Short-Term Stimulus, Long-Term Growth and JGTRRA

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Democratic Policy Committee

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Submitted by

William G. Gale[1]
Brookings Institution
Tax Policy Center

Mr Chairman:

Thank you for inviting me to testify at this hearing on the effects of the Job and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) on jobs and growth. My testimony is divided into a summary of the major conclusions and the analysis supporting those conclusions. My principal conclusions are as follows:

- **Taxes and short-term stimulus:** In the short run, in an economy operating with excess capacity, increases in aggregate demand can raise output and income even without raising the capital stock.

- **JGTRRA and short-term stimulus**: JGTRRA will boost aggregate demand in the short term and thereby generate higher short-term levels of income and employment than would occur if no policy were enacted. But this is a very minor accomplishment. Almost any increase in spending or cut in taxes would boost a sluggish economy. JGTRRA was not the only policy option: policy makers could have provided more progressive tax cuts, increased federal spending or transfers to the states, and extension of unemployment benefits. In comparison to those other policies, JGTRRA is a poor way to stimulate the economy in the short-term: the same or bigger stimulus could be obtained with a lower long-term cost, simpler rules, a more equitable distribution of benefits, and less deterioration (or stronger preservation) of basic social needs. The two principal components of the plans -- acceleration of the 2001 tax cuts and dividend/capital gains tax cuts -- are regressive. This implies that they will be less effective in stimulating current activity, holding the size of the tax cut constant, than more progressive options, since high-income households are less likely to spend available resources immediately than would low- or moderate-income households.

[1] This testimony is based in large part on work I have undertaken with Peter Orszag and Len Burman. The views expressed here are my own and should not attributed to those individuals, or to the officers, staff, or trustees of the Brookings Institution or the Tax Policy Center.

- **Taxes and long-term growth**: In the long run, economic growth reflects expansions in the capacity to produce goods and services. Such expansions, in turn, reflect increases in labor supply and capital, improvements in the allocation of labor and capital, and technological advances. Tax cuts can increase growth by providing incentives to raise the level, and improve the allocation of, labor supply, saving, and investment. But tax cuts can reduce long-term growth by raising after-tax income (which discourages work), by providing windfall gains (which encourages consumption rather than saving), and by reducing public and national saving (which reduces the capital stock owned by Americans and hence reduces future national income). The net effect on growth depends on the balance between these various impacts.

- **JGTRRA and long-term growth:** Although the tax cut is called a "Jobs and Growth" package, this moniker is extraordinarily misleading. The Joint Committee on Taxation has analyzed the tax cut passed by the House of Representatives (which is essentially JGTRRA with the sunsets removed). This analysis explicitly incorporates macroeconomic feedbacks, as tax cut advocates have demanded for years. Using a variety of models and assumptions, the JCT shows that the House plan would *reduce* the size of the economy in the second half of the decade, and by implication would reduce the size of the economy by increasing amounts after that. The reason why JGTRRA, extended, would reduce growth is that the impact of the tax cuts in raising individuals' after-tax income holding work constant, the increase in the stock market, and the increase in the deficit, will reduce net work, raise consumption, and reduce national saving. In the long-term, all of those effects reduce the size of the economy. In the case of JGTRRA, those effects outweigh the positive impacts on incentives to work and save. The acceleration of EGTTRA would reduce marginal tax rates for fewer than one-third of all tax-filing units and so is unlikely to have substantial supply-side benefits. Despite claims suggesting sizeable benefits for small business, only about one-third of small business returns would receive marginal tax rate cuts and only 2 percent of all small business returns would benefit from the reduction in the top tax rate. The cuts in dividend and capital gains tax rates will do little to improve the allocation of capital.

<u>Taxes and the economy: A framework</u>

The short-term stimulus effects of tax proposals and their long-term effects on economic growth are often discussed independently, but they are related. An economy operating below capacity can increase output in the short run without an increase in productive capacity, simply by boosting aggregate spending and allowing businesses to increase use of extant capacity. In the long run, however, an economy can only grow by expanding its capacity, which requires an increase in the supply of labor and capital, an improvement in the allocation of labor and capital, or an improvement in technology. As a result, policies that serve to reduce private and national saving saving can raise output in the short-term, but if they persist, they will reduce the amount that households save and hence can dampen growth in the long-term.

Tax cuts can play important roles in both the short run and the long run. In the short run, most tax cuts will boost aggregate spending simply because consumers have more cash in hand. But as long as taxpayers spend a positive fraction of any tax cut they receive, public saving will fall (from the reduction in tax revenues) by more than the increase in private saving, so national saving will fall and aggregate demand will rise. That is helpful in a stagnant, under-utilized short-term economy, but it sows the seeds of a long-term slowdown in economic growth if it is continued over time.

In the long run, tax cuts have potentially offsetting effects on economic growth: while they can stimulate growth through better incentives, they can also reduce growth by generating (a) positive income effects for households, which reduce labor supply, (b) windfall gains for current owners of capital, which reduce current private saving, and (c) increased budget deficits, which reduce national saving. That does not mean that the overall growth effects of tax cuts are necessarily negative, but it does mean that in order to generate growth, the positive effects of the proposals must be sufficiently large and persistent to offset the fiscal drag and to produce additional gains. The net effect depends on the interaction between these events.

<u>JGTRRA and short-term stimulus</u>

JGTRRA will boost short-term economic activity, but this is not a major accomplishment. Almost any tax cut or spending increase would succeed in boosting a sluggish economy if the Federal Reserve Board follows an accommodative monetary policy (which it would likely do during a recession). *The key question is, therefore, not whether the proposals provide any short-term stimulus, but whether they are the most effective way to provide stimulus*. For several reasons, JGTRRA is not the most effective way to provide stimulus.

First, because of growing fiscal concerns, a good proposal would provide a strong short-term stimulus without compounding medium- and longer-term budget problems. By this criterion, JGTRRA is poorly designed. The acceleration of EGTRRA provides most of its benefits to high-income households, who would be less likely to spend the additional funds upon receipt; thus, only a relatively small share of the tax cut will appear as immediate spending.

Likewise, boosting the stock market -- which is often alleged to be one of the goals of dividend and capital gains tax cuts -- raises wealth and therefore raises consumption this year and in the future. The expansion in consumption this year is beneficial in spurring short-term growth by bolstering aggregate demand, but the effect is likely to be small relative to other options that have the same cost. For example, consider two policies with a net present value cost of $1. A permanent reduction in dividend taxes that reduces the present value of revenues by $1 would raise the value of the stock market by $1 and, using estimates of the responsiveness of consumption to changes in wealth, would raise current consumption spending by between 3 and 5 cents. As an alternative, consider $1 in aid to the states this year. The $1 increase in aid could boost state spending or reduce taxes by $1, relative to what it would otherwise have been, with an immediate effect on the economy that is much larger than 3 to 5 cents. For the same present value cost to the government, aid to the states thus provides much larger immediate stimulus than a dividend tax cut.

Second, extending the expiration date of the "bonus depreciation" provisions -- with the clear implication that tax cut advocates would like to extend the provision even further and make it permanent--will impede short-term recovery. Temporary investment incentives provide a stronger motivation for corporations to invest immediately or in the very short term than do permanent incentives, for the simple reason that, in order to benefit from the temporary subsidy, the firm must make the investment soon. But, by lengthening the period of eligibility, JGTRRA will reduce the incentive to invest now, especially if the lengthening of the period of eligibility is taken as a signal that legislators intend to make the provision permanent. (The proposal also raises the share of investment expenditure that is eligible for immediate write-offs, which would raise the incentive to invest now. It is important, however, to separate the effects of the generosity of the depreciation provision from its timing.)

<u>JGTRRA and long-term growth</u>

A. Analyses

A number of recent studies have examined these issues in the context of full-blown macroeconomic models. The CBO (2003a) recently analyzed the impact of the President's overall budget proposals in a series of different models and under varying assumptions. CBO found the effects on growth would generally be small and could be negative. By estimating the combined effects of the President's tax and spending proposals over the next 10 years, however, it does not provide information on (a) what would happen after 10 years or (b) the effects of the tax proposals separately from the spending options.

The effects on the economy after 10 years -- that is, the long-term growth effects -- can be gleaned from a similar CBO (2002) macroeconomic analysis of tax reform proposals. That study found that tax cuts uniformly reduced long-term GDP (relative to baseline) unless they were offset by sufficient spending cuts to ensure budget neutrality.

Two recent studies examine the Administration and House tax proposals in isolation of the spending proposals. Macroeconomic Advisors (2003), the consulting firm that developed the macroeconomic model used by the White House's Council of Economic Advisers, estimated that the President's tax cuts would reduce the size of the economy in the long run.

More recently, the Joint Committee on Taxation estimated the macroeconomic effect of the House plan (Congressional Record 2003). Using a variety of models and assumptions, the JCT results show that the House plan (which is essentially the same as the recent tax cut, but with the provisions extended instead of temporary) would boost the economy in the short-run but by relatively small amounts. Four of the five models suggest average real GDP effects over the first five years of between 0.2 and 0.3 percent ($18 billion to $27 billion). Given the price tag on the overall House plan, these are miniscule effects.

Most strikingly, the JCT also estimated that the House "Growth and Jobs" plan would end up *reducing* GDP relative to the baseline in the second half of the decade. Although the JCT does not report results beyond the 10-year window, the language implies that the growth effect would continue to decline.[2]

B. Why don't the JGTRRA tax cuts generate long-term growth?

The key point for understanding the long-term growth effects of JGTRRA is simply that they are not well-designed to maximize the positive effects on growth and minimize the negative effects.

1. Lack of supply side incentives

First, the acceleration of EGTRRA tax cuts is unlikely to provide a serious boost on the supply side. The Tax Policy Center microsimulation model shows that less than 30 percent of tax filing units will see reductions in marginal tax rates due to the acceleration. Among households with income below $75,000, only about 18 percent would obtain a reduction in marginal tax rates. Thus, the acceleration would produce significant income effects (64 percent of tax filing units would get a tax cut (Burman, Gale and Orszag 2003), which would tend to reduce labor supply, but the substitution effects that would tend to raise labor supply would be small and uneven.

2. Boosting the stock market can hurt long-term growth

Second, a less well-understood point is that the expansion in consumption due to a permanent rise in the stock market continues in the future, which has an adverse effect on long-term growth. In particular, higher consumption translates into lower national saving. The reduction in national saving reduces future national income (Gale and Orszag 2002). *The larger the effect on the stock market, the larger the increase in consumption, the larger the reduction in national saving, and the larger the decline in future national income.* A stock market boost due to tax cuts may also raise investment, but if it does, the additional investment will be financed by borrowing from abroad (since private saving and public saving will both have declined). The borrowing will have to be paid back in the future and thus effectively represents a mortgage on the future income produced by the investments.

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[2] For example, after noting that the residential capital stock falls but non-residential capital rises in the first 10 years (with the overall capital stock falling, as best we can estimate), JCT notes that "The simulations indicate that eventually the effects of the increasing deficit will outweigh the positive effects of the tax policy, and the build up of private nonresidential capital stock will likely decline." Thus, in the longer run, the JCT analysis of the Thomas plan foresees rising deficits, and declining residential and non-residential capital stocks. Taken together, these imply declining GDP and GNP over time.

3. The benefits to small business will be small

Third, another commonly made argument is that acceleration of the EGTRRA tax cuts, especially the cuts in the top rate, would be a great boon to small business. Even including the dividend and capital gains tax cut in the House package, more than half of all returns with small business income would receive tax cuts of $500 or less, and half of those (a quarter of the total) would receive no tax cut (Burman, Gale and Orszag 2003). That fact notwithstanding, tax cut advocates claim repeatedly that reducing the top rate disproportionately helps small business. Burman, Gale, and Orszag (2003) present data that can help clarify this discussion. It shows that the vast majority of small business owners do not face anything approaching high marginal income tax rates. Only about one-third of small business returns are in tax brackets of 26 percent and above, less than 5 percent face rates of 35 percent and above, and only 2 percent are in the top tax bracket. Thus, the claim that cutting the top rate or the top two rates is crucial for small business is misplaced. Roughly 95 percent of small businesses are not affected at all by cuts in the top two tax rates. Although it is clearly the case that the share of returns that report at least some business income rises as income rises, business income is not the dominant form of income for most of those returns. In the top two brackets more than half of returns have some business income and in the top bracket almost three quarters have some. But much of that business income is not from the taxpayer's primary occupation. For example, a professor's consulting income or an executive's compensation from serving on a board of directors would appear as business income, rather than wages and salaries, on a tax return. Only about one quarter of households in the top bracket and one-sixth in the second bracket have more than half of their income from business income.

4. Deficits reduce national saving and hence future national income

Fourth, the reduction in government revenues will reduce national saving. This in turn will reduce future national income. Holding other factors constant, an increase in budget deficits (or a reduction in surpluses) will reduce future national income under conventional views of how the economy operates. This occurs because the deficit reduces national saving, which in turn reduces national investment. The reduction in national investment can take the form of lower domestic investment and/or lower net foreign investment by Americans. In either case, the expected future income received by Americans falls. If capital income flows equal the reduction in national saving, then domestic production does not fall, but future national income still falls, because Americans have a smaller claim on that production.

5. Economic improvements due to better allocation of capital will be small

The main potential benefit for long-term growth is intended to come from the dividend and capital gains tax cuts. In the United States, some corporate income is currently taxed twice (once at the corporate level and again when received by shareholders as dividends or capital gains); some is taxed once, at either the corporate or individual level; and some is never taxed. Although precise data are difficult to obtain, it appears that roughly one quarter of corporate income is taxed twice, one quarter is never taxed and about half is taxed once.[3]

Taxing all corporate income once at the same, full rate is a sound idea, other things equal. It would ensure that capital were allocated to its most economic uses. Thus, a proposal that improved the allocation of capital could raise growth even if it did not raise the level of capital.

To ensure that all corporate income were taxed once, however, would involve both eliminating tax on the doubly taxed portion of corporate income *and* taxing the currently untaxed portion. Such an objective could be accomplished in a roughly revenue-neutral manner, and indeed the first President Bush's Treasury Department proposed to do just that in 1992.

The reduction in taxes on dividends and capital gains is ostensibly motivated by a desire to tax corporate income once, but it will do little to improve the allocation of captial. First, shareholders would get the benefit of the lower dividend tax rates and lower capital gains on corporate stocks regardless of whether the corporation had paid taxes on them. Thus, the proposal does nothing to reduce any overinvestment in corporations due to sheltering. Second, taxpayers would benefit from lower capital gains tax rates even if their investment were not in corporate stock. Indeed, about half of capital gains are on assets other than corporate stock. Third, the capital gains tax cut provides as much additional incentive to purchase other assets, such as land or small businesses, as it does to purchase corporate shares, and so does not reduce the distortion created by the corporate tax.

Fourth, and of most concern, the proposal could invite a wave of tax shelters for corporations and individuals. Corporations would become a much more effective tax sheltering device.[4] Under pre-JGTRRA law, arranging to earn income through a corporate shell subjects the investor to full taxation on dividends plus any tax levied at the corporate level. Under JGTRRA, however, if an investor in the top income tax bracket can arrange to channel income through a corporation, which can take advantage of corporate tax shelters to avoid tax, any income distributed to the investor would be taxed at less than half the rate of other income. In addition, the increase in the capital gains tax differential would likely fuel the growth of individual tax shelters. Virtually all individual income tax shelters exploit the difference between tax rates on capital gains

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[3] See Gale (2002), who estimates that about half of dividends are not taxed at the shareholder level under current law. The Tax Policy Center estimates that more than one-third of dividends are paid out of corporate earnings that did not face corporate tax. McIntyre (2003) estimates that about half of all corporate earnings are untaxed at the corporate level.

[4] One gauge of the potential impact of this problem is that the JCT estimate of the cost of dividend and capital gains tax cuts in the House bill is $246 billion over 10 years. This is on the order of twice the "static" estimate from the TPC micro-simulation model. The difference is likely due to the fact that JCT may consider several margins of behavior that the TPC model does not.

and on ordinary income and deductions. The 15-percent top tax rate on capital gains would be the lowest rate in effect since 1941. It would provide massive incentives for any scheme to convert ordinary income into capital gains. Because the proposal does not effectively integrate the corporate and personal taxes, it does not generate the benefits of reallocating the capital stock from non-corporate to corporate uses. In addition, the increase in sheltering and in the national debt would serve to reduce growth.

Thus, it is not surprising that as noted above, the Joint Committee on Taxation concluded that the House plan would reduce economic output over the decade.

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