No. 784 October 16, 2001

THREE OBSTACLES TO GOOD TAX POLICY

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President George W. Bush has proposed supply-side tax reforms that will increase work, saving, and investment. Critics argue that a permanent tax cut is not necessary and that any tax cut enacted should be modest in size and temporary in duration. Such advice is bad for America's workers and bad for the economy. Tiny tax cuts usually have tiny benefits, and temporary tax cuts have almost none. If policy-makers want to stimulate more job creation and higher levels of saving and investment, they should make changes that represent sound long-term tax policy.

Principles of Tax Reform. With the exception of a rebate for workers who earn too little to pay income taxes, the components of the President's tax plan move toward fundamental tax reform by:

- **Accelerating implementation of lower personal income tax rates.** Though the tax cut approved earlier this year reduces tax rates across the board, most of the reductions will not occur until 2004 and 2006. Thus, most of the benefits of this change will not occur until 2004 and 2006 either. Moving the tax rate reductions forward so that they take place immediately, as the President proposes, would instantly improve incentives to work, save, and invest—the real causes of economic growth.

- **Reducing the tax burden on business investment by shifting toward expensing.** When a business spends money to build new plants and buy new equipment, it cannot fully subtract those expenses (unlike employee wages, office supplies, and raw materials) from total revenue in calculating its taxable profit. The President proposes reducing this "depreciation" tax on business investment.

- **Repealing the corporate alternative minimum tax (AMT).** When income falls during a downturn, businesses often must pay the corporate AMT because their expenses become "too large" for their income. The President proposes to eliminate this tax, which has the perverse effect of making companies pay more when they earn less.

Produced by the
Thomas A. Roe Institute for
Economic Policy Studies

Published by
The Heritage Foundation
214 Massachusetts Ave., NE
Washington, D.C.
20002–4999
(202) 546-4400
http://www.heritage.org

This paper, in its entirety, can be found at: *www.heritage.org/library/execmemo/em784.html*

These modest changes were good tax policy before September 11, and they are good tax policy today. If implemented, they would increase the economy's long-run performance and help end the current slump.

Obstacles to Tax Reform. Opponents argue that these reforms are not necessary. Their assertions should be rejected.

- **Obstacle #1: The assertion that tax cuts should be small and short-lived to "protect" long-run fiscal discipline.**

Reality: Fiscal discipline means controlling the size of government, not maintaining a tax system that retards economic performance. Neither budget surpluses nor debt reduction should be the lodestar of fiscal policy. Instead, lawmakers should implement policies that will lead to strong and sustainable long-run growth. This approach relies on a frugal government and a tax system that collects revenue in the least destructive manner possible.

Pro-growth tax cuts are an important part of fiscal discipline. They take money out of Washington, thereby removing the temptation to spend tax dollars on programs that are wasteful, duplicative, or counterproductive. If anything, the Bush tax cut is too small. Accelerated rate reductions will affect revenue only until 2006, and reducing the depreciation tax has very modest long-term revenue implications.

- **Obstacle #2: The assertion that there is only a need to put money in peoples' pockets today, so a permanent tax cut is not necessary.**

Reality: Shifting money from one group to another does not increase incentives to work, save, or invest. Any money the government gives to one person must first be taken from someone else. This Keynesian approach—attempting to boost the economy by giving people more money to spend—makes sense only if one assumes that the money distributed by the government for tax relief or new spending materializes out of thin air.

The essential insight of supply-side economics is that the right kind of tax cuts will help an economy by increasing incentives to work, save, and invest. This relationship is the reason why President Reagan's across-the-board reductions in marginal tax rates resulted in nearly 20 years of above-average economic performance. President Bush's proposed tax cut package seeks to reduce the tax penalty on productive behavior, so there is every reason to think it would yield significant benefits as well.

Those benefits will be almost nonexistent, however, if the tax cut is temporary. A short-term tax cut—even if it is a pro-growth rate cut instead of a rebate—will not alter people's long-run behavior. At best, a temporary tax cut will encourage people to shift some economic activity from the future into the present.

- **Obstacle #3: The assertion that tax cuts should be small to keep interest rates low.**

Reality: The right kinds of tax cuts—like permanent depreciation reform and AMT repeal—are likely to lower interest rates. People invest in the expectation of earning after-tax income. Taxes on savings and investment result in a tax premium that increases interest rates—much as investors insist on an inflation premium when prices are rising. Lowering these taxes therefore puts downward pressure on interest rates.

Critics contend that government borrowing puts offsetting upward pressure on interest rates. This claim may be true, but the effect is very small. Even big shifts in government debt have no discernable effect on interest rates because global capital markets are immense, with trillions of dollars changing hands every day. Those who fear that tax cuts will drive up interest rates should recall that interest rates fell after Congress enacted President Reagan's sweeping tax rate reductions.

Conclusion. The argument for supply-side tax policy is simple: Lowering tax rates on productive behavior will improve the incentives to work, save, and invest. That argument is true when the economy is performing well, but it is even more true when the economy is struggling. Critics may argue that President Bush's proposed tax cuts are too big and too risky, but there is no evidence to support their assertions.

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