CENTER ON BUDGET AND POLICY PRIORITIES

820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1080 center@cbpp.org www.cbpp.org

Revised August 23, 2002

A NEW ROUND OF TAX CUTS?

by William G. Gale and Peter R. Orszag[1]

Introduction and Overview

In the aftermath of the forum held in Waco, Texas, President Bush is considering a new round of tax cuts. The new tax reductions would come on top of the large tax breaks passed last year and the stimulus package enacted this spring. The President is said to be considering several options:[2]

- Increasing the deductibility limit on capital losses (that is, sales of stocks at a lower value than the value at where they were purchased);
- Reducing capital gains tax rates or indexing the capital gains tax to inflation;
- Raising the contribution limits for IRAs and 401(k)s or accelerating the phase-in of the increases in the limits enacted as part of last year's tax-cut legislation; and
- Eliminating or reducing the so-called double taxation of corporate dividends

The Administration has not provided a clear and compelling rationale for these policies, but there appear to be three possible motivations: to boost the stock market, to spur a slowing economy, and to ensure adequate retirement income levels and security. Some Administration officials also argue that the proposals would bolster the economy in the long run. The Administration has consistently argued, however, that the long-term economic outlook is sound, and the primary motivation for the proposals being presented does not appear to be their long-term impact.

The first possible motivation for the proposals — using tax policy to offset short-term fluctuations in the stock market and cushion the blow on investors from market declines — is

---

[1] William Gale is the Arjay and Frances Fearing Miller Chair in Economic Studies at the Brookings Institution. Peter Orszag is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution. The opinions expressed represent those of the authors and should not be attributed to the staff, officers, or trustees of the Brookings Institution. This paper also is being issued as a Brookings Institution Working Paper.

[2] See Mike Allen and Jonathan Weisman, "President Moves to Spur Investors Tax Cuts, Bigger Loss Writeoffs, Higher 401(k) Limits Considered" *Washington Post*, August 17, 2002, page A01, and Laurence McQuillan, "Bush Considers Factoring Inflation for Tax Break," *USA Today*, August 21, 2002.

particularly troubling. The government should not be in the business of bailing out private-sector investors when the stock market turns down, especially since the current downturn was preceded by an unprecedented stock market boom. As Treasury Secretary Paul O'Neill has stated, "I'm certainly not for bailing out investors when they made a free-will decision and it turned out to be wrong."[3] Having the government bail out investors who voluntarily accepted risks by investing in the stock market would set a dangerous precedent.

The second possible motivation for the proposals — stimulating the economy — is more debatable. The economy appears to be growing more slowly than its potential growth rate (that is, the growth rate that the economy could achieve without sparking higher inflation), which may argue for additional stimulus from the government. The history of fiscal stimulus measures, however, suggests that they are often mistimed, taking effect after the economy has begun growing rapidly again. Furthermore, even if short-term fiscal stimulus were appropriate now, none of these proposals would be particularly effective at delivering it, and some could actually be counterproductive.[4] The proposals are flawed as short-run stimulus measures for several reasons:

- The proposals would do little, if anything, to boost demand for the goods and services that firms produce, which is crucial to economic recovery in the short run. These tax cuts would provide a large and disproportionate share of their benefits to higher-income taxpayers, who tend to spend a smaller percentage of additional income they receive than lower-income taxpayers do.[5] Furthermore, some of the proposals — such as the proposed increase in contribution limits for 401(k)s and IRAs — are designed to shift resources from consumption to saving, precisely the opposite of what one should do to stimulate a sluggish economy.

- The proposals would apparently be permanent rather than temporary. They would therefore exacerbate the nation's long-term fiscal imbalance, which in turn would put upward pressure on long-term interest rates.[6] Increases in long-term interest rates would attenuate any stimulus benefit from the proposals in the short run. (Increasing the *current* budget deficit provides a direct spur to economic activity today, since it raises demand in the midst of a sluggish economy even though it also raises interest rates. Increasing

---

[3] Transcript from hearing on "State of the International Monetary Financial System," House Financial Services Committee, May 22, 2001.

[4] For further discussion of short-term stimulus measures, see William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," *Tax Notes,* October 8, 2001

[5] See Karen E. Dynan, Jonathan Skinner, and Stephen P. Zeldes, "Do the Rich Save More?" NBER Working paper 7906, National Bureau of Economic Research, September 2000. Jonathan Parker, "The Consumption Function Re-estimated," August 1999, and Jonathan McCarthy, "Imperfect Insurance and Differing Propensities to Consume Across Households," *Journal of Monetary Economics*, November 1995, 301-27.

[6] For a discussion of the relationship between fiscal deficits and long-term interest rates, see William G. Gale and Samara R. Potter, "An Economic Evaluation of the Economic Growth and Tax Relief Reconciliation Act of 2001," *National Tax Journal*, March 2002, and Peter R. Orszag, "The Budget and the Economy," Testimony before the Senate Budget Committee, January 29, 2002.

future budget deficits, by contrast, does *not* have a direct effect on current economic activity but still raises current long-term interest rates and thereby impairs economic activity today by increasing the cost of business investment and mortgage financing.)

- The proposals would exacerbate fiscal pressures on state governments, which would cause further spending reductions and tax increases at the state level.[7] Such state-level adjustments could further offset any stimulus benefit from the proposals.

The third possible motivation for the proposals is to shore up retirement accounts and boost retirement income security. Despite the rhetorical emphasis placed by some of those promoting these proposals on the losses incurred in 401(k) and other retirement accounts, however, most of the proposals would have no direct effect on retirement accounts. For example, neither the current $3,000 deductibility limit on net capital losses nor capital gains taxes directly affect retirement accounts; those tax provisions *do not apply* to 401(k) plans, IRAs, or traditional pensions. The only proposal that would directly affect retirement saving is the proposal to raise IRA and 401(k) contribution limits. But that provision would be of limited benefit to most workers: Only a very small fraction of workers contributes the maximum amount allowed under the current limits, and most workers thus would not be affected by an increase in the limits. Moreover, those who are currently constrained by the limits (and therefore might take advantage of higher limits) typically are those who have relatively high incomes and already are best-prepared for retirement.

Our conclusion is that these tax proposals are fundamentally flawed. The government should not be in the business of insuring investors against short-term stock market fluctuations, the proposals are not well-designed to stimulate the economy in the short run, the proposals would do little if anything to shore up retirement accounts for most workers, and they would add to the federal budget deficit over the longer term.

For each of the possible motivations, better solutions exist. More open and complete accounting practices (such as requiring that firms expense their options in their financial statements), stronger regulation, and a more auspicious long-term fiscal outlook would give investors more confidence to invest in the stock market. Increased federal aid to state governments and targeted extensions of unemployment benefits would provide a bigger short-term macroeconomic boost than the tax policies under consideration. Expanding the new SAVER credit (a progressive tax credit for retirement saving by moderate-income taxpayers that last year's tax legislation created) and making it permanent, along with other changes to expand pension coverage, would do more to enhance retirement security than the provisions being considered. Finally, the nation's long-term economic outlook could be improved much more significantly by getting our fiscal house in order.

---

[7] See Iris J. Lav, "A New Stimulus Package? States Stand to Lose Substantial Additional Revenue," Center on Budget and Policy Priorities, August 22, 2002.

We now turn to the individual proposals.

Raising the Amount of Deductible Capital Losses

One proposal would increase the amount of net capital losses that can be deducted for federal income tax purposes. Currently, taxpayers can deduct $3,000 in net losses. For example, if a taxpayer had $50,000 in realized capital gains and $53,000 in realized capital losses, she would have a net capital loss of $3,000. If the taxpayer had realized losses beyond $53,000, she could not deduct the additional losses in the *current* year but could carry the additional losses forward and deduct them either against gains in future years or as a net loss in future years.

Net capital losses up to the allowable amount can be deducted against ordinary income, despite the fact that the tax rate on capital *gains* is substantially lower than the tax rate on ordinary income. Consider a high-income taxpayer in the 38.6 percent marginal tax bracket. The capital gains tax rate for such a taxpayer, assuming that he or she has owned the stocks for at least one year before selling them, is 20 percent. The taxpayer would therefore pay $600 on a $3,000 net long-term capital gain (20 percent of $3,000). But the taxpayer would receive a tax benefit equal to $1,158 — nearly twice as much — on a $3,000 net capital loss (38.6 percent of $3,000).

The President is apparently considering raising the amount of net losses that can be immediately deducted from $3,000 to $6,000 or perhaps even more. Such a proposal is flawed for several reasons.

- The proposal would represent a government bail-out for investors who had willingly risked funds in the stock market and consequently would represent a dangerous precedent: The government should not be in the business of insulating investors from short-run market fluctuations. It also is peculiar to consider such a proposal at this time, since the current stock market declines follow unusually high stock market returns over the past 20 years. Individuals who have been invested in the market for a considerable period of time and who have held a broadly diversified portfolio are still well ahead overall.

- The proposal would have no direct effect on any tax-preferred retirement account, since the net capital loss rules do not apply to such accounts. It would therefore do nothing to address directly the declines in retirement wealth.

- Raising the amount of deductible capital losses could cause a *decline* in stock prices, since it would encourage people to sell stocks in companies whose share prices have declined. Consider, for example, an individual with exactly $3,000 in net capital losses who holds a stock that has declined in value. Under the current tax system, the individual's incentive to sell the stock is reduced, since the capital loss on the stock could not be immediately deducted. If the limit on deductible net capital losses were raised, however, the individual may be tempted to sell the stock. As a result, firms that have already been hit the hardest by declines in stock prices could be hit once again by this policy, since the policy could lead more shareholders to dump stocks.

- The change would be regressive, further reducing any economic stimulus effect. Analysis using the Urban Institute-Brookings Tax Policy Center model shows that if the net capital loss deduction were increased to $6,000 in 2003, more than half of the tax cut would accrue to tax filers with incomes above $100,000.[8] The fact that this change would be regressive would attenuate its impact in boosting the economy though more consumer spending, since higher-income taxpayers tend to spend a smaller percentage of additional income they receive than lower-income taxpayers do.

Finally, the shift would exacerbate the long-term fiscal imbalance facing the nation. Estimates from the Joint Committee on Taxation suggest that raising the net capital loss deduction to $6,000, for example, could cost more than $1.5 billion a year.[9]

Reduce Capital Gains Tax Rates

The Administration is apparently also considering reducing the maximum tax rate on long-term capital gains from its current level of 20 percent.[10] This proposal is not new. Proposed capital gains tax cuts formed a centerpiece of domestic policy in the earlier Bush Administration in 1989 to 1992, and were repeatedly offered in Congress in the late 1990s. Such proposals have been promoted in response to everything from a booming economy to a slumping economy and the September 11th attacks. An old idea is not necessarily a sound idea.

Capital gains are already taxed at lower rates than other forms of investment income under the individual income tax. The statutory tax rate is lower on capital gains than on other income (20 percent on capital gains compared to 38.6 percent on ordinary income received by taxpayers in the highest income tax bracket). Furthermore, capital gains are only taxed when the gains are "realized" as a result of the sale of stock or certain other assets, not when the gains accrue. As long as an investor holds on to stock rather than selling it, no capital gains tax is

[8] Such filers account for 11 percent of tax filing units and 46 percent of adjusted gross income.

[9] On December 18, 2001, the Joint Tax Committee issued a preliminary estimate of the revenue effects from raising the net capital loss deduction to $6,000 for two years. The cost in the initial year was $2.1 billion and the cost in the second year was $1.8 billion. Since some of the additional losses deducted in those years would have been carried over and deducted in future years, however, those figures overestimate the long-run impact of the change.

[10] For assets held more than one year, taxpayers in the 15 percent bracket and lower brackets face a 10 percent capital gains rate, while taxpayers in the 27 percent bracket and higher brackets face a 20 percent capital gains rate. Rates lower than these can apply to assets held for at least five years. Assets acquired after December 31, 2000 that would otherwise be subject to the 10 percent rate will be taxed at 8 percent if they have been held for more than five years before being sold. For assets otherwise subject to the 20 percent rate, an 18 percent rate will apply if the asset has been held for more than five years and was acquired after December 31, 2000. This 18 percent rate thus will apply to some assets sold beginning in 2006. Assets held for less than one year (short-term capital gains) are taxed at the same rate as regular income. If the top capital gains tax rate were reduced from 20 percent to 15 percent, the 10 percent rate would presumably be reduced to 7.5 percent. (That has been the case with similar proposals in the past, but no specifics are currently available.)

levied on the increased value of the stock. Finally, capital gains that are inherited are never subject to the income tax.

Since capital gains already are taxed at substantially lower effective rates than other income, they already are the source of tax avoidance and tax sheltering efforts, as investors move funds from other types of investments to investments that produce income in the form of capital gains. Reducing the capital gains tax would further enhance such opportunities for avoidance and sheltering. As Herbert Stein, the chair of the Council of Economic Advisers under President Nixon, once noted, "I think the only economic consequence we can confidently expect from reducing the capital gains tax is increased activity by lawyers and accountants in converting other income into capital gains."[11]

It also should be noted that even if the motivation to raise stock prices were sound, the effect of a capital gains tax cut on stock prices may be limited. Stocks held in pension funds and individual retirement accounts do not face the individual capital gains tax. Nor do stocks held by foreign investors, corporations, non-profits, or those who offset capital gains with capital losses. Similarly, capital gains on stocks held for less than one year are subject to the regular income tax rate, not the preferential long-term capital gains rate, and thus would be unaffected by a reduction in capital gains taxes. Investors also can reduce or avoid the impact of capital gains taxes by deferring the sale of assets; about half of all capital gains avoid taxation because investor hold on to assets until they die. As noted above, heirs do not have to pay tax on the gains accrued during the lifetime of the original owner.

If a capital gains rate cut were permanent, it also would reduce revenue in the long run.[12] Based on past estimates by the Joint Committee on Taxation, reducing the maximum capital gains tax rate from 20 percent to 15 percent would be expected to result in revenue losses totaling more than $50 billion over ten years.[13] The deterioration in the long-term fiscal outlook this could cause would likely exert some upward pressure on long-term interest rates. That, in turn, would increase costs on home mortgages and car loans and, all else being equal, place downward pressure on stock prices.

Moreover, as economic stimulus, a capital gains tax cut is poorly designed.[14] A capital gains tax cut is typically promoted by its supporters as producing economic benefits in the long

---

[11] Herbert Stein, Summary of Statement before the House Ways and Means Committee, December 17, 1991.

[12] If the cut were instead temporary, it would provide an incentive to sell shares in the short run and thus could cause a further deterioration in stock prices.

[13] In 1999, the Joint Tax Committee estimated a similar proposal to cost $52 billion between 2000 and 2009. See Joint Committee on Taxation, "Estimated Budget Effects of H.R. 2488, the Financial Freedom Act of 1999, as passed by the House of Representatives," JCX-53-99, July 22, 1999. One would expect the costs to be higher today, since the budget window has shifted forward to 2003 through 2012.

[14] For further discussion, see Leonard Burman, *The Labryrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Brookings Institution, 1999, and Henry Aaron, "The Capital Gains Tax Cut Mystery," Tax Notes, March 9, 1992.

run, not the short run. And even in the long run, the benefits are limited. A recent Congressional Budget Office study concluded that reducing the top tax rate on long-term capital gains from 20 percent to 15 percent would have only a very small effect on private saving and long-term economic growth. CBO estimated that private saving would rise by 0.3 percent, adding about 0.06 percent to the capital stock after ten years. The increase in GDP would amount to *less than two one-hundredths of one percent of GDP* (about $2 billion to $3 billion over ten years).[15] As economist Jane Gravelle of the Congressional Research Service has concluded, "a capital gains tax cut appears the least likely of any permanent tax cut to stimulate the economy in the short run..."[16]

In addition, like the proposed expansion in net capital loss deductions, the capital gains tax cut would not apply to retirement accounts.

Finally, the capital gains tax reduction would produce disproportionate benefits for higher earners, who already garnered a highly disproportionate share of last year's tax cut. The Urban-Brookings Tax Policy Center model indicates that 91.1 percent of the benefits from reducing the 20 percent capital gains tax rate to 15 percent (and reducing the 10 percent rate to 7.5 percent) would accrue to the 11 percent of tax filers with incomes above $100,000.

Index Capital Gains For Inflation

A related proposal reported to be under consideration is to index capital gains for inflation.[17] This proposal would subtract inflation from a capital gain in determining the amount of the gain for tax purposes. For example, assume that an individual bought a stock for $10,000 five years ago and sold it for $15,000 today. Under the current tax system, the $5,000 gain (the sale price of $15,000 minus the purchase price of $10,000) would be subject to capital gains tax. The indexing proposal would instead net out inflation from the gain before imposing tax. If the inflation rate had averaged 3 percent per year in the five years since the asset was purchased, roughly $1,600 of the $5,000 gain would reflect inflation. The indexing proposal would therefore subtract the $1,600 from the $5,000 nominal gain, and impose capital gains tax only on the $3,400 gain after inflation.

This proposal has some theoretical appeal, since the case for taxing purely inflationary gains is weak. But indexing only one form of capital income for inflation and not indexing other forms of capital income or capital expenses would create large tax sheltering opportunities. And indexing all forms of capital income and expenses would both be extremely complex and fiercely opposed by various interest groups. It is rarely seriously proposed, and it would have virtually no chance of enactment.

[15] Congressional Budget Office, "An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998," CBO Memorandum, August 1998.

[16] Jane G. Gravelle, "Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts," Congressional Research Service, September 17, 2001.

[17] Laurence McQuillan, "Bush Considers Factoring Inflation for Tax Break," *USA Today*, August 21, 2002.

This is a matter of considerable importance because indexing capital gains *without* indexing interest on debt would create major tax shelter opportunities. Investors who were able to borrow could fully deduct the interest they paid on the amount they had borrowed, while investing the borrowed funds in stocks or other capital assets and excluding from taxation the portion of their profits that was attributable to inflation. This would produce after-tax windfalls, which would result from the difference between the tax treatment accorded the capital gains (from which inflation would be subtracted to lower the amount of the gain subject to tax) and the tax treatment accorded payments made on the amount the investor had borrowed to purchase the capital assets. The debt payments — including the portion of the payments that simply covered inflation on the borrowed amounts — would be fully deductible for sophisticated investors.[18]

To see why indexing capital gains but not interest on debt would create large tax sheltering opportunities, consider an example in which an investor borrows $100,000 and uses the funds to purchase stocks.[19] Assume, for simplicity, that the interest rate charged on the loan was 10 percent per year, that stocks returned 10 percent per year, that the inflation rate was 5 percent per year, and that the taxpayer held the stocks for just over a year. After the year, the taxpayer would pay $10,000 in interest (10 percent of $100,000) and deduct the full amount. At a 38.6 percent marginal tax rate, that deduction reduces the investor's taxes by $3,860. The taxpayer also would sell the stock for $110,000, yielding a $10,000 nominal capital gain. But in computing the capital gain for tax purposes, the taxpayer would subtract $5,000 (5 percent inflation on a $100,000 purchase), producing an inflation-adjusted gain of $5,000. The taxpayer would then pay the capital gains tax rate (20 percent) on this $5,000 gain, producing a tax bill of $1,000. As a result of the transaction, the taxpayer enjoys a $2,860 tax benefit: The $3,860 tax benefit of the deduction more than offsets the $1,000 capital gains tax. Despite the fact that the interest rate was equal to the rate of return on the stocks *before* tax, the transaction produces a significant financial benefit *after* tax. This occurs because inflation is subtracted from the capital gain but *not* from the interest deduction (and also because the tax rate on capital gains is lower than the marginal tax rate on ordinary income).

A system that indexed *all* forms of capital income and expenses for inflation — including debt repayments — would attenuate the incentive to create these large tax shelters but would be extremely complex (in addition to being impossible to pass politically). Many analysts have thus concluded that *not* indexing capital gains is preferable to indexing only one form of capital income and even to trying to index all forms of income and expenses.

In addition to the complexity and tax sheltering that capital gains indexing would create, it also would share all of the defects of the capital gains rate cuts described above. It would represent an attempt to bolster the stock market following a short-term decline, would

[18] Interest on consumer loans (such as auto loans) is not deductible, but interest used to finance investments may be deducted as long as it does not exceed the amount of investment income reported in a year. For taxpayers with large portfolios, the investment income generated each year is likely to be significant. Such taxpayers therefore are likely to have sufficient investment income against which to deduct investment interest.

[19] We assume the taxpayer has a substantial portfolio, which generates enough income to ensure that the interest on the loan is fully deductible.

significantly reduce revenue in the long term, is poorly designed as short-run stimulus measure, would not directly benefit retirement accounts, and would be highly regressive.

Finally, indexing would provide windfall gains to existing shareholders. These shareholders bought their stock at prices reflecting the non-indexation of capital gains for inflation. To index now would provide unnecessary and inappropriate windfall gains to these stock owners.

Expand Contribution Limits for Retirement Accounts

The President apparently also is considering raising the amounts that could be deposited in tax-preferred retirement accounts. This year, workers are allowed to deposit a maximum of $11,000 in a 401(k) account (and up to $12,000 for taxpayers age 50 or over). Last year's tax legislation raises the maximum to $15,000 by 2006 (and by an additional $5,000 for those age 50 or over). Workers with incomes below certain thresholds (or who are not covered by a pension plan at work) are also allowed to deposit up to $3,000 into an IRA this year (and up to $3,500 for taxpayers age 50 and over). Last year's tax bill raises the maximum contribution to $5,000 by 2008 (and by an additional $1,000 for those 50 or over).[20]

Increasing these limits — or accelerating the increases that will occur as a result of last year's tax bill — would represent unsound policy for two reasons.

- Whatever their actual effects, increases in contribution limits are typically advertised as inducing additional saving. From a short-term macroeconomic perspective, however, inducing additional saving — rather than additional consumption — is precisely the wrong thing to do. In the short run, it is additional consumption that would spur the economy. This proposal is a peculiar one to be advocating in the current sluggish macroeconomic environment.

- In addition, increasing the contribution limits would have little effect on middle- and upper-middle-income families and individuals. The vast majority of Americans do not make the maximum contributions to their 401(k)s or IRAs and therefore would benefit little, if at all, from raising the maximum contribution levels. For example, a Department of Treasury study found that only four percent of all taxpayers who were eligible for conventional IRAs in 1995 made the maximum allowable $2,000 contribution.[21] The Treasury paper concluded: "Taxpayers who do not contribute at the $2,000 maximum would be unlikely to increase their IRA contributions if the contribution limits were increased whether directly or indirectly..."[22] The proposed 401(k) changes similarly

[20] An additional $1,000, as of 2006, could be contributed by taxpayers aged 50 or over.

[21] Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000.

[22] Robert Carroll, "IRAs and the Tax Reform Act of 1997," Office of Tax Analysis, Department of the Treasury, January 2000, page 7. In addition, an immediate increase in the IRA contribution limits to $5,000 may adversely affect some low- and middle-income workers by discouraging some small businesses from offering an employer-sponsored pension plan. Small business owners wanting to save $10,000 for themselves and their spouses in a tax-

would affect a very small percentage of the population: In 1996, only 5.5 percent of participants in 401(k) plans made the maximum allowable contribution.[23] Moreover, those who are constrained by the cap are disproportionately high-income individuals: the average compensation among those making the maximum 401(k) contribution, according to Treasury Department data, was approximately $130,000 in 1999. An immediate increase in the limit to $15,000 would disproportionately benefit those at or near the top of the compensation scale.

Some have argued that boosting retirement contribution limits would help fuel the stock market. As noted above, it is not clear that the government should be attempting to manipulate stock market values. Even if this were an appropriate policy goal, raising contribution limits is an inefficient way of injecting new funds into the market. Evidence suggests that most contributions made by individuals who are at the contribution limit — a group that, as noted, tends to have quite high incomes — are not net additions to saving but rather are reshuffled assets. In other words, individuals at the contribution limit typically use funds that are (or would otherwise be) invested in other assets to increase their 401(k) or IRA contributions in order to maximize available tax advantages. The total amount saved and invested, however, remains essentially unchanged. In addition, there is no guarantee that any new net investments would be made by purchasing stocks; people may prefer to buy bonds. Finally, because relatively few people are at the contributions limits, the additional amounts that would be placed in 401(k)s and IRAs if these limits were increased may have only a minimal market impact.

Eliminate Or Reduce Double Taxation Of Corporations

The final proposal under consideration involves the "double taxation" of corporate dividends. Under current law, dividends are paid out of taxable profits at the firm level (i.e., they are not deductible). They also are taxed when received at the individual level (when they are received by taxable investors). In contrast, interest payments on debt are *deductible* at the firm level, while the interest payments received by the individual creditors who have loaned the funds to the firms are taxable at the individual level. The Administration is apparently considering some modification in the tax treatment of dividends, which could involve either a deduction at the corporate level or some sort of exclusion at the individual level.

Economists have long argued that the double taxation of dividends could create a bias toward financing corporate activities with debt rather than equity. But it is important to realize that the stock market boom from 1982 to the late 1990s occurred with the current dividend tax system in place. It is therefore implausible to argue that double taxation either prevents strong stock market gains or has caused the current stock market decline.

---

preferred retirement account are currently required to set up an employer-based plan; with the higher IRA limits, they would not need to do so.

[23] Donald Kiefer, Robert Carroll, Janet Holtzblatt, Allen Lerman, Janet McCubbin, David Richardson, and Jerry Tempalski, "The Economic Growth and Tax Relief Act of 2001: Overview and Assessment of Effects on Taxpayers," *National Tax Journal*, March 2002, page 112.

Tax changes to address the double taxation of dividends are worthy of further consideration as part of a broader tax reform. Whatever its long-term costs or benefits, however, reducing taxes on dividends would represent poor policy in the current environment, since it could easily be viewed as an attempt to manipulate stock prices and could result in large revenue losses over time.

Moreover, abolishing or reducing the tax on dividends now would give large windfall gains to existing investors, who bought their stocks at prices that reflected the current taxation of dividends. Stock prices embody the tax treatment of dividends, and reducing taxes on dividends would provide a windfall gain to investors who purchased stocks under the previous dividend-taxation system. Providing such a bailout to investors in the midst of a short-term stock market decline would represent a dangerous precedent for the government.

The proposed change also would undermine long-term fiscal discipline. One way to reduce taxes on dividends would be to provide a partial or full exclusion for dividend income at the individual level. Individuals declared $126 billion in dividend income on their 1999 tax returns.[24] The Urban-Brookings Tax Policy Center model suggests that providing a 50 percent exclusion on dividend income at the individual level would cost $22 billion in 2003 alone. Excluding the first $1,000 in dividend income would cost $4 billion in 2003.

Reducing the tax on dividends also would be regressive. The Urban-Brookings tax model suggests that if a 50 percent exclusion of dividend income at the individual level were instituted, three-quarters (75.3 percent) of the tax benefits would accrue to the 11 percent of tax filers with incomes above $100,000. One quarter (25.3 percent) of the tax benefits would accrue to those with incomes above $1 million. Excluding the first $1,000 in dividend income also would be regressive, albeit less so than the 50-percent exclusion: some 46 percent of the benefits would accrue to filers with incomes above $100,000. (Two percent of the benefits would accrue to those with incomes above $1 million.)

Finally, reducing the tax on dividends could benefit stock investors but adversely affect families with home mortgages or car payments. Making stocks more attractive to investors — for example, by providing a partial or full exclusion of dividend income — could reduce demand for bonds, which would put upward pressure on interest rates. The revenue losses associated with the change themselves also would tend to put pressure on long-term interest rates. The likely net effect would be that families with home mortgages and car loans would pay higher interest rates over time than would otherwise be the case.

Conclusion

The options under consideration by the Bush Administration appear to be motivated, in part, by a desire to boost the stock market in the short run. Such a motivation is misguided: The government should not be in the risky business of insuring individuals who voluntarily choose to invest funds in the stock market against poor performance. Furthermore, many of the examples cited by Administration officials involve losses occurring within retirement accounts, but most of

[24] Internal Revenue Service, *Individual Income Tax Returns 1999*, Table 1.4, page 37.

the proposals would not directly affect such accounts since the provisions that they would change do not apply to retirement accounts. Instead, the proposals would bail out investors who voluntarily accepted risks by investing in the stock market using funds outside their retirement accounts. (The President's willingness to consider bailing out such investors also highlights a fundamental problem with his commitment to create individual accounts in Social Security: Imagine how intense the pressure would be to bail out investors if the current stock market decline had occurred after Social Security money had been invested in private accounts.)

The proposals also may be motivated by a desire to stimulate the economy in the short run. Even if that motivation is sound — a debatable proposition — the proposals are poorly designed to achieve that objective. The proposals are flawed as short-run stimulus measures because they may boost saving rather than consumption, would provide large benefits to higher-income taxpayers (who tend to spend less of any additional income they receive than other households do), would exacerbate the nation's long-term fiscal imbalance (which would put upward pressure on long-term interest rates), and would exacerbate fiscal pressures on state governments and thereby engender further budget cuts and tax increases at the state level.