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Senate Finance Committee Hearing on the Consumption Impact of Proposed Tax Reductions

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Mr. Chairman and Members of the Committee,

Thank you for the opportunity to testify before you this morning. My views are my own, and do not necessarily reflect the opinions of everyone at IRET.

The debate over the right tax policy response to the slower than desired economic recovery seems to be focused on a number of inappropriate dichotomies. Some people favor tax changes aimed at boosting consumption for the short run. Others favor tax changes that promote long run growth of saving and investment. Some want some of each. Some worry that temporary tax reductions are unlikely to change behavior, and want pending tax reductions (and any new ones that might be enacted) to be made permanent. Others worry that any permanent tax reduction will interfere with investment by boosting deficits, or perhaps they worry it would interfere with future government spending. Many of these conflicts stem from a misunderstanding of how tax and budget changes affect taxpayers' behavior and the economy, and lead to poor analysis and poor policy choices.

Let me note first that the focus on consumption is misplaced. Consumption has been strong throughout the business cycle. The 2001 recession was due to a slump in investment spending, and that spending has been slower than normal to recover, which is the source of the current unsatisfactory rate of economic growth and job creation. More fundamentally, we need to focus on production, not on spending, to create growth and jobs.

As for policy changes that would improve the economy, let us get the analytical framework right. Let me assert, up front, that there is no meaningful distinction between tax changes that are good for the economy in the short run and the long run. Only policies that are good for long run growth and economic efficiency have any favorable short run effects.

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In particular, there are no tax changes that would succeed in "pumping up consumption" in the short run by "giving people money to spend", because the Treasury would have to immediately borrow the tax cut back to cover its outlays. Furthermore, tax changes that promote work, saving, investment, and long run growth actually start to work immediately, although they build over time. Fine tuning is impossible. Temporary tax cuts are not generally effective at much of anything. Permanent tax cuts can promote growth in the near term and the long term, but only if they are of the right sort. The deficits associated with the various saving, investment, and work incentive tax changes proposed by the Administration are manageable, and would not raise interest rates by enough to dampen investment.

Changing views of economics and tax policy.

There was a time in economics, from the mid-1930s to the mid-1960s, when economists believed in the "pump priming" efficacy of rebates, credits, rate cuts, or any old tax reduction. But that time is long past. Or it should be.

The old view was that a tax cut worked by giving people money to spend. Supposedly, if a tax cut boosted "disposable income" by a dollar, some of the dollar would be saved, but most would be spent. Whoever received that round of spending would owe some tax to the government and would put some of the receipts into saving, but would spend the rest. That would lead to yet another round of spending, and so on. This led to the old notion of "Keynesian multipliers", that a dollar of tax cut might lead to $2 or $3 dollars of increased "demand" for goods and services. The effect was supposedly even higher if the initial impetus was a dollar of additional government spending, because none of that first dollar would be saved.

Traditional economists were never comfortable with these notions. In the mid-1960s, the Keynesian theory was called into question by the monetarists, led by Professor Milton Friedman at the University of Chicago. It was also opposed by "neo-classical" economists such as Norman B. Ture, a long-time tax advisor to the Congress.

Friedman made two key contributions. In his "permanent income" theory, he demonstrated that people do not rush out and spend as soon as their disposable income increases. It takes them time to become certain that the change in their income is permanent, and they increase their spending only gradually in line with their view of their "permanent income". Meanwhile, the increase in income is saved. The corollary is that permanent tax changes have a much greater impact on spending than temporary ones, and neither will have much impact on "demand" in the short run.

Later, Friedman went further to observe that a tax cut or a government spending hike that increased the deficit would not stimulate spending or demand unless the Federal Reserve "monetized" the added debt. In one of his famous Newsweek columns, Dr. Friedman asked, "If the government cuts taxes from $500 billion to $450 billion without cutting spending, where does the $50 billion come from, the tooth fairy?" His point was that, if the Federal Reserve did not pony up the money to buy the extra Treasury debt, the government was simply borrowing the tax cut back from the public. And if the Fed did monetize the debt, that was a change in

monetary policy, not the consequence of the fiscal policy. He reiterated this point last month in a Wall Street Journal editorial, pointing out that tax cut recipients keep more of their money, but they, or others, must lend a similar amount to the government to cover the additional federal borrowing, and the lenders have that much less to spend. Whether total "demand" goes up or down is uncertain and unlikely to have much impact.

It may be argued that, insofar as foreigners buy a portion of the added federal debt, then U.S. residents may in fact have some of the tax cut to spend. But foreigners who buy the added federal debt either have fewer dollars to lend to other U.S. residents or to spend on U.S. goods. Another way to put this is, if more foreign capital flows in, induced by higher U.S. demand for credit, the dollar will rise on the foreign exchange markets, imports will become cheaper and U.S. exports will become more expensive, and there will be a drop in foreign demand for U.S. goods. Again, there is no initial gain for "demand" from the tax reduction.

Conclusion: the government cannot pump up consumption, either in the long run or the short run, merely by cutting taxes or by increasing government spending, because of the government budget constraint. There is no first order demand effect from a tax cut.

If tax cuts do not work by giving people money to spend, then how do they work? In neo-classical thinking, **tax cuts improve economic performance and raise individual and national incomes if and only if they reduce tax barriers to producing more income by working, saving, and investing more than before.** That is, as marginal tax rates are reduced on incremental income, and the tax rules governing the level of tax on additional investment are made less restrictive, the after-tax rewards to labor and capital inputs will rise and their pre-tax costs will fall. As people are given the incentive to offer more labor and capital services than before, the supply of labor and capital inputs to the production process increases, and so does output. Labor and capital are paid for their effort, and they can then buy the output they have created. Supply creates its own demand. As Ture pointed out time and again, unless there is a supply response to a tax change, there will be no added output and no demand response. The two rise together or not at all. The added output comes from an expansion of productive resources, and is not inflationary. Indeed, more goods are chasing the stock of money, and the Federal Reserve can be more generous with money growth without triggering inflation.

Events in the 1960s and 1970s bore out this neo-classical view. The Kennedy marginal personal income tax rate reductions, corporate tax rate cut, and investment tax credit boosted real output and employment. The Johnson income tax rate surcharge led to the 1969-70 recession. Several increases in the personal exemption and standard deduction in the 1970s, which were not at the margin and did nothing for incentives, did little or no good. Inflation-induced bracket creep, which sharply raised the tax burden on additional labor and capital income, led to stagflation.

These lessons helped shape the Economic Recovery Tax Act of 1981. It provided personal marginal income tax cuts, combined with tax indexing effective in 1985, which lowered the marginal tax rates and reduced the cost of labor while raising the reward to incremental work, saving, and investment. At the same time, lower inflation due to more effective monetary policy on the part of the Federal Reserve boosted the real value of the allowances that businesses may

claim for the cost of their outlays on plant, equipment, and buildings. Because of these positive developments, the 1980s saw a return to job and income growth and price stability. Real after-tax incomes, which had been falling in the late 1970s, turned around and began to rise at all income levels.

Failure of rebates.

Rebates, by contrast, have a long history of failure. President Ford proposed, and the Congress enacted, the Tax Reduction Act of 1975. It contained a retroactive tax rebate of 10% of 1974 tax liabilities, with minimum and maximum bounds of $100 and $200, paid in May and June of 1975. It also included a $30 tax credit per personal exemption for 1975 (later raised to $35 and made effective for two years) and a one-time $50 bonus for Social Security and other income maintenance programs to fight recession. The view at the time was that the tax cut did no measurable good.

When President Carter proposed an even larger rebate in 1976, Senator Russell Long laughed the idea out of the Finance Committee, and replaced it with a modest, and more effective, tax rate reduction (a credit of 2% of income up to $9,000, effectively cutting marginal tax rates on incomes up to that size, which was middle income at the time) and an investment credit.

A subsequent study by Franco Modigliani and Charles Steindel (Brookings Institution, 1977) concluded that less than 25% of the Ford rebate was spent. They wrote, "We conclude that there is strong, though not uniform, evidence that a rebate is not a particularly effective way of producing a prompt and temporary stimulus to consumption." Alan Blinder (later appointed to the Council of Economic Advisers and the Federal Reserve Board by President Clinton) conducted a study in 1981 which concluded that temporary tax changes, such as the 1968 income tax surcharge (a rate hike) and the 1975 rebates (lump sum hand-outs), have less than half the impact of permanent tax changes of similar magnitudes, and that rebates have the least benefit, yielding less than forty percent of the "kick" of a permanent tax cut.

The 2001 rebates of $300 per adult taxpayer (actually a down payment on the new 10 percent tax rate bracket) were about 80% saved, creating a very visible jump in the personal saving rate in the last half of that year. There was no noticeable lift to the GDP.

Conclusion: Permanent tax cuts that work at the margin to raise rewards to additional work, saving, and investment expand economic capacity, output, employment and income. They begin to work at once, and build over time as the additional capital is put in place. The primary beneficiaries are the workers, because they get additional capital to work with, which increases their productivity and wages. Workers capture over half of each added dollar of GDP made possible by added investment. Federal state and local governments capture about a third of each dollar of added GDP via higher tax receipts. A bit over 10 cents is used up by depreciation of the added capital stock. Capital owners gain too, but much of their gains are competed away as the "new" capital competes with the old, and the after-tax returns are driven down to normal levels as the capital stock expands. They get about 5 cents, net, of the added national output.

President Bush's growth proposals.

President Bush's proposed new tax reductions would do much economic good. Major provisions would encourage work, saving, and investment at the margin. They would add nearly a million and a half jobs over two years, according to the CEA, and would boost GDP by several percent over the next decade.

• Dividend and capital gains relief. The Bush plan would eliminate most of the double taxation of corporate income via dividend exclusion and capital gains relief, and increase small business expensing. These proposals would reduce the cost of capital, meaning that it would reduce the gross return that investment in capital assets must earn in order to pay the associated taxes, replace the plant, equipment and buildings as they wear out, and still yield an acceptable after-tax return to the owners. The proposals would trigger a substantial increase in capital formation over the next decade, boosting GDP in the near term as the capital is created, and in the long term as it is employed. Associated productivity gains would raise employment and labor income.

• Accelerated reductions in marginal income tax rates. The Bush plan would advance the remaining marginal income tax rate reductions scheduled under the 2001 tax cut. These rate cuts would reduce the cost of capital and increase after-tax rewards to affected workers, especially small business owners, sooner rather than later. There would be an immediate, rather than a delayed improvement in GDP because of these economic incentive effects. The improvement would not be do to any impact these provisions would have on aggregate consumption.

• Enhanced and simplified saving incentives. President Bush has unveiled three new proposals to promote saving: new Lifetime Savings Accounts (LSAs) useable for any purpose, Retirement Saving Accounts (RSAs) which would replace deductible, non-deductible and current Roth IRAs, and Employer Retirement Savings Accounts (ERSAs) which would enormously simplify defined contribution plans. They would replace 401(k), 403(b), and government 457 plans, SARSEPs and SIMPLE IRAs. More saving would be eligible for tax favored treatment than under current law. The tests and restrictions required for such plans under current law would be greatly simplified and relaxed, reducing legal and compliance costs to enable more companies to offer such plans to their employees.

LSAs would be of great benefit to lower income savers who cannot afford to save separately for retirement and emergencies, such as being laid off, and who are therefore afraid to use ordinary IRAs because of their penalties for early withdrawal. They put their saving into ordinary accounts that are subject to the full tax bias against saving, where the saving is taxed each year with no deferral and no exclusion, either at the time of deposit or withdrawal. Under the lifetime savings accounts, there would be no income limits on participation, no minimum holding period, and no restrictions on what the money could be used for. The LSAs would give lower income people who want to save the same access to tax-neutral saving that higher income workers currently enjoy.

These proposed saving plans are good tax policy, in that they remove one of the layers of tax bias that the income tax imposes against saving relative to consumption. Reducing the tax bias

against saving would in turn increase investment, productivity, employment, wages, and income across the board. Combined with Mr. Bush's other saving and investment proposals, the new saving initiatives constitute a significant step toward fundamental tax reform. All these features of the proposal would boost GDP and recover a good portion of their "static" revenue cost.

Social policies in the President's tax plan.

Not all of the President's tax plan is designed to boost economic performance, however. Several provisions are meant primarily to address social goals or attract political support for the bill by giving more money to lower and lower-middle income taxpayers. Among these are advancing to 2003 the effective dates set in the 2001 tax cut for widening the 10% bracket, for marriage penalty relief (making the standard deduction and 15 percent bracket for married couples twice that of single filers), and for raising the child credit to $1,000 (from $600 this year).

- Accelerated widening of the 10 percent bracket. The provision would have a small incentive effect for those who drop down from one tax rate to the next, but their numbers are few and they do not produce much GDP.

- Accelerated marriage penalty relief and accelerated increase in the child credit. The marriage penalty relief includes widening the standard deduction and 15 percent tax bracket for married couples to twice the amounts for single filers. These provisions should be viewed as social policy, not growth policy. For reasons described above, the provisions will not boost aggregate consumption. The wider 15 percent bracket would reduce marginal tax rates for those who drop down a bracket, but the expansion of the child credit contains some hidden marginal tax rate increases for some families.

The larger standard deduction and higher child credit would drop another three million people from the income tax rolls, and that would reduce their marginal tax rates. However, dropping millions of taxpayers from the tax rolls would be bad public policy, because it would increase the number of voters who think that general government (federal outlays excluding Social Security and Medicare) is a free good, and do not care how big the government gets or how high the income tax rates are pushed. Already, the bottom half of the income distribution pays only about 4 percent of the income tax. If we go much further down that road, the tax system will create a voting majority for the federal provision of food, clothing, shelter, and transportation, not to mention health care.

The child credit provision, as drafted, has the added drawback of raising marginal tax rates for many highly productive workers and savers. The credit is "phased out" for single filers with adjusted gross incomes (agi) over $75,000 and married filers over $110,000. The credit is reduced in $50 steps for each $1,000 or fraction thereof by which income exceeds the thresholds. This effectively boosts the taxpayers' marginal tax rates by 5 percentage points on average until the credit is gone. (The "excess" income is rounded up to the next $1,000. If income exceeds the threshold by $1 to $1,000, the taxpayers lose $50 of the child credit; between $1,001 and $2,000, they lose $100 of the credit; etc.)

Families subject to the phase-out were mostly in the old 28 percent tax rate bracket, now 27 percent in 2003 thanks to the 2001 Bush tax cut, and which his new plan would hasten to cut to 25 percent. Some are calling this rate cut a give-away to the rich. In fact, in the phase-out range for the child credit, the old 28 percent rate was implicitly bumped up to 33 percent. The new implicit marginal rate will still be 30 percent, even with the rest of the marginal rate cuts. That's before Medicare and state and local income taxes typically add about 8 points more, and several points more from the not-yet-expired phase-outs of personal exemptions and itemized deductions.

Furthermore, the phase-out range expands, boosting the tax rate over more taxable income. When the credit is $600, the phase-out range is $11,000 wide for one child, $23,000 wide for two children, etc. With a $1,000 credit, the phase-out range would be $19,000 wide for one child, and $39,000 wide for two, affecting many more families. For them, the 3 percentage point reduction in marginal tax rates in the President's 2001 tax cuts will be more than offset by the implicit 5 point rate hike in the enlarged penalty zone for the child credit.

Summary of tax rate effects of the child credit:

For 2003....................	2000 law	2001 law	Bush plan
credit/child................	$500	$600	$1000
explicit tax rate...........	28%	27%	25%
implicit rate w. phase-out...	33%	32%	30%
agi phase-out range for --			
1 child, from $110,001 to:	$119,001	$121,001	$129,001
2 children, from $110,001 to:	$129,001	$133,001	$149,001

How best to describe the President's proposals.

The Administration has spoken favorably about how much spending money these social provisions would put into the pockets of lower and middle income families to show that the tax plan is not just for the rich. As tax cuts meant to be made permanent, they would do more for people of all incomes than the one-shot rebates that have been offered by some in Congress. Indeed, they would be worth several thousand dollars over the decade for families with children. Further, by boosting productivity and wages, the growth-related provisions also raise pre-tax incomes and create new jobs. That all needs to be said, but carefully. It is one thing to point out that the President's tax plan is generous to a wide range of taxpayers. It is another thing to describe the tax cuts (even the good parts) as "giving consumers money to spend" in the aggregate to pump up the economy, which they certainly do not, once additional federal borrowing is taken into account.

Tax cuts improve economic performance and raise individual and national incomes if and only if they reduce tax barriers to producing more income by working, saving, and investing more than before. It is a technical and political mistake to allude to fictitious benefits from not-at-the-margin "demand-side" tax hand-outs. That improperly puts them on a par with economically

beneficial "supply-side" incentive provisions, giving ammunition to those who would substitute more of the redistributionist sort of tax changes for the ones that are good for the economy.

The Administration bent over backwards to "spread the wealth" in its tax reduction plan. The rate cuts are modest; they leave marginal tax rates higher than after the Senior Bush tax hike. The tax code still has stealth tax rate spikes due to "phase-outs" of credits and deductions, one of which, due to the child credit, the plan makes worse. These considerations suggest that there is no excuse to water down either the advancement of previously enacted marginal rate cuts or the newly-proposed relief from the double taxation of shareholders' corporate earnings that President Bush has proposed.

Arguments over the deficit.

Deficits of the magnitude projected under the President's tax proposals would have only a modest effect on interest rates. The CEA estimates that interest rates rise by only about 3 to 5 basis points for each $200 billion in new debt. I have seen other estimates that an additional trillion dollars of debt over a decade would raise interest rates by between 5 and 20 basis points. The effects on investment would not be large. They would certainly be an order of magnitude smaller than the effect of the reduction in the cost of capital from ending the double taxation of corporate income.

One reason for the small impact is that the United States is part of the global economy, and has access to world capital markets. The other reason is that the supply of saving is not inelastic, as was once thought. Rather, people seem quite willing to add to their saving as after-tax rates of return rise by even small amounts.

Note that it is the impact of deficits on the entire stock of existing debt, not just new borrowing out of current saving, that determines interest rates and saving behavior. The value of world bonds, stocks, mortgages, and other credit instruments will be approaching $100 trillion over the next decade. If the United States government were to borrow an additional $1 trillion, it would be adding only one percent to the stock of world financial instruments. To make people want to hold that much added debt in their portfolios, interest rates would have to rise by enough to drive down the value of existing debt by about one percent, so that people would feel the need to replenish their assets by that amount. Long term interest rates might have to go from 6% to 6.06% to effect that adjustment.

Provision for new temporary individual tax cuts.

A number of Members of the House and Senate have introduced income or payroll tax reductions on the first few thousand dollars of income, or tax rebates of a specific dollar amount. Insofar as these proposals have little or no incentive effect at the margin to earn additional income in the future, they would have no beneficial effect on employment or saving. They would not stimulate aggregate consumption, because the amounts given out would be borrowed back by the Treasury.

• Senator Baucus has proposed to eliminate the income tax on the first $3,000 of wages earned in 2003, and to provide low income workers not subject to income tax with a $300 rebate. The plan is effective "at the margin" for only a handful of workers. He has also offered a temporary health insurance tax credit, which is primarily an incentive for employers to offer health coverage to their work force, not an economic stimulus program.

• Senator Daschle and Congresswoman Pelosi have offered two variations on tax rebates. For reasons described above, neither is likely to be successful in increasing consumption or employment. Even if made permanent, they are lump sum payments that are not "at the margin" and provide no incentive to work longer hours or save additional income. Each has also proposed increasing the 30 percent expensing provision of last year's stimulus package to 50 percent for 2003, but would drop the provision (Daschle) or reduce it to 10 percent (Pelosi) for 2004. These steps would borrow investment spending from next year, and simply be more ineffective fine tuning. The 30 percent expensing provision in current law should be expanded to 50 percent, or better, 100 percent, and made permanent. Many firms will not expand their factories just for a temporary improvement of the treatment of investment if they have to face old law when it comes time to replace the additional assets.

• Senators Landrieu and Corzine have proposed a refundable income tax credit equal to the payroll taxes on the first $10,000 of wages. For workers, it would be based on wages paid in 2001. Rebates on income earned in past years gives no incentive to earn additional income in the present. Witness the Ford fiasco. For employers, the credit would be based on payroll taxes paid in 2003. But even if the employers' tax relief were based on current wages, the cap would make it not "at the margin" for most employees. The one year relief would not give much incentive to take on a permanent employee, as it would not lower future year's labor costs. The best that can be said is that it might help cover the cost of training a new hire.

Fiscal relief for states.

Federal payments to aid state budgets will not boost aggregate "demand" because the federal government will have to borrow the funds transferred to the states. This is the same objection to "demand management" as applied to tax cuts or other government spending increases. The only economic benefit to aiding the states in the short run is that it might fend off state income tax or local property tax hikes, which would increase disincentives to work, hire, save, and invest. The drawback is that it will let the states delay dealing with their recent wave of overspending as good times brought a temporary surge in revenues.