



BRIEF ANALYSIS

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The Bush Tax Plan: Tax Reform in the Making

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President Bush has proposed a tax package to spur economic recovery and promote growth. The President's plan includes accelerating scheduled tax rate cuts, ending the double taxation of corporate income and increasing the amount of capital expenditures small businesses can deduct from their taxable income. The President also wants to simplify and expand tax-favored saving arrangements. These proposals are initial steps toward his long term goal of fundamental tax reform.

The Four Layers of Taxes on Saving. One objective of fundamental tax reform is to eliminate current tax law biases against saving and investment that retard capital formation and reduce productivity, employment and wages. Under the current tax code, income that is spent on consumption is taxed once, but income that is saved is taxed as many as four times.

- Income is taxed when earned, and if it is spent on consumption, there is generally no additional federal tax on the enjoyment of that consumption except for a few selective excise taxes.
- If the earnings are saved, however, the saver has to pay tax on the rewards for the saving — interest, dividends, and capital gains (such as occur when firms retain their after-tax income to make the company grow) — when he or she receives them.
- If the saving was put into corporate stock, there was also a corporate tax to be paid before the income became a dividend or was retained to boost the value of the company.

- If an individual has saved a great deal, the accumulated savings may be additionally subject to the estate and gift tax.

The Figure shows the effect of just two layers of taxes on returns to investors:

- When a corporation retains and reinvests a dollar of profits, \$0.35 goes to pay the corporate income tax, and the shareholder must also pay \$0.13 in long-term capital gains tax on the share's increased value when it is sold, leaving him with \$0.52.
- If the corporation distributes a dollar of profits as dividends, after paying the \$0.35 corporate tax, the shareholder must pay up to \$0.25 in personal income taxes (at a rate of up to 38.6 percent), and the shareholder is left with only \$0.40.

	Dividend Payout	Retained Earning (Capital Gain)
Corporate Income	\$1.00	\$1.00
Corporate Tax	-\$0.35	-\$0.35
= After-Tax		
Corporate Income	\$0.65	\$0.65
Shareholder Tax*	-\$0.25	-\$0.13
= Left to Shareholder	\$0.40	\$0.52
Total Tax	\$0.60	\$0.48

*Note: Dividends are taxed at a rate of up to 38.6 percent; long-term capital gains are taxed at a rate of up to 20 percent.

Source: Institute for Research on the Economics of Taxation.

Eliminating this double tax burden would reduce from 7.5 percent to 4.6 percent the pretax return on assets a company would have to earn to provide a 3 percent after-tax return to shareholders. As a result, much idle capacity would be put to work, and potential investments in new plant, equipment and commercial and residential buildings that could earn more than 4.6 percent but less than 7.5 percent would go forward. The capital stock would expand. Share values would

rise and firms could more easily raise funds to pay for the added capital. Production costs would drop, benefiting consumers. Productivity would rise, employment and wages would increase, and the expanding economy would generate new government revenues.

The President's plan would end most taxes on dividends held outside retirement accounts and provide tax relief to individuals for already-taxed earnings retained at the corporate level. Shareholders would be told each year how much income per share had been retained and reinvested. They would add that amount

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to the cost basis of their shares, which would reduce their future taxable capital gains when they sell the shares.

Three Simplified Savings Plans. President Bush also has unveiled three new proposals to promote saving and to simplify its tax treatment.

Lifetime Savings Accounts (LSAs) would let people set aside \$7,500 (for 2003, indexed for inflation in future years) in after-tax funds from any source each year in addition to any other saving plan.

- Earnings would be tax free.
- There would be no income limits on participation, no minimum holding period and no restrictions on the use of the money.
- LSAs would be ideal for low-income savers who cannot afford to save separately for retirement and emergencies and who are hesitant to put money in IRAs because of the penalties imposed on early withdrawals.

Retirement Saving Accounts (RSAs) would replace current deductible, nondeductible and Roth IRAs.

- As with Roth IRAs, there would be no tax deduction for contributions and no tax on withdrawn earnings.
- RSAs would have a higher annual contribution limit than current IRAs — \$7,500 in 2003, indexed for inflation in future years — with no income limits on participation.

Employer Retirement Savings Accounts (ERSAs) would simplify defined contribution plans to enable more companies to offer such plans to their employees. ERSAs would replace future contributions to 401(k), 403(b) and government 457 plans, SARSEPs, and SIMPLE IRAs.

How the Bush Plan Advances Tax Reform.

Taken together, the President's proposals would largely eliminate the income tax bias against saving and would approach the tax reform ideal. His dividend and capital gains proposals would end the double taxation of corporate income, but their larger effect would be to relieve the personal income tax bias against saving. The President also proposes permanently to triple the amount of investment that small businesses may ex-

pense — from \$25,000 to \$75,000 — thus lowering their net cost of capital.

Common Features of Tax Reform Proposals.

More fundamental reforms would replace the income tax with a “neutral” tax system that is not biased against saving. Neutral tax systems include consumption taxes such as a national retail sales tax or Value Added Tax (VAT). They also include taxes on “consumed income” such as the Armey Flat Tax, the revised USA Tax proposed by Rep. Phil English (R-PA), a savings-deferred income tax such as the original graduated-rate Nunn-Domenici USA Tax or the flat-rate Inflow-Outflow Tax proposed by the Institute for Research on the Economics of Taxation. These proposals have some common features:

- They would end the income tax bias against saving either by deferring taxes on income that is saved — as in a deductible Individual Retirement Account (IRA) or pension — until it is withdrawn for consumption or by taxing the amounts saved up front and excluding the returns from further tax, as with a Roth IRA.
- They would end double taxation of corporate income by taxing it at either the individual or corporate level — but not both — or, perhaps, by collecting a tax at half the normal rate at each level.
- They would let businesses immediately deduct or expense their investment spending instead of depreciating it over time.
- They would eliminate the estate and gift taxes.

Conclusion. Complete tax reform requires permanently ending the corporate income tax, estate tax and gift tax. The temporary 30 percent “bonus” depreciation allowance passed in 2002 was a rational move toward deducting rather than depreciating capital expenditures and should be made larger and permanent. Full-blown tax reform would yield a far simpler tax code and a far larger capital stock. This in turn would engender higher productivity, higher wages and higher incomes across the board.

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