsID.17195,filter./news_detail.asp

[7] Leonard Burman, William Gale, and Peter Orszag, "Thinking Through the Tax Options," Urban-Brookings Tax Policy Center, May 13, 2003.

the economy in 2003 than they were during the more severe economic downturns of the mid-1970s and early 1980s, in no small part because of the large tax cuts enacted in 2001. Indeed, even with the tax cuts assumed in the $350 billion Senate Finance package, revenues this year are on track to fall to their lowest level as a share of the economy since 1959, the next-to-last year of the Eisenhower administration. Overall, these strikingly lower tax collection figures have disturbing implications for revenues and deficits for years to come.