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Make the Tax Cuts Permanent and Fully Effective Now

Lawrence H. Whitman

The Senate's failure to make last year's tax rate cuts permanent and fully in effect now is hurting America's workers and families, the economy, and the stock market. By fostering uncertainty, the current policy is reducing investment, limiting job growth, slowing the economy, and depressing the stock market. Specifically, the 2001 tax cut legislation—which lowered tax rates by one percentage point immediately and reduces them further over the next few years—expires in 2011, allowing most tax rates to return to pre-2001 levels and imposing probably the largest tax increase in history on workers and families. The temporary and delayed structure of this policy is wrong. The President should demand that Congress make the tax rate reductions permanent and fully effective now for four reasons.

Reason #1: Certainty about tax rates improves general incentives to work, save, and invest. In tax policy, certainty, immediacy, and permanence are commonsense principles that lead to positive results, while uncertainty breeds caution and makes it much more difficult for people and businesses to plan properly. In particular, uncertainty about how much the government will punish success—that is, how much of additional income it will take in taxes—in the future discourages people and businesses from saving and investing today.

Because temporary tax rate cuts do not fundamentally lower government-imposed barriers (such as high tax rates) to working, saving, investing, or developing a business, they prompt people merely to shift the timing of those activities. Some policymakers suggest preventing the tax rate cuts from becoming permanent; workers, investors, and entrepreneurs understand this risk and discount the likelihood that the tax rate cuts will last. Making the tax rate reductions permanent and fully in place now would remedy this problem, bringing the benefits of those tax rate cuts forward to today, providing greater certainty about future tax rates, and increasing incentives to work, save, and invest today.

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Reason #2: Making the tax rate cuts permanent and fully effective now would especially help small businesses and workers. Small businesses are the engine of the economy, creating countless jobs. Many small-business owners pay the top individual tax rate. They make decisions about investing, expanding operations, and hiring based on anticipated future *after-tax* profits, thus making the top tax rate critical to job creation. If they are uncertain about how much the government will punish their success—that is, take in taxes—or if they are certain that tax rates will rise in the future, then they will resist expanding their operations now. After-tax profits likely will not exist in the future to support that growth. Small firms, then, are particularly sensitive to tax rates. Therefore, making the tax rate reductions permanent and fully effective now would help workers and families and spur small business growth immediately, prompting higher wages and lower unemployment.

Failing to make the tax rate cuts permanent not only harms workers and small businesses now, but also would dramatically hurt people in the future. Policymakers must remember that they cannot help employees by punishing employers. Clearly, repealing the tax rate cuts would even more severely harm both small businesses and workers.

Reason #3: Making the tax cuts permanent and fully effective immediately would bolster the recovery now and foster greater growth over time. The economy is an aggregation of the actions of people in their roles as producers (particularly small business owners) and consumers. Though the economy is rebounding from a recession, it could perform better. Making the tax rate cuts permanent and fully effective now would lower government obstacles and increase the rewards for working, saving, investing, and developing a business. In the long run it also would create more jobs, increase wages, expand prosperity, and decrease poverty.

Reason #4: Making the tax rate cuts permanent and fully effective now would improve the stock market. The stock market, which represents people's current collective view of future conditions, has fallen sharply since its peak in 2000. Uncertainty exists regarding the war on terrorism, war with Iraq, the health of the economy, and the promise of lower tax rates. Investors, like business owners, make decisions based on anticipated *after-tax* returns. Because financial markets look forward and are sensitive to unknowns, building confidence in the future would lead to more investment and higher stock prices now. By reducing government's multiple taxation of investment, making the 2001 tax rate cuts permanent and fully effective now would increase incentives to invest in stocks, improving stock market conditions now.

The Federal Budget. Making the tax rate cuts permanent and fully effective now would likely lead to more, not less, tax revenue than government collects now. A more robust economy—particularly in the long run—would increase incomes and thus federal tax revenue (though the latter should not, in itself, be a policy goal). Yet tax cut opponents still cite concerns about the budget. Some even mistakenly advocate postponing or repealing parts of the tax cut as a way to balance the budget. Either policy would harm people, the economy, and the stock market but not improve the government's budgetary situation. The economy drives the federal budget, not the other way around. The keys to balancing the budget are economic growth and restraining government spending, not higher tax rates on people.

Government should not act like a business and try to bring in as much money as possible. In fact, it should take from people only as much money as it needs to fund truly essential functions in the most efficient—that is, economically least destructive—way possible. Policymakers should move away from the flawed goal of maximizing government tax revenue and toward the correct goal of maximizing economic growth by limiting the size of government and lowering tax rates on working, saving, investing, and developing a business.

Conclusion. President George W. Bush should demand that Congress make the entire 2001 tax cut package—particularly the rate cuts and death tax repeal—permanent and fully effective immediately. Such a policy would remove economically damaging uncertainty about tax rates and instantly improve incentives and lower government barriers to working, saving, investing, and developing a business. Workers, families, the economy, and the stock market would benefit from this wise policy.

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NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

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MAKE THE TAX CUTS PERMANENT AND FULLY EFFECTIVE NOW

LAWRENCE H. WHITMAN

The Senate's failure to act on legislation that would make last year's tax cut package permanent and fully in effect now is hurting individuals, families, the economy, and the stock market. By fostering uncertainty and undermining long-term investment, the current policy is curtailing investment, limiting job growth, slowing the economic recovery, and depressing the stock market, which is especially sensitive to uncertainty about the future.

Because of a misguided Senate budget rule, the tax cut package passed last year in the Economic Growth and Tax Relief Reconciliation Act of 2001[1]—which lowered tax rates by one percentage point in 2001 and will reduce them further over the next few years—expires at the start of 2011. Unless policymakers act beforehand, many tax rates not only will increase in 2011, but also, like other provisions in the tax code, will revert to their pre-2001 levels. The temporary, delayed, and uncertain nature of the present tax policy is wrong and counterproductive. The sooner policymakers correct this mistake, the less damage it will cause to American individuals and families, small businesses, the economy, and the stock market.

The economy has been recovering from last year's lows, but the growth has not been steady or robust. After growing in the first quarter of this year at a 5.0 percent annual rate, the pace of expansion slowed in the second quarter to just 1.3 percent.[2] While the government's early report for the third quarter suggests that the pace of economic growth accelerated to 3.1 percent,[3] this level of economic expansion falls short of the rates of historical post-recession recoveries.

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1. Public Law 107–16, also known as EGTRRA.
2. U.S. Department of Commerce, Bureau of Economic Analysis, news release, September 27, 2002, at *http://www.economicindicators.gov/*.
3. U.S. Department of Commerce, Bureau of Economic Analysis, news release, October 31, 2002, at *http://www.economicindicators.gov/*.

The stock market has been doing far worse than the overall economy. During the first three quarters of the year (from the beginning of the year through September 30), the Dow Jones Industrial Average declined 24.2 percent; the Standard & Poor's index of 500 stocks fell 29.0 percent; and the technology-heavy NASDAQ plummeted 39.9 percent.[4] Despite a subsequent reversal of this trend in October, market indices are still down for the year and far below their all-time high marks.

Because of misguided concerns about the federal budget, the 2001 tax rate reductions are scheduled to phase in slowly over time; the lower income tax rates will not be fully phased in until 2006; and the death tax rate cuts will not be fully phased in until 2010. When the tax cuts expire in 2011 and tax rates revert in most cases to their pre-2001 levels, Congress will in effect be imposing probably the largest tax increase in history.

In attempting to address this issue, the House of Representatives passed a bill (H.R. 586) to make the entire 2001 tax cut package permanent, but the Senate failed to vote on it. Similarly, the House also passed a bill (H.R. 2143) to make the repeal of the death tax permanent; but while a majority of the Senate supported that bill, opponents of tax cuts used Senate procedures to block their will. In fact, in testimony before Congress's Joint Economic Committee, Federal Reserve Board Chairman Alan Greenspan warned of the dangers of failing to make the tax rate cuts permanent: "It would probably be unwise to unwind the long-term tax cut."[5]

President George W. Bush should demand that Congress make the entire 2001 tax cut package permanent and fully effective immediately. Such a policy would remove unnecessary and economically damaging uncertainty regarding tax rates. It also would permanently and instantly lower government barriers—and improve incentives—to working, saving, investing, and developing a business. This prudent policy would benefit American workers, families, businesses, the stock market, and the economy.

FOUR KEY BENEFITS OF MAKING THE TAX CUTS PERMANENT AND FULLY IN EFFECT NOW

Making the tax rate cuts permanent and fully effective now is the right short-term and long-term policy for four key reasons.

Reason #1: Certainty about tax rates improves general incentives to work, save, and invest.

People act on their ambitions and expectations of the future. In tax policy, certainty, immediacy, and permanence are commonsense principles that lead to effective planning. Uncertainty about the future breeds caution and makes it much more difficult for people and businesses to plan properly.

Today, there are many unknowns about the future—the war on terrorism and possible terrorist attacks, a potential war in Iraq, the health of the economy, and the promise of lower future tax rates. Although some of these things are difficult for policymakers to control, tax policy is something they can control. The uncertainty about how much the government will punish success—that is, how much income it will take in taxes—in the future is causing economic stagnation now. As Princeton University Economics Professor Harvey S. Rosen noted earlier this year, after studying the effects of permanent vs. temporary tax rate reductions, "Clearly, it is undesirable to have massive uncertainty about what the tax law will look like at the beginning of the next decade."[6]

Temporary tax rate reductions do not lower government-imposed barriers to working, saving, investing, and developing a business; instead, they cause people merely to shift the timing of such productive activities. In contrast, making last year's tax rate cuts permanent would reduce uncertainty about tax rates in the future and would genuinely lower government obstacles to those activities. As Professor Rosen explains, "A natural way to resolve the uncertainty is to pass legislation now to make EGTRRA [the Economic Growth and Tax Relief Reconciliation Act of 2001] permanent."[7]

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4. "Market Watch," *The Wall Street Journal*, October 1, 2002, p. C1.
5. Edmund L. Andrews, "Fed Chief Says He Backs Bush on Tax Cut," *The New York Times*, November 14, 2002.
6. Harvey S. Rosen, "The Case for Making the Tax Cuts Permanent," Unpublished Working Paper, February 27, 2002, p. 1.
7. *Ibid*.

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Making the tax rate reductions fully effective now instead of slowly phasing them in over several years would bring the future benefits of those changes forward to today and provide even greater certainty about tax rates in the future. Tax rate cuts now help the economy substantially now. While making the tax rate cuts permanent would be an important and positive step, making the tax rate reductions fully effective immediately would be an additional improvement. Tax rate reductions that take effect in the future would help the economy more in the future but will have less effect on incentives now to work, save, invest, and develop businesses. Tax rate cuts now would dramatically benefit the economy now.[8]

Future tax rate reductions are uncertain because politicians ultimately may decide to delay them further or prevent them from occurring at all. Already, Senate Majority Leader Thomas Daschle (D–SD) has gone on record against the 2001 tax cuts, stating "I don't believe we ought to make those tax cuts permanent."[9] Senator Edward Kennedy (D–MA) has called for delaying the scheduled cuts, and Representative Ellen Tauscher (D–CA) has suggested postponing planned rate cuts if there were no budget surplus.[10] Workers, investors, and entrepreneurs understand this risk and thus discount the likelihood that the tax rate cuts will materialize in the future.

Tax cuts delayed usually mean tax cuts denied. Tax cuts subject to a budget surplus "trigger" likely will not happen, since politicians almost certainly will find ways to spend the people's money. From a budget perspective, a real trigger should be placed on government spending rather than on tax rate cuts. Moving the tax rate reductions scheduled for the future to the present would decrease the drag on the economy today and remove uncertainty about whether the policy will ever take place.

Reason #2: Making the tax rate cuts permanent and fully effective now would especially help small businesses and workers.

Small businesses are the engine of the economy and create countless new jobs. Many small-business owners pay taxes through the individual income tax rather than the corporate income tax, often paying the top individual tax rate. These entrepreneurs make their decisions about whether to invest, expand, and hire more people based on their anticipated future *after-tax* profits.

That relationship is why the top tax rate is critical to new job creation. If entrepreneurs are uncertain about how much the government will punish their success—that is, take from them in taxes—in the future, or if they know that tax rates definitely will rise in the future, then they will resist expanding operations today since the after-tax profits needed to support that growth likely will not materialize.

Small firms, then, are particularly sensitive to tax rates. A study released by the National Bureau of Economic Research (NBER) that looked at changes in small firms between 1985 and 1988 (when the tax rates changed) highlights this relationship. Its authors conclude that "the greater the decrease in the sole proprietor's marginal tax rate between 1985 and 1988, the greater the increase in the size of his or her business."[11] Therefore, making the tax rate reductions permanent and effective now would immediately increase confidence and would spur small-business growth, prompting increased wages and lower unemployment among workers, and increasing jobs and prosperity for workers and families today.

8. Even for individuals with forward-looking expectations, the uncertainty over the timing and duration of the tax rate cuts could lead to inaction. Removing this uncertainty, therefore, would allow these individuals to assess their future more accurately and to derive greater benefit from their tax savings.

9. "Senate Democrats to Fight Making Tax Cuts Permanent, Daschle Says," Bureau of National Affairs, *Daily Report for Executives*, November 12, 2002, p. G1, at *http://pubs.bna.com/ip/BNA/der.nsf/is/a0a6d5t4u5*.

10. See Ellen Tauscher, "Tax Cuts Only When We Can Afford Them," *The Washington Post*, January 9, 2002, p. A19; see also remarks of Senator Edward Kennedy at the National Press Club, January 16, 2002.

11. See *National Bureau of Economic Research Digest*, April 2001, at *http://www.nber.org/digest/apr01/w7980.html*, quoting from Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Personal Income Taxes and the Growth of Small Firms," National Bureau of Economic Research *Working Paper* No. W7980, October 2000.

Conversely, failing to make the tax rate cuts permanent not only harms workers now, but also would dramatically hurt people in the future. If the tax rate reductions are not made permanent and instead expire in 2011, the increase in many tax rates that year to pre-2001 levels will probably mean the largest tax increase in history. People whose wages had grown faster than inflation between now and 2011 would face higher tax rates in 2011 than they did in 2001. (See text box, "The Cost to People in 2004 of Repealing the 2001 Tax Cuts in 2003.")

Even if only the top individual tax rate returned to its pre-2001 level, workers not paying that rate would suffer along with those who face that rate increase. The reason: Many people who pay lower tax rates work or would like to work at small companies whose owners pay the top tax rate. Imposing high tax rates on small-business owners forces them to reduce their payrolls and/or workers' salaries.

Congress, by failing to make the tax rate cuts permanent and allowing the rate reductions—especially the reduction in the top rate paid by many small-business owners—to expire in 2011 is thus effectively imposing a tax increase on small businesses that hurts both their current and potential workers. As the authors of the NBER study pointed out, their findings were "consistent with the view that raising income tax rates discourages the growth of small businesses."[12]

Policymakers cannot help employees by punishing employers. By increasing certainty about the future, making the 2001 tax rate cuts permanent and fully effective immediately would increase the benefits of the rate reductions for all taxpayers. Government would take less in taxes from people, and people would know going forward that they would keep more of their own money. Government would decrease its punishment of working, saving, investing, and developing a business but increase incentives (rewards) for engaging in those productive activities. With permanent and immediate tax rate reductions, small-business owners would have greater resources to hire people and increase salaries right away, as well as greater confidence that they would have the means to do so in the future.

Reason #3: Making the tax cuts permanent and fully effective immediately would bolster the recovery now and foster greater growth over time.

The economy is an aggregation of the actions of people in their roles as producers and consumers. The actions of small-business owners and others reverberate throughout and affect the entire economy.

Though the economy is rebounding from its recession, it could be performing more strongly; but doubts persist about its prospects. Making last year's tax cut package permanent and completely effective now would bolster the recovery and foster even greater growth by creating more jobs, increasing wages, expanding prosperity, and decreasing poverty. Such a policy also would lessen the chances of another slowdown—a situation known as a "double-dip" recession.

Not making last year's tax cut package permanent creates unnecessary and counterproductive uncertainty that makes it difficult for individuals and businesses to plan for the future. The problem faced by small-business owners who are considering expanding their operations is just one example of the detrimental economic effects of not making the tax rate cuts permanent. The current uncertainty also distorts the decisions of those who are trying to plan for the death tax.

Under current law, the death tax burden declines slowly over 10 years until it is eliminated in 2010. Unless something is done, however, in 2011 it will return with punitive rates.[13] This bizarre scenario makes it impossible for people to plan their finances, since they cannot know when they will die and be subject to the death tax. Clearly, people cannot count on dying in 2010 when there will be no death tax. Therefore, small-business owners, farmers, and others must assume that the death tax will still exist and must employ costly and otherwise economically unproductive tactics to minimize

12. Carroll *et al.*, "Personal Income Taxes and the Growth of Small Firms," abstract.

13. For more on the effects of the return of federal estate transfer taxes, see Alfredo B. Goyburu, "The Economic and Fiscal Effects of Repealing Federal Estate, Gift, and Generation-Skipping Taxes," Heritage Foundation *Center for Data Analysis Report* No. CDA02–08, November 15, 2002.

THE COST TO PEOPLE IN 2004 OF REPEALING THE 2001 TAX CUTS IN 2003

RALPH A. RECTOR

Repealing the Bush 2001 tax plan in 2003 instead of making the tax cuts permanent and fully in effect would increase taxes or reduce refunds for filers in all income classes in 2004. (See Table 1.) Overall, the rate of increase in income taxes after refundable credits would be greatest for those with incomes between $10,000 and $30,000. Many tax filers with incomes less than $15,000 would notice the tax change as a reduction in their refundable tax credits. Taxpayers with incomes over $500,000 would have the smallest percentage increase.

All tax filers, including those with incomes under $10,000, would lose the benefit of the new 10 percent tax bracket. This new bracket lowers the tax rate on the first $6,000 of income for single filers and the first $12,000 of income for married couples filing jointly. The new bracket is a major source of tax relief for tax filers with incomes less than $100,000.

Families with incomes between $10,000 and $30,000 would also lose the benefits provided by changes in the child tax credit. Repealing the 2001 tax cut would reduce the value of the child credit by over 15 percent in 2004. In addition, many taxpayers who pay little if any tax would no longer qualify for the refundable child credit. Prior to the Bush tax plan, the credit was refundable only for families with three or more qualifying children.

Table 1 — B1614

The Effect on Taxpayers in 2004 If the Bush Tax Plan Is Repealed in 2003

Adjusted Gross Income Class (2002 Dollars)	Percent of Income Tax Returns	Percent Increase in Average Tax After Refundable Credits
ALL	100.0%	8.8%
$1 – $10,000	18.5	8.1
$10,000 – $20,000	16.5	74.2
$20,000 – $30,000	13.5	44.9
$30,000 – $50,000	18.5	15.1
$50,000 – $100,000	22.2	10.1
$100,000 – $500,000	9.4	6.5
Over $5000,000	0.5	4.4

Note: The Percentage Increase in Average Tax refers to a change in the federal personal income tax after refundable credits and includes an inflation adjustment. Average increases for income classes below $20,000 reflect lower refundable credits. Taxpayers with adjusted gross income (AGI) of less than zero are included in the total. The averages are based on projections of the total number of tax returns filed. The effective date for the tax change is assumed to be January 1, 2004. Tax changes include estimates for the child credit, individual marginal rates, the 10 percent bracket, limitation of itemized deductions, the personal exemption phaseout, the standard deduction, the 15 percent bracket, the earned income tax credit (EITC), and the alternative minimum tax (AMT).

Source: Calculations used The Heritage Foundation's Center for Data Analysis microsimulation tax model. This model estimates the change in federal taxes for a representative sample of federal income tax filers using data from the Public Use version of the 1995 Tax Model File produced by the Statistics of Income (SOI) Division of the Internal Revenue Service. Data from the SOI file have been supplemented with additional information from the March 1996 Current Population Survey (CPS) produced by the Bureau of the Census. The March 1996 CPS contains family income information for 1995. The 1995 data from the SOI and CPS have been "aged" to 2004 using a forecast produced from the WEFA macroeconomic model, which has been calibrated to the 2001 baseline economic assumptions published by the Congressional Budget Office.

Repealing the tax rate reductions, which are the source of important economic incentives, would be particularly noticeable for taxpayers with incomes over $50,000.

the future effects of that tax. Consequently, they divert resources from economically constructive activities, such as saving, investing, and business development, to economically less productive tax techniques designed only to limit their exposure to the death tax.

This inefficient result harms the economy today as people engage less in those productive activities and more in trying to reduce their death tax liability. Making last year's tax cut permanent and fully effective now would decrease their uncertainty about future tax conditions and allow the resources that otherwise would be used to meet that uncertainty to flow to beneficial activities that help the economy today, creating jobs and increasing wages immediately.

Many economists across the range of ideologies have suggested that the economy would benefit from eliminating the death tax. For example, Joseph Stiglitz, a Nobel Prize–winning economist and Chairman of the Council of Economic Advisers under President Bill Clinton, has observed that if the death tax does lower saving, then the pool of money to invest will fall, resulting in lower wages for workers.[14]

Recent research has found that the death tax does, indeed, decrease saving.[15] One study suggests that eliminating the death tax would significantly benefit the economy by resulting in a 1.5 percent increase in wealth accumulation.[16] Clearly, making last year's tax cut permanent and fully effective now would eliminate death taxes immediately, quickly bringing about enormous benefits to the economy and even to workers who would not pay death taxes.

Taxes inflict a cost on the taxpayer and the economy because they distort incentives and, as a result, economic activity. The more government taxes something (working, saving, investing, or developing a business), the less it occurs. This economic loss surpasses the revenue government takes and represents sheer waste for the economy. The higher the tax rate, the greater this waste will be.

Another study suggests that the last dollar of tax revenue collected by the U.S. government costs 33.4 cents in terms of this waste imposed on the economy.[17] Using this figure, Professor Rosen estimates that the current tax rate reductions in 2010 will decrease this loss by $39.5 billion—"about the size of last year's tax rebate."[18] Making the tax rate cuts permanent would make the reduction in waste permanent, and making the tax rate cuts fully effective now would accelerate that benefit to today instead of postponing it to 2010.

Since small businesses are central to the U.S. economy, the effects of tax policy on small businesses are key. High income tax rates are a drag on small business development. Consequently, making permanent the income tax rate reductions enacted last year would spur small business growth, as noted above, expanding jobs and increasing wages. And, again, making the tax rate reductions effective immediately would bring those benefits forward to today. Potential entrepreneurs would be more inclined to start their own businesses, since they would be certain about the tax rates they would face.

While it is not easy to determine exactly the extent of the beneficial effects of tax rate reductions on the overall economy, one study estimates that a 5 percentage point reduction in income tax rates would lead to a 0.2 to 0.3 percentage point increase in the economy's growth rate.[19] This increase in growth may sound small, but such a change would have dramatic results over time.

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14. Joseph E. Stiglitz, "Notes on Estates Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Public Economics*, 1978, pp. S137–S150.
15. Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," National Bureau of Economic Research *Working Paper* No. 7960, October 2000. See also Douglas Holtz-Eakin and Donald Marples, "Distortion Costs of Taxing Wealth Accumulation: Income Versus Estate Taxes," National Bureau of Economic Research *Working Paper* No. 8261, April 2001.
16. Kopczuk and Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors."
17. Dale W. Jorgenson and Kun-Young Yun, *Investment Volume 3—Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (Cambridge, Mass.: MIT Press, 2001).
18. Rosen, "The Case for Making the Tax Cuts Permanent," p. 3.

Professor Rosen used this figure to estimate that the current policy would increase the size of the economy by $24 billion in 2010, but that making the tax rate cuts permanent would result in an economy that is $349 billion larger in 2020 than it would be if the tax rate reductions expire in 2011, as they currently will do unless policymakers act.[20]

Furthermore, Rosen estimates that making the tax rate cuts permanent would result in an aggregate increase in the size of the economy of roughly $1.9 trillion between 2011 and 2020.[21] In other words, the total increase in the economy over this period would be equal to roughly 20 percent of the size of today's entire economy. Making the tax rate cuts permanent and fully in effect now would dramatically increase these numbers and substantially increase the long-term economic benefits by making those benefits begin today.

No respectable and reasonable economic school of thought maintains that tax rate increases help economic growth. Failing to make last year's tax cut permanent not only hurts the economy now, but also—if policymakers do not remedy the problem before the tax cut expires—will harm the economy in the future. When the tax cuts expire in 2011, the reversion to many pre-2001 tax rates would mean probably the largest tax increase in history, a policy that would substantially depress the economy at that time. Professor Rosen explains it this way: "If these [tax rate] reductions are not made permanent, we should expect to see a decrease in entrepreneurial activity at the start of the next decade, other things being the same."[22] Making the tax rate cuts permanent and immediately effective would avoid this harm to the economy.

Reason #4: Making the tax rate cuts permanent and fully in effect now would improve the stock market.

Even as the economy seems to improve, the stock market has continued to remain at low levels (despite an October rebound) because of the tremendous uncertainty regarding the future. The stock market has been dropping since its peak in 2000, and many investors have seen their investments decline drastically in value—some by 50 percent or more. Making the tax rate cuts permanent and fully effective now would give confidence to these investors and encourage new investors to participate, thereby shoring up the stock market.

Investors receive their returns from stock investments from two components—regular payments (dividends) from companies to their shareholders and increases in the stock price from the time of purchase to the time of sale (capital gains). The government taxes dividends at ordinary income tax rates and capital gains at lower rates. Since government taxes both elements of investment returns (on top of already taxing them through corporate income taxes), the effect on the stock market of changes in tax rates on capital gains provides some insight into how changes in tax rates on dividends might affect the stock market.

As history shows, when capital gains tax rates decrease, stock prices increase. Mark H. Lang and Douglas A. Shackelford of the NBER found that a 1997 reduction in capital gains tax rates had increased stock prices in large part because lower capital gains tax rates made stocks more attractive to potential investors. "[T]he results suggest," they conclude, "that anticipated shareholder taxes affect firm values."[23]

A study in 1999 by David Wyss of Standard & Poor's DRI supports this conclusion. As Wyss notes, "Since the new law passed in 1997, stock prices have soared 30%. About 8 percentage points (or 25 percent) of that rise can be explained by the change in capital gains treatment."[24]

Since lowering tax rates on one part of investor returns (capital gains) improves stock market conditions, reducing tax rates on the other part of investor returns (dividends) should have a similar

19. Eric Engen and Jonathan Skinner, "Taxation and Economic Growth," *National Tax Journal*, December 1996, pp. 617–642.

20. Rosen, "The Case for Making the Tax Cuts Permanent," p. 6.

21. Heritage calculations using Rosen's data.

22. Rosen, "The Case for Making the Tax Cuts Permanent," p. 5.

23. Mark H. Lang and Douglas A. Shackelford, "Capitalization of Capital Gains Taxes: Evidence from Stock Price Reactions to the 1997 Rate Reduction," National Bureau of Economic Research *Working Paper* No. W6885, January 1999, pp. 4–5.

effect. Unfortunately, even if it is made permanent and effective today, the cut in ordinary income tax rates probably would not be as substantial a tax rate reduction as the 1997 capital gains tax rate cut was. Consequently, the positive effects on the stock market likely would not be as great. But making the income tax rate reductions permanent and effective now would still improve stock market conditions.

Further evidence of the positive effects on the stock market of reducing tax rates on dividends is contained in a study of various tax reform proposals by Federal Reserve economist John E. Golub. According to Golub, eliminating taxes on dividends would increase stock market prices.[25] Lowering tax rates on dividends by permanently and immediately reducing ordinary income tax rates would not increase stock prices as much as completely eliminating taxes on dividends would, but the effect still would be positive. The policy would improve the stock market now and in the future because financial markets represent people's current collective view of future conditions.

Financial markets look forward, not backward or just at today; therefore, they are very responsive to perceived dangers and future unknowns. More confidence in the future would lead to more investment and higher stock prices now. Making last year's tax rate reductions permanent and fully effective immediately would reduce an element of uncertainty now—a "risk premium" in the market—and improve prospects for the future.

Investors make investment decisions based on anticipated *after-tax* returns, but the government incorrectly taxes stock dividends as ordinary income. As long as a corporate income tax exists, all other investment returns—both dividends and capital gains—should not be taxed at all, because the government is taxing the same income multiple times. Making the tax rate cuts permanent and fully effective now would raise the benefits of investing in dividend-paying stocks or mutual funds, increasing the incentives of people to invest. Thus, decreasing future market uncertainty and increasing after-tax rewards for investing now would increase investment and thereby improve current stock market conditions today.[26]

Making the tax rate cuts permanent and fully in place today would have a similarly positive effect on the bond market, where prices move in the opposite direction of bond yields (interest rates). Higher bond prices mean lower interest rates. As in the stock market, uncertainty currently exists in the corporate bond market with worries about the ability of companies to repay investors. Consequently, bond investors demand lower prices and, therefore, higher interest rates—a greater "risk premium"—on their investments. By reducing one aspect of risk for bond investors, making the tax rate cuts permanent and completely effective now would decrease uncertainty about the future and lower this "risk premium." The result would increase bond prices and lower interest rates.

Making the tax rate reductions permanent and totally in place today would help the bond market and lower interest rates in another way as well. Taxable bonds (including corporate bonds and U.S. Treasury bonds) pay higher interest rates than do tax-exempt state and local government bonds. The difference between the interest rates on taxable and tax-exempt bonds represents the cost to investors of paying taxes on the taxable bonds—the "tax premium."

Because investors make their decisions based on *after-tax* returns, the after-tax returns to taxable and tax-exempt bonds should be very similar. Therefore, permanently and immediately cutting income tax rates would lower the tax premium and result in lower taxable interest rates. If investors know they will be taxed less in the future on the interest they earn from taxable bonds, then taxable interest rates (pre-tax) will fall.

Golub concludes that tax reform—which would eliminate taxes on interest—would decrease interest rates.[27] As was the case with the taxation of divi-

24. David Wyss, "Capital Gains Taxes and the Economy: A Retrospective Look," Standard & Poor's DRI, June 1999, p. 3.

25. John E. Golub, "How Would Tax Reform Affect Financial Markets?" Federal Reserve Bank of Kansas City *Economic Review*, Fourth Quarter 1995, p. 35.

26. The resulting increase in stock market prices would represent a real increase in asset prices and not a speculative "bubble," because permanently lower tax rates would reduce uncertainty and increase the after-tax rewards of stock ownership, thus making stocks, in fact, a more attractive investment.

dends and the positive effects on the stock market of permanently and immediately reducing income tax rates, the policy would result in lower taxable interest rates, but not so as much as if Congress were to implement fundamental tax reform to eliminate taxes on interest.

THE FEDERAL BUDGET

One additional effect of making the tax rate cuts permanent and fully in effect now is that it would likely lead to higher, not lower, federal tax revenue—particularly in the long run—than government collects now. Yet opponents of tax cuts still cite concerns about the federal budget. Some, like Senator Joseph Lieberman (D–CT), have joined Senator Kennedy and Representative Tauscher to advocate postponing or repealing parts of the tax cut under the guise of attempting to balance the budget.[28]

These claims defy logic, because not making the 2001 tax plan permanent would harm people, the economy, and the stock market while failing to improve the government's budgetary situation. Economic growth and restraining government spending, not imposing higher taxes on people, is the best prescription for balancing the government's budget. As Professor Rosen notes, "In short, the possible budget deficits associated with the new law are no obstacle to making it permanent."[29]

Policymakers who genuinely care about fiscal discipline or fiscal responsibility should focus their efforts on limiting government spending and on permanently and immediately removing government obstacles—that is, high tax rates—to a growing economy. To the extent that a budget problem exists, the fault lies in too much government spending and an economy that is growing too slowly. In fact, studies show that the 2001 tax cuts were the cause of only 8 percent of the decline in the projected 2002 budget surplus and less than 25 percent of the 10-year decrease in the projected surplus.[30] The most important determinant of federal government tax revenue is a rapidly expanding economy—not high tax rates.

Policymakers should remember that the economy drives the federal government budget; the federal budget does not drive the economy. In fact, the slow economy and the falling stock market have been major reasons for the change in the federal budget outlook.[31] Increasing government tax revenue—which should not in itself be a goal of policy—nevertheless would result from a more robust economy.

Some opponents of making the tax rate cuts permanent and fully effective today claim that such a policy would "cost" too much or would "spend" too much money. Such sophistry reveals that these tax cut opponents believe that the money belongs first to the government, to do with as it pleases, and only secondarily to the people who earned it in the first place. In reality, government cannot "spend" money on a tax cut, because the money does not belong to the government. It belongs to the people who earned it.

Government, after all, is not like a business whose objective is to bring in as much money as possible. In fact, government should not take as much money as it can, but rather only what it needs to fund truly vital activities. Policymakers should move away from the flawed goal of maximizing government tax revenue and toward the correct goal of maximizing economic growth by limiting the size of government, having government take from people only as much money as it needs, and doing so in the most efficient—that is, economically least destructive—way possible.

Additionally, it is somewhat contradictory for policymakers who support permanent, immediate, and ever-growing federal government spending to express concerns about the federal budget and advocate tax rate cuts that are temporary, delayed, and shrinking. This position has the relationship completely backwards. To the extent that they exist

27. Golub, "How Would Tax Reform Affect Financial Markets?" p. 32.

28. Dan Balz, "Lieberman Urges Congress to Delay Future Tax Cuts," *The Washington Post*, May 21, 2002, p. A6.

29. Rosen, "The Case for Making the Tax Cuts Permanent," p. 12.

30. Brian M. Riedl, "The Disappearing Budget Surplus Highlights the Importance of Economic Growth," Heritage Foundation *Backgrounder* No. 1599, October 2, 2002, p. 1, at *http://www.heritage.org/Research/Budget/bg1599.cfm*.

31. *Ibid.*, p. 3.

at all, government spending programs should be temporary and continually reviewed. Tax rate cuts should be permanent and immediate so that individuals, families, and businesses can benefit today and better plan for the future.

With permanent tax rate cuts, if at some point in the future policymakers wanted to increase tax rates, they would have to argue and vote openly to do so. In the current situation, unless the tax rate cuts are made permanent, taxes will rise automatically without policymakers having to vote to impose that historic tax increase.

WHAT WASHINGTON SHOULD DO

Although the U.S. House of Representatives passed a bill (H.R. 586) to make the entire 2001 tax cut package permanent, the Senate did not vote on it. Similarly, the House then passed a bill (H.R. 2143) to make the repeal of the death tax permanent; but while a majority of the Senate supported this bill, opponents of tax cuts used Senate procedures to block the will of the majority.

President Bush should demand that Congress make the entire 2001 tax cut permanent and fully effective immediately. Such a policy would remove unnecessary and economically damaging uncertainty regarding tax rates and permanently and instantly improve incentives and lower government barriers to working, saving, investing, and developing a business. Contrary to claims of opponents, by unleashing a more rapidly growing economy, making last year's tax cut permanent and completely in effect now likely would result in more, not less, tax revenue, particularly in the long run, than government collects now. As Professor Harvey Rosen has observed,

> to the extent that the new law stimulates entrepreneurial activity, it will increase incomes, which will make most Americans better off, and, incidentally, increase tax revenues and reduce the deficit. Making the law permanent would lock in these benefits in the future, and reduce the uncertainty facing people today.[32]

Fully implementing the tax rate reductions now would dramatically magnify these gains.

CONCLUSION

Opponents of tax cuts who, under the pretext of so-called fiscal responsibility, fight against making last year's tax cut package permanent and completely in effect now should instead fight to limit government spending and adopt policies—like pro-growth tax rate cuts—that promote greater economic growth. Making last year's tax rate reductions permanent and fully in effect immediately would benefit individuals, families, businesses, the economy, and the stock market.

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32. Rosen, "The Case for Making the Tax Cuts Permanent," pp. 12–13.