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President Bush's Tax Package: Pro-Growth and Pro-Tax Reform

Daniel J. Mitchell, Ph.D.

The Bush Administration has announced a supply-side tax package that will significantly improve the economy and make America more competitive. Its crown jewel is a proposal to eliminate the double taxation of dividend income. This dramatic initiative, which is an important part of fundamental tax reform, will increase investment, improve corporate governance, and attract capital to the U.S. economy.

The White House also has proposed to immediately implement the personal income tax rate reductions that were approved in 2001 but were not scheduled to be fully effective until 2006—fixing a bizarre policy that encourages taxpayers to delay economic activity. In addition, the President is seeking a three-fold increase in the amount of small-business investment that can be immediately deducted ("expensed"), thus reducing a perverse bias in the tax code and taking a further step on the road to fundamental tax reform.

The Problem of Double Taxation. The Internal Revenue Code imposes two layers of tax on corporate income. Companies must pay a 35 percent tax on profits. If the remaining after-tax income is then distributed to shareholders, it is subject to another layer of tax, since individuals must include dividends in their taxable income. Depending on an individual's tax rate, the effective tax rate on corporate income can exceed 60 percent. Moreover, companies generally have to overstate their profits thanks to depreciation, foreign tax rules, and the alternative minimum tax. This income can also be hit by capital gains taxes and the death tax, further exacerbating the tax code's bias against investment.

The President's Solution. The Administration proposes to end the double taxation of dividends by allowing individuals to "exclude" dividends from their tax return, while preserving the current 35 percent corporate tax that is imposed on this income. The President's plan recognizes that dividends are after-tax payments and puts an end to the discriminatory and unfair practice of making individuals pay a second layer of tax on this income.

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Alternatively, the double tax could be eliminated by keeping the tax on individuals and instead allowing companies to deduct dividends—similar to the tax treatment of interest payments to corporate bondholders. While both approaches help to ensure that the income is taxed only one time, the President's approach is simpler to administer and promotes privacy, since individuals presumably would no longer have to report their dividends to the IRS.

Multiple Benefits. Eliminating the double tax on dividend income will increase growth by dramatically lowering the effective tax rate on business equity investment. Tax rates currently can exceed 60 percent, making many investments that could be profitable not worth undertaking. The President's bold proposal will result in more jobs for American workers and more capital for American businesses.

The President's plan will have additional benefits. Currently, subjecting dividend income to an extra layer of tax creates a bias for corporate debt. The White House growth package will put debt and equity on a level playing field, encouraging companies to restructure their finances and improve their balance sheets, reducing bankruptcies.

Another benefit is the plan's impact on investors' attitudes. Current tax law imposes a heavier tax on dividends (distributed earnings) than on capital gains (retained earnings). President Bush's proposal will eliminate this anti-dividend bias, and companies will be more likely to attract investors by offering periodic payments instead of promising capital gains. This will improve corporate governance, since firms no longer will feel as much pressure to boost share prices by making unwarranted claims about future revenue. Investors then will be more likely to judge companies by the dividends paid to shareholders.

International Competitiveness. According to a Cato Institute survey, only three of the world's 30 developed nations—America, Switzerland, and Ireland—double tax corporate income. Given that Switzerland and Ireland have lower corporate tax rates, America has the most punitive and anti-growth treatment of dividends in the industrialized world. This is an embarrassment, and it clearly puts America in a disadvantageous position. Nearly one-fourth of our competitors do not impose any double taxation on dividends, while almost all the rest have policies that provide at least partial protection from double taxation. Eliminating the double taxation of dividends can bring America from last place to first place in this critical measure of global competitiveness. This means more jobs for American workers and more capital for American companies.

Making Tax Rate Reductions Effective Immediately. The President also is proposing to immediately implement the tax rate reductions that are scheduled for 2004 and 2006. This is particularly important for short-term growth since workers, savers, and investors now face a perverse incentive to defer economic activity to take advantage of future rate reductions. Making the tax rate reductions immediately effective will encourage people to earn more income and therefore simultaneously boost consumption and saving. The plan also will be a boon for small business, since a substantial share of "upper-income" taxpayers are non-incorporated companies. Equally important, lower tax rates will make America more competitive in the global economy.

Small Business Expensing. The final supply-side component of the President's growth package is a reduction in the tax penalty on new investment. Under a neutral tax system, companies should only have to pay tax on their net income—the difference between total revenue and total costs. Under current law, however, businesses can deduct only a fraction of new investment expenses in the first year and must wait years to deduct the full cost of a new investment. President Bush's tax reform initiative will help reduce this anti-investment bias by increasing the amount of investment that can be immediately deducted ("Section 179 expensing") from $25,000 per year to $75,000 per year. (Ultimately, lawmakers should allow all investment costs to be immediately expensed, a policy that is part of the flat tax.)

Good tax policy will lead to faster economic growth and more prosperity. President Bush's tax plan meets this test and is also an important step on the road to tax reform. Like the flat tax, it is based on key principles of reform, including low tax rates, taxing income only one time, and taxing companies on profit instead of cost. The President's growth package will create a stronger economy today and a better tax code tomorrow.

—Daniel J. Mitchell, Ph.D., is McKenna Senior Fellow in Political Economy at The Heritage Foundation.