Backgrounder

Published by The Heritage Foundation

No. 2145
June 18, 2008

The Tax Relief Program Worked: Make the Tax Cuts Permanent

J. D. Foster, Ph.D.

Tax relief worked. It put the federal tax burden on track toward its historic norm. Combined with an aggressive monetary policy, tax relief helped to restore robust economic growth following the Clinton recession and subsequent shocks early in the decade. It produced a more growth-oriented tax policy for the long term, helping the economy to weather current storms arising in the housing and capital markets. And it made important strides toward fundamental tax reform.

The 2001 and 2003 tax cuts will expire at the end of 2010 unless Congress acts. Congress should act quickly, making the tax cuts permanent, and then pursue additional pro-growth tax policies. Many major trading partners, including France, Germany, and other countries throughout Europe, are looking to lower tax rates and reform their tax systems to become stronger competitors, while other economic powerhouses such as China and India are bursting onto the scene. Standing still is not an option unless the United States is willing to lose ground consistently and persistently in the international economy.

Tax Relief as Economic Stimulus

The economic boom of the late 1990s was driven by many factors, one of which was a major bubble in the equity values of information technology companies. This was clearly reflected, for example, in the tech-heavy NASDAQ stock index that averaged 1570 in January of 1998; peaked more than three times higher at 5049 on March 24, 2000; and averaged only 2577 in all of 2007. The popped bubble led to a contracting economy in the third quarter of 2000 and

Talking Points

- The 2001 and 2003 tax relief was intended to reduce tax burdens and get the economy growing again. It succeeded on both counts.
- Tax relief was also intended as basic tax reform. It largely succeeded by lowering tax rates, reducing the tax bias against saving and investment, phasing out the death tax, and reducing the marriage penalty.
- The net effect of tax relief was to *increase* the tax share paid by upper-income taxpayers. While not a goal of reform, it refutes arguments that tax relief made the tax code less fair.
- Tax relief strengthens the fundamental underpinnings of an economy; it cannot inoculate against all economic shocks, such as the current high energy prices and blows to the housing and credit markets.
- Congress should act quickly to make the tax relief permanent and to enact additional tax relief to enhance the international competitiveness of American workers.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/bg2145.cfm

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

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

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.

again in the first quarter of 2001. The Clinton recession greeted the new President.

The correct policy response involved stimulative monetary and fiscal policies. The Federal Reserve lowered the federal funds rate from 6.5 percent at the start of 2001 to 1 percent by late spring of 2003. President Bush campaigned in 1999 and 2000 on a well-crafted program of individual income tax relief. Congress responded quickly, allowing the President to sign the Economic Growth and Tax Reform and Relief Act of 2001 (EGTRRA) on June 7, 2001.

The 2001 tax relief bill was supposed to strengthen the economy partly through the simple expedient of lowering tax burdens. A contributing factor to the 2001 recession was the oppressively high levels of federal tax extracted from the economy. In the 40 years prior to 2000, federal tax receipts averaged about 18.2 percent of gross domestic product (GDP). In 1998 and 1999, the tax share stood at 20.0 percent, and in 2000, it shot up to tie the previous record of 20.9 percent set in 1944.

Regrettably, Congress chose to phase in much of the tax relief over the ensuing years, depriving the economy of a much-needed immediate tax stimulus. Tax relief in 2001 amounted to only about 0.8 percent of GDP, leaving the tax share at a still heavy 19.8 percent. Even by 2002, the tax share remained just below the modern norm at 18.2 percent despite the drop in tax receipts from a weakened economy. Furthermore, little of the tax relief that really would have helped, such as cutting individual income tax rates, had yet taken effect. Not surprisingly, especially in light of the September 11 terrorist attacks and subsequent corporate scandals, the economy struggled into 2002.

Tax Relief Had Many Goals

The 2001 tax bill had many additional objectives beyond short-term stimulus, including establishing a better tax framework for long-term growth, making the tax code simpler, reducing the tax burden on families, preserving the essential progressivity of the federal individual income tax, and taking a big step toward fundamental tax reform. Some of the major provisions included:[1]

- Eliminating the 10 percent income tax surcharge that created a top rate of 39.6 percent and lowering the top 36 percent rate to 35 percent;
- Reducing most other individual income tax rates;
- A new 10 percent bracket providing additional relief, especially for low-income taxpayers;
- Eliminating the phaseout of personal exemptions and the overall limitation on itemized deductions;
- Phasing out the "death tax" by 2010;
- Doubling the child tax credit to $1,000;
- Eliminating almost all aspects of the tax code that created a marriage tax penalty;
- Expanding incentives for retirement saving; and
- Enacting of a new alternative minimum tax (AMT) "patch" to ensure that AMT taxpayers participate in tax relief and to inoculate taxpayers whose regular income tax liability would otherwise fall below their AMT liability.

More Needed to Be Done

Two facts were plain going into 2002.

First, delaying the full implementation of the 2001 tax cuts was a mistake. The economy had contracted again in the third quarter of 2001 following the September 11 attacks, and employment in the first quarter of 2002 fell by 303,000 jobs.

Second, the economy's accumulated troubles meant that additional and immediate tax relief was needed if employment was to recover soon.

Congress turned to a modern version of a common tax remedy of decades past. In the 1960s and 1970s, Congress often enacted a temporary investment tax credit (ITC) to spur business investment.[2] As a tax device, the ITC has properly fallen out of

[1] For a useful summary of EGTRRA provisions, see "Summary of Provisions Contained in the Conference Agreement for H.R. 1836, The Economic Growth and Tax Relief Reconciliation Act of 2001," Joint Committee on Taxation, U.S. Congress, May 26, 2001, at *http://www.jct.gov/x-50-01.pdf* (June 11, 2008).

[2] A 10 percent investment tax credit (ITC), for example, would allow a business spending $100 on a new piece of equipment to take a $10 credit against its current tax liability while depreciating the remaining $90 under the normal method.

favor, but the principle of encouraging business investment remains sound.

The more correct approach adopted by Congress was partial expensing.[3] Full expensing, or allowing a business to take an immediate and full deduction for the costs of acquiring new plant and equipment, is a core feature of most pro-growth tax reform proposals. Under normal circumstances, businesses must deduct the cost of their equipment purchases over many years in calculating income tax liability. While the total amount deducted is equal to the purchase price, in present-value terms, the amount deducted is considerably less. The result is that businesses face the equivalent of a tax surcharge on investments. Partial expensing allows the business to deduct some portion of its investment immediately, while the balance is taken according to the normal depreciation schedules.

The Wrong Depreciation Can Raise the Cost of Business Investment

Suppose a business purchases a piece of machinery for $70 to be deducted proportionally over seven years, a common period for business investment. The depreciation charge taken each year is shown in the middle column of the table below. Suppose the discount rate reflecting the time value of money is 5 percent. The right column shows the value today of the depreciation taken in subsequent years. The business is able to deduct the full $70, but the present value of those deductions is only $57.90. In this example, the depreciation system has effectively reduced the amount of depreciation allowed by more than 17 percent.

Year	Current Value	Present Value
1	$10.00	$9.50
2	10.00	9.10
3	10.00	8.60
4	10.00	8.20
5	10.00	7.80
6	10.00	7.50
7	10.00	7.10
Total	**$70.00**	**$57.90**

Table 1 • B 2145 heritage.org

Legislation enacted in 2002 included two important provisions for business investment: It increased the amount of investment that small businesses could expense in full from $25,000 to $100,000, and it adopted partial expensing for the balance of business investment in equipment. Specifically, it allowed businesses to expense 30 percent of their equipment purchases; the remaining 70 percent was deducted over time according to the regular schedule. Legislation enacted in 2003 increased the percentage of immediate expensing to 50 percent. According to a recent Treasury Department study, between 55 percent and 63 percent of corporations took advantage of partial expensing, though the extent to which the level of investment was higher as a result remains unclear.[4]

The 2002 tax bill is often overlooked in hindsight because it was a temporary measure by design. However, it remains an important element of the tax story because it represented a sensible policy response to the circumstances and an improvement over the investment tax credit adopted in past years. It reflected Congress's renewed appreciation of the importance of tax policy, specifically depreciation policy, for economic growth. It also reflected a significant, albeit temporary, step toward fundamental tax reform. As evidence of its importance, Congress turned again to partial expensing in the 2008 tax stimulus bill.

Third Time's the Charm

In early 2003, the economy was still laboring. Employment fell by 540,000 jobs in 2002 and by another 287,000 jobs in the first quarter of 2003. Quick, bold action was needed, and Congress came through in May with the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA).

Congress corrected its previous error by making most of the 2001 tax relief effective immediately,

[3] This provision is often called "bonus depreciation," but the use of "bonus" is highly misleading, suggesting a subsidy or extra tax benefit, which it is not.

[4] See Matthew Knittel, "Corporate Response to Accelerated Depreciation: Bonus Depreciation for Tax Years 2002–2004," U.S. Department of the Treasury, Office of Tax Analysis *Working Paper* No. 98, May 2007, at *http://www.treas.gov/offices/tax-policy/library/ota98.pdf* (June 11, 2008).

and it enhanced the partial expensing enacted the previous year to 50 percent. Congress then added two profoundly important additional tax cuts, reducing the top capital gains and dividend tax rates to 15 percent.

The double taxation of corporate income has long been recognized as a serious flaw. It subjects the owners of U.S. corporations to a punitive, anticompetitive, and unfair extra layer of tax.[5] The simple way to view this is that taxation of corporate income creates a wide array of growth-depleting distortions with respect to how, where, and how much to invest and operate. The sum effect of these distortions is reflected in the corporation's net income. Dividends are paid out of a corporation's net income and accumulated capital; i.e., previously retained earnings. The dividend tax therefore magnifies the negative consequences of all the distortions arising from corporate income tax.

A common feature of modern tax reform proposals is to eliminate the double taxation of corporate income, generally by retaining the corporate income tax while eliminating the individual level tax on dividends. The President proposed the complete elimination of the tax; Congress came along most of the way by cutting the rate to match the capital gains rate at 15 percent on most dividends for most taxpayers.[6]

Lower income tax rates, lower dividend and capital gains tax rates, and improved saving and investment incentives offered powerful short-term stimulus and long-term support to the economy. The lower tax burden on the marginal dollar of workers' earnings improved incentives for people to enter the labor force, as well as for those already in the labor force to work more hours. Taxpayers faced lower hurdles to saving. Businesses were able to raise equity capital at lower cost and were encouraged to substitute equity for debt.

A key to long-term prosperity is reducing the tax disincentives facing productivity-enhancing business investments. These disincentives are captured in the marginal effective tax rate (METR) on capital—the rate most relevant to business decisions. According to Treasury Department data, tax relief dropped the METR in the business sector from 27.6 percent to 23.4 percent and economy-wide from 19.4 percent to 16.2 percent.[7]

Tax Relief Worked

The lingering weakness in the economy in 2001 and on into 2003 is sometimes used to suggest that tax relief did not work. As noted above, however, the 2001 tax relief was phased in slowly so that in fact there was little pro-growth tax relief in those years.

The passage of JGTRRA in 2003 started a different story. In the first quarter of that year, real GDP grew at a pedestrian 1.2 percent. In the second quarter, during which JGTRRA was signed into law, economic growth jumped to 3.5 percent, the fastest growth since the previous decade. In the third quarter, the rate of growth jumped again to an astounding 7.5 percent.

Employment, too, began to take off. In the fourth quarter of 2003, payroll employment rose by 311,000 jobs, the fastest growth in two and a half years. Strong job growth continued, hitting a peak growth in 2006 of nearly 2.4 million jobs.

Of course, even the soundest long-term, pro-growth tax policies cannot inoculate an economy entirely against the effects of internal and external shocks. The bursting of the housing bubble and the attendant credit crunch have slowed the economy to a crawl. But there can be little doubt the economy was better positioned to absorb these shocks and will return to strong and steady growth sooner because of the tax relief implemented in 2001 and 2003.

[5] Double taxation arises with the traditional "C" corporation, which is how most corporations are organized. Double taxation does not arise with "S" corporations, which typically are smaller in size but provide their owners with the essential legal protections available to C corporations and are subject to certain limitations with respect to ownership structure.

[6] Before 2003, dividends were taxed at regular individual income tax rates. The new lower rate does not apply to "ordinary dividends," which generally are dividends received from foreign corporations. Lower-income dividend earners face an even lower dividend tax rate.

[7] U.S. Department of the Treasury, "Topics Related to the President's Tax Relief," May 2008, at *http://www.treas.gov/press/releases/reports/president_taxrelief_topics_0508.pdf* (June 11, 2008).

Response to the Critics

Critics of the tax relief note correctly that the recovery from the Clinton 2001 recession was more or less average and in some respects below average when measured by the change in GDP, employment, or real wages. They then use this observation to argue that the tax relief had little effect. This conclusion is wrong for at least three reasons.

First, economic recoveries by their very nature reflect the return of the economy from the nadir of the recession to more or less full employment. A deep recession tends to produce stronger recoveries because the economy has further to go to return to normal. A shallow recession tends to produce a shallow recovery because the economy is only operating a tad below normal. The 2001 recession was brief and shallow. The economy contracted in the third quarter of 2000 by one-half of a percentage point on an annualized basis, by a similar amount in the first quarter of 2001, and by 1.4 percent in the third quarter. With such a shallow recession, a shallow recovery was inevitable.

Second, proponents argued the tax relief would accelerate the recovery and put the economy on a stronger long-term growth path. Considering the ensuing shocks to the economy, including the 9/11 terrorist attacks, corporate accounting scandals, and soaring energy prices, the economy's performance once the full scope of tax relief took effect in 2003 was remarkable. The issue is whether tax relief helped, *not* whether it should have produced the strongest recovery on record. The evidence, especially the coincidence between the full implementation of tax relief and the acceleration of the economy in 2003, strongly suggests that tax relief worked.

Third, tax relief is a standard component of the arsenal of tools to counteract periods of economic weakness. The Congress demonstrated this again in 2008 by passing a poorly crafted yet substantial tax-based economic stimulus package. Critics may erroneously discount the importance of the supply-side effects of changes such as marginal rate reductions. If they were objective, however, they should then acknowledge, according to their own economic lights, the stimulative effects to the demand side of the economy. To argue that the 2001 and 2003 tax cuts were of little or no effect is to denounce entirely the use of fiscal policy as a counter-cyclical tool.

Making the Tax System Less Fair by Increasing Progressivity

One complaint sometimes lodged against the tax cuts is that they were unfair because upper-income taxpayers received large amounts of tax relief. Since taxpayers who earn high salaries pay enormous amounts of tax, a broad array of tax relief centering on tax rates would be expected to provide them with significant tax relief. But the fact is that the tax relief *raised* the progressivity of the federal income tax.

The standard metric for progressivity is the share of taxes paid. A tax system is more progressive when taxpayers with the highest incomes pay greater shares. According to data released by the Treasury Department for 2008, without the tax relief, taxpayers in the highest 1 percent of adjusted gross income (AGI)—that is, those with an AGI above $425,036—would have paid 38.4 percent of all federal individual income taxes. With tax relief, their

Projected Share of Individual Income Taxes in 2008

	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%	Bottom 50%
Income above AGI	$425,036	$164,594	$117,241	$69,687	$35,134	$0
With Tax Relief	39.1	59.4	70.1	85.8	96.9	3.1
Without Tax Relief	38.4	57.8	68.7	85.0	96.6	3.4
Change in Tax Share	0.7	1.6	1.4	0.8	0.3	-0.3

Source: "Topics Related to the President's Tax Relief," May 2008, U.S. Department of the Treasury, *http://www.treas.gov/press/releases/reports/president_taxrelief_topics_0508.pdf* (June 11, 2008).

Table 2 • B 2145 ☎ heritage.org

share rose to 39.1 percent.[8] Similar patterns occur with taxpayers in the top 5 percent, top 10 percent, and top 25 percent of all taxpayers.

Step One: Prevent a Massive Tax Hike

The tax relief of 2001 and 2003 is due to expire after 2010. To prevent a massive tax hike, Congress must enact new legislation before January 1, 2011. Congress should not wait to act. Individuals are making career and investment decisions today, and businesses are making decisions about their investments in plant and equipment today that will result in taxable income in 2011 and beyond. The threat of increased taxes on future income hangs over today's decisions, increasingly discouraging investment and weakening the economy until Congress acts.

Extending current tax policy will be hindered by a systemic flaw in congressional budget processes. The problem is that the Congressional Budget Office (CBO) revenue baseline against which all tax legislation is measured assumes current law, and under current law, the tax relief expires. Thus, extending the tax relief embodied in current law appears as a tax cut. Of course, preventing a tax hike is *not* a tax cut.

The CBO methodology, while long-standing, is fundamentally flawed. In contrast to tax policy, the CBO spending baseline correctly assumes the extension of current spending policy even if the underlying law expires. Step two in tax policy is for the CBO to correct its methodology, establish a level playing field in budget deliberations, and henceforth construct its revenue baselines in the same manner as its spending baselines.[9]

Steps three, four, and five in tax policy are to pursue additional pro-growth tax relief consistent with broad tax reform principles. Neither the 2001 and 2003 tax relief nor its extension will be the final word on tax policy. As the economy continues to expand, tax burdens will continue to rise, and U.S. workers and businesses will continue to lose competitiveness. Congress should look to additional pro-growth tax cuts to maintain and then reduce the tax share of the federal government.

Conclusion

Tax relief enacted in recent years has altered the fiscal landscape profoundly. It helped move tax levels toward historic norms. It helped end the period of slow growth that persisted into 2003. It helped strengthen the foundation for a strong economy in general and built up resistance to the economic shocks, like the housing bubble and credit crunch, of 2007 and 2008. And it was largely consistent with fundamental tax reform principles.

This tax relief should be made permanent, thus preventing a massive tax hike. Then Congress should return to the task of enacting additional pro-growth tax relief.

—J. D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

[8] *Ibid.*

[9] J. D. Foster, "Individual Income Tax Reform," testimony before the Committee on Finance, U.S. Senate, May 13, 2008, at *http://www.heritage.org/Research/Budget/tst061008a.cfm*.