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Pro-Growth Tax Policy

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Introduction

While taxes are necessary to finance the public sector, they have a substantial cost to the economy. If there were no taxes on labor and capital income, individuals and firms would allocate their resources where they are most productive. Taxes encourage individuals to lower their tax burdens by avoiding activities that are taxed, thereby distorting the efficient allocation of resources. For example, taxes on labor income reduce the reward from working. Taxes on capital income reduce the reward from saving and investing.

Pro-growth tax policy aims to reduce economic distortions. In 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) reduced individual income tax rates, created a new 10% bracket rate, provided marriage penalty relief, and began a phase-out of the estate tax. In 2003, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the tax rates on dividends and long-term capital gains. It also accelerated the phase-in of the tax rate reductions scheduled to occur under EGTRRA.[1]

These tax cuts have reduced distortions to labor supply, saving, and investment decisions by lowering the tax burden on labor and capital income. They have also resulted in a more efficient tax structure by reducing the double taxation of corporate income. However, the economic benefits of the tax cuts are limited because they are scheduled to expire at the end of 2010. Making the tax cuts permanent could greatly improve long-run economic performance.

Key Findings

1. The 2001 and 2003 tax cuts have substantially reduced the tax burden on labor and capital income, thereby increasing the rewards from working, saving, and investing.

2. The 2003 reduction in the dividend and capital gains tax rates improved the business tax structure by reducing the tax bias in favor of retaining earnings relative to paying out dividends, and using debt rather than equity to finance new investments.

3. If the tax cuts were made permanent and financed by a reduction in government spending, long-run economic output could be expected to increase substantially.

[1] These two tax bills also included an increase in the child tax credit, increased contribution limits to IRAs and 401(k) plans, and other provisions. The provisions discussed in the text accounted for the bulk of the tax relief. In 2005, the Tax Increase Prevention and Reconciliation Act extended the dividend and capital gains tax rate reductions through 2010.

General Points

- **The individual income tax creates substantial distortions.** A recent study estimates that for every dollar of revenue raised by the individual income tax, there is an additional cost to society of 30-50 cents from distortions to behavior and the resulting lost output. That is, raising a dollar from the individual income tax has a cost to taxpayers of $1.30-1.50 – the dollar collected by the government plus an additional 30-50 cents from distorted behavior. Analogously, a reduction in individual income taxes leads to reduced distortions. (Source: Parry)

- **Cutting individual income tax rates improves labor supply decisions.** Lowering individual income tax rates increases the reward for entering the labor force, working more hours, choosing higher paid occupations, and investing in education. One recent study shows that the 2001 tax cuts encouraged more single mothers – whose child care demands make them particularly sensitive to tax distortions – to join the labor force. (Source: Eissa, Kleven, and Kreiner)

- **Cutting tax rates on capital income improves incentives to save and invest.** Cutting taxes on capital income rewards saving by individuals and investing by businesses. Increased investment raises the amount of capital per worker, which in turn improves productivity and long-run economic growth. Making the tax cuts permanent could increase the Nation's capital stock by 2.3% in the long run. A larger capital stock improves the productivity of labor and results in higher wages. (Source: Treasury)

- **Cutting dividend tax rates improves the efficiency of the business tax system.** When a corporation issues shares to finance an investment, the returns on the investment are taxed once at the corporate level and again when shareholders receive them in the form of dividends. Thus, corporations have an incentive to use debt rather than equity to finance new investment and to retain earnings rather than pay out dividends. The 2003 dividend tax cut reduced these distortions and is estimated to have increased regular dividend payments by about 20%. (Source: Chetty and Saez)

- **Making the 2001 and 2003 tax cuts permanent can have a substantial impact on economic output.** Making the 2001 and 2003 tax cuts permanent – and financing them with reductions in government spending – could be expected to increase output by 0.7% in the long run. In terms of today's $14 trillion economy, this would amount to almost $100 billion per year in additional output, or $329 per capita. (Source: Treasury)

1. Labor Supply and Saving

Taxes represent a transfer of resources from the private sector to the government. In the process of making the transfer, output that would have created value for producers, consumers, and workers is lost because taxes give individuals an incentive to avoid activities that are taxed. The lost value of output from tax distortions is referred to as *deadweight loss* – it is a cost borne by the private sector that does not result in any additional government revenue. A recent study by Parry (2002) suggests that the personal income tax creates 30-50 cents of deadweight loss for every additional dollar of revenue raised.[2] Thus, any government services funded by that revenue would have to have a social value of at least $1.30 in order to justify the cost (direct taxpayer cost plus deadweight loss).

Individuals decide whether to work and how much to work by weighing the take-home pay that they would earn against the value of the leisure time they forgo. Income taxes distort the labor supply decision by reducing individuals' take-home pay from working.

- Example: Suppose an individual is currently earning $30,000 per year before taxes. The individual is considering a higher paying job (which requires much longer hours) and pays $70,000. In the absence of taxes, the individual would take the higher paying job if the value of the forgone leisure time is less than $40,000 (the difference in pay). If the individual pays a tax of 25% on the additional $40,000 in income, then he or she would only take the higher paying job if the value of the forgone leisure time is less than $30,000 (the difference in pay after taxes). Suppose the value of the individual's forgone leisure time is $35,000. Then, with taxes, the individual would not take the higher-paying job. However, there is a net loss to society from this decision. The higher paying job would have resulted in a benefit of $30,000 in additional take-home pay to the individual and $10,000 in revenue for the government. The total social benefit would have been $40,000, $5,000 more than the cost to the individual of forgoing the leisure. That $5,000 net loss in value is the deadweight loss from the tax.

The *average* tax rate – the share of income paid in taxes – affects an individual's decision to enter the labor force. High average tax rates can discourage labor force participation. The *marginal* tax rate – the share of additional income paid in taxes – affects an individual's decision to work more hours, take a higher paying job, or invest in education. Because of the joint treatment of married individuals, a family's marginal tax rate can also affect the second earner's decision to enter the labor force. Workers vary in their sensitivity to average and marginal tax rates. Single mothers and married women are especially sensitive to income taxes, so the deadweight loss is particularly high for these groups. Meyer and Rosenbaum (2001) show that a $1,000 reduction in taxes increases single mothers' employment rate by 2.7 percentage points. Eissa, Kleven, and Kreiner (2004) show that the 2001 tax cuts increased the labor supply of single mothers.

Income taxes also distort the decision to save and invest. When individuals choose to save, they forgo current consumption in favor of future consumption. Individuals' savings get channeled

[2] This study takes into account the various exemptions and deductions (for example, the mortgage interest deduction) that narrow the tax base. If all income were taxed at the same rate, the deadweight loss would be lower.

through financial markets to firms, which can use the funds to invest in capital and become more productive in the future. Taxes on capital income reduce the return to saving and investment. Under the current tax code, some firms (Subchapter C corporations) are subject to a firm-level tax on their income (after deducting expenses, including interest payments). Individual savers may also be subject to tax when they receive this income in the form of interest on bonds or dividends and capital gains on stock. Thus, income from dividends and capital gains is often subject to double taxation – it is taxed at both the firm and the individual levels.

- Example: Suppose a corporation is considering an investment project that generates a 10% rate of return. The return will be paid out to the firm's shareholders in the form of dividends. Suppose further that individuals are willing to forgo $1 of current consumption in exchange for $1.08 of future consumption. Under these circumstances, the investment project generates a net benefit for society – by forgoing $1 of consumption today and investing in the project, individuals can receive $1.10 of consumption in a year. In the absence of taxes, this is exactly what will occur – individuals will save and invest by buying the firm's stock and receive a 10% return in the form of dividends. Now suppose the corporation is required to pay a 20% firm-level tax on the investment return. This reduces the project's after-tax return to 8%. Also suppose that individual shareholders pay a tax of 10% on their dividend income, which further reduces the after-tax return to 7.2%. Individuals no longer find it desirable to buy the firm's stock, and the investment project does not take place. This outcome results in deadweight loss because the total social benefit from the project is still 10% – 7.2% would go to individuals and 2.8% would go to the government in the form of taxes. This would exceed the cost to individuals of forgoing current consumption. But the project does not take place, so the value created by the project is lost.

The tax cuts of 2001 and 2003 reduced the tax burden on capital income in several ways. First, the 2001 tax cuts lowered individual income tax rates. Many small businesses – including Subchapter S corporations, sole proprietorships, and partnerships – are subject to individual income tax. These types of firms are known as *flow through* businesses – their income flows through to the owners who pay personal income tax on it. As a result of the lower individual income tax rates, these businesses face a lighter tax burden on their investment returns. Interest income also receives the benefit of lower ordinary income tax rates. Second, the 2003 tax cuts reduced the top tax rate on qualified dividends and long-term capital gains. Third, the 2001 tax cuts also began a phase-out of the estate tax, which reduces the tax burden on savings left to one's heirs.

2. The Business Tax Structure

The *structure* of taxation refers to the way in which the tax burden is distributed across individuals and activities. A tax structure is more efficient if it can raise the same amount of revenue with less deadweight loss. Thus, making the tax structure more efficient can improve economic outcomes even if the overall level of taxation remains the same.

The 2003 tax cuts have substantially improved the business tax structure. As discussed above, many small businesses do not pay a firm-level tax – their income is attributed to the owners and taxed under the individual income tax system. However, businesses organized as Subchapter C

corporations (referred to here as "corporations") pay a firm-level tax of up to 35% on their income after deducting wages, interest payments, raw materials, and depreciation. When corporations undertake investments, they can finance them with equity (issuing new shares of stock or using retained earnings) or debt (issuing bonds). If a firm chooses equity financing, it can either pay the investment returns to shareholders in the form of dividends, or retain the earnings to reinvest in the firm. The tax treatment of these organization, financing, and payout options results in a number of distortions.

- Dividends versus retained earnings: Dividends paid to shareholders are taxed at both the corporate level and the individual level. Prior to 2003, dividends were potentially subject to the top individual tax rate (38.6% in 2002). Retained earnings are taxed at the firm level; to the extent that they result in capital gains for shareholders, they are potentially subject to individual-level tax as well. Prior to 2003, long-term capital gains faced a maximum tax rate of 20%, generally lower than the rate on dividends. Capital gains taxes are also deferred until the stock is sold, which gives retained earnings an additional tax advantage over dividends. Therefore, there is a tax bias in favor of retaining earnings rather than paying out dividends. This tax bias has a social cost in terms of corporate governance. Dividends provide a way for firms to return earnings to shareholders, rather than leaving them in the hands of managers. Because managers' pay is not perfectly tied to their firm's performance, managers may have an incentive to use retained earnings in a way that does not maximize shareholder value.

- Equity versus debt financing: Interest payments on bonds are deductible to the firm and taxable at the individual level, at ordinary income tax rates. Thus, debt-financed investment faces only one layer of taxation, giving debt financing a considerable tax advantage over equity financing. The overuse of debt financing can potentially increase the chances of bankruptcy, subjecting investors to unnecessary costs and risks.

- Organizational Form: The double taxation of corporate equity distorts a firm's choice of organizational form. It discourages firms from organizing as corporations rather than flow-through entities.

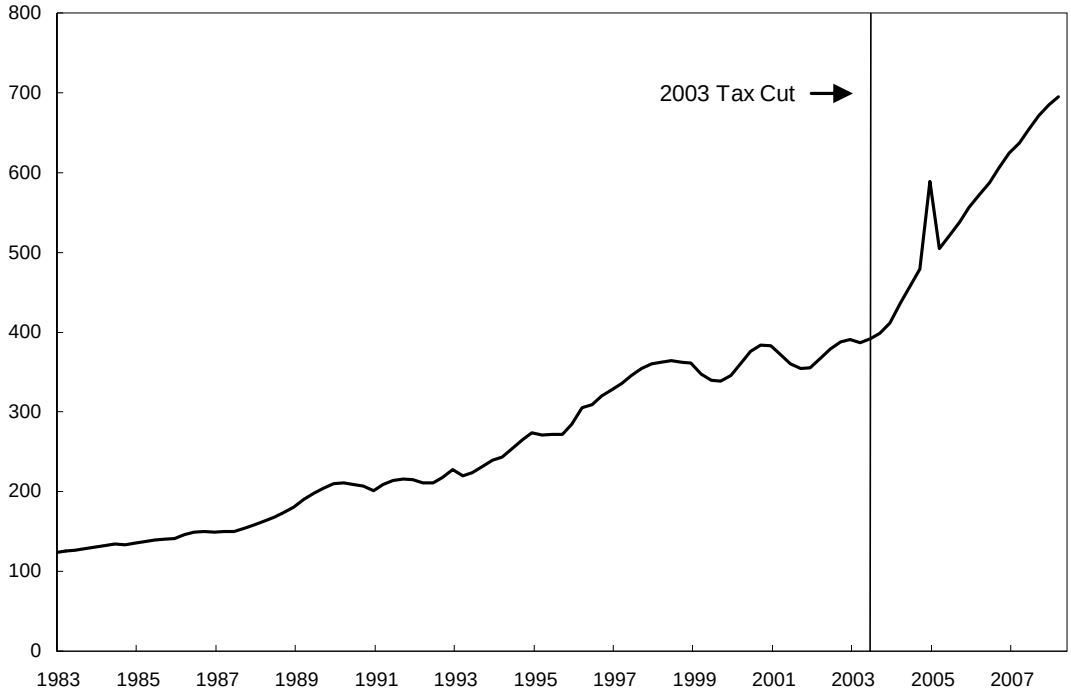
The tax cuts of 2003 reduced all three of these distortions by lowering individual-level tax rates on qualified dividends and long-term capital gains to 15%. This substantially reduced the bias against paying out dividends (although capital gains still have some tax advantage because of deferral). It also reduced the tax bias in favor of debt financing. Finally, it reduced the tax disadvantage from choosing the corporate form of organization.

The tax cuts have clearly had an impact on dividend payments. Chart 1 shows the amount of dividend income received by households over time. From the beginning of 1983 to the end of the second quarter of 2003, real dividend income increased at an annual rate of 5.8%. After the second quarter of 2003, that rate increased to 12.8%.[3] Chetty and Saez (2005) find that the fraction of companies paying dividends increased substantially following the 2003 tax cuts, after 20 years of decline. Moreover, firms that were already paying dividends increased their regular

[3] The spike in the graph represents a special one-time dividend paid by Microsoft Corporation.

dividend payments after 2003. Overall, there was a 20% increase in regular dividend payments.[4] A study by Poterba (2004) suggests that the reduction in distortions has the potential to raise the long-run level of dividends by 31%.

Chart 1 **Real Personal Dividend Income**
Dividend payments have increased since the 2003 tax cut.
Billions of chained 2000 dollars, seasonally adjusted at an annual rate



Source: Department of Commerce (Bureau of Economic Analysis).

[Alt text: The chart shows the level of real personal dividend income measured in constant 2000 dollars from 1983 through the first quarter of 2008. Real personal dividend income was $110 billion in 1993:Q1, $392 billion in 2003:Q2, and $695 billion in 2008:Q1.]

3. Benefits of Making the Tax Cuts Permanent

The 2001 and 2003 tax cuts are currently scheduled to expire at the end of 2010. This scheduled expiration limits their beneficial impact on the economy, particularly with regard to decisions that pay off over long periods of time (for example, education or long-term investments). Making the tax cuts permanent can substantially improve economic performance. However, the long-run effects of extending the tax cuts depend on how the tax cuts are financed.

This point is illustrated in a 2006 study by the Treasury Department, which examines the long-run macroeconomic impact of making the tax cuts permanent.[5] This study assumes that the tax cuts are financed by additional government borrowing through 2016. After 2016, two scenarios are considered. In the first scenario, government spending is reduced after 2016 to maintain a

[4] As further evidence, they note that dividend payments did not increase for the subset of firms whose largest shareholder was exempt from taxes (as would be the case for a pension fund). This suggests that the increase in dividend payments was indeed a response to the reduction in the tax distortion.
[5] This study includes all of the tax cuts except for the estate tax.

constant debt-to-GNP ratio. In the second scenario, income tax rates are raised across-the-board after 2016 to maintain a constant debt-to-GNP ratio. Treasury finds that in the first scenario, the capital stock increases by 2.3%, and long-run GNP increases by 0.7%. In terms of today's $14 trillion economy, this would amount to almost $100 billion per year in additional output, or $329 per capita. In the second scenario, long-run GNP falls by 0.9%.

Not all of the tax cuts have the same impact on output. Treasury also estimates that extending only the dividend and capital gains rate cuts would raise long-run GNP by 0.4% (assuming they are offset by spending reductions). If the top four ordinary income tax rates were made permanent as well, long-run output would increase by 1.1%. Adding the remaining tax cuts (including the child tax credit, marriage penalty relief, and the 10% bracket rate) would lower the impact on long-run output to 0.7%. These remaining provisions lower long-run output because they increase take-home pay without a reduction in marginal tax rates. The increase in take-home pay allows individuals to reduce their labor supply.

4. Summary and Conclusion

The tax cuts of 2001 and 2003 reduced the tax burden on labor and capital income, thereby reducing economic distortions to individuals' work, saving, and investment decisions. The tax cuts of 2003 also improved the efficiency of business taxation and reduced distortions to corporate financing and payout decisions. Making the tax cuts permanent – combined with control of government spending – can substantially boost economic performance.

Additional Reading

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