



## **ACCELERATING INCOME TAX RATE REDUCTIONS**

### *President Bush's Plan To Cut Income Taxes Will Have A Significant Impact*

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Last week, President Bush announced a new economic growth package that seeks to inject adrenaline and confidence in a growing (but sluggish) economy, improve the incentives for long-run economic growth, and move the country one step closer to tax reform. Americans for Tax Reform (ATR) in cooperation with American Shareholders Association (ASA) will be issuing a weekly report analyzing different components of the plan. The first report examines the President's proposal to accelerate all scheduled future income tax rate reductions to January 1, 2003. The paper below describes the income tax reduction proposal and explains why Congress should approve the proposal quickly.

#### ***Overview***

President Bush proposed accelerating all future scheduled income tax rate reductions to January 1, 2003. Clearly, the economy is not growing at its full potential, as high-tax rates are lowering the rate of return on capital and thus has been stifling investment, a key variable to the current slowdown. Therefore, accelerating the income tax cuts is a necessary proposal for strengthening the long run growth potential of the economy by providing all taxpayers with greater incentives to work, save, and invest in the economy.

It appears that some opposition has been growing in Congress to this idea. Yet, Congress has already passed the scheduled rate reductions for future years, which only delays economic growth. There is absolutely no justification why these reductions should not be pushed forward to increase economic activity now by reducing the after tax return on capital.

Furthermore, the first rate income tax rate reductions of the 2001 provided short-term support during the business investment slowdown. The income tax rate reductions boosted income growth, which has worked to keep consumers spending, saving, and pay off their debt during the investment slowdown. Yet, the limited size of the first round of reductions will not keep resilient consumer spending lasting indefinitely. With business investment slow to recover, accelerating income tax rates are essential. Moreover, the evidence overwhelmingly demonstrates temporary rebate checks do very little to improve economic growth and that without the tax rate reductions, the US economy would have not recovered as quickly than without the tax cuts. As such, the tax changes should be permanent, marginal rate reductions, not rebate checks.

## ***Improving Long-Term Incentives and Growth***

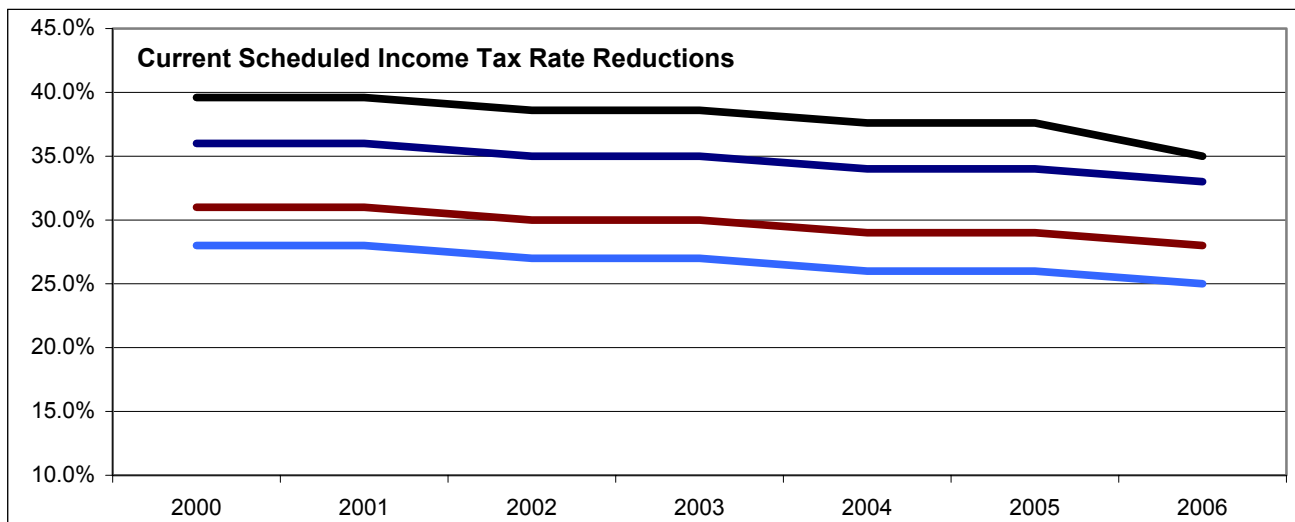
Design of a successful economic growth package first requires understanding why the U.S. economy is not growing at its full potential. The current slowdown has been characterized, unusually, by a turndown led first by business spending followed by a moderation in consumer spending. Clearly, the business slowdown eventually dampened consumer spending over time. As businesses cut back production, layoffs occurred, unemployment increased, income growth (while still growing) slowed and ultimately consumer confidence significantly declined.

The cause of the current slowdown is a lack of capital investment. Capital investment is needed to develop new technologies, which drives productivity. Greater labor productivity, which accounts for 20 percent of all economic growth since 1929, increases job creation, raises the wages of workers, produces more goods and services at a lower cost, and ultimately increases the standard of living for all workers and consumers.

Income tax rate reductions, as proposed by the President, will replenish capital investment by increasing after-tax return rates on capital. Accordingly, the President correctly proposed lowering rates for all income earners, because the income tax on high-income earners is really on tax on capital, not consumption. Moreover, roughly 60 percent of upper-income filers are small businesses, Subchapter S companies, and limited-liability companies. As such, accelerating the income tax cuts will clear the hurdles to capital investment for small businesses, which results in more jobs, increases the wages of employees, and ultimately raises the standard of living for all Americans.

Investment and production is what will create the jobs that will fuel consumer spending, not the other way around. However, the original schedule of the tax cut implementation was too small and too delayed to have a significant, sustained short term or a long term effect to change taxpayers incentives to save, work and invest (Chart 1). Accelerating the rate reductions, as the President proposes, will build on the short, but declining, success of the first round of income tax cuts, while increasing badly needed investment and production in the future.

**Chart 1: Faster, Larger Rate Reductions Needed**



Source: Joint Committee on Taxation, Americans for Tax Reform

## *Learning From The 2001 Income Tax Cuts*

As part of the 2001 tax cut, a new 10 percent income tax bracket was created for a portion of taxable income that was being taxed at 15 percent. The changes to the 10 percent bracket resulted in all taxpayers receiving checks of up to \$300 per person and \$600 for couples to provide for a retroactive tax cut for 2001. Bush's tax cut also reduced the remaining marginal income tax brackets by roughly one percent at the start of years 2002, 2004, and 2006. As such, a temporary rebate check and a small rate cut have already been put in place, which permits for an evaluation of the already implemented tax cuts and what will happen if more significant rate cuts are implemented as the President proposes.

Some opponents of the Bush plan have argued for one-time tax rebates again similar to the 2001 rebate checks, which is the wrong approach to take. Many pundits theorized the rebate checks would lead people to spend money immediately and thus boost economic growth. However, Milton Friedman's "permanent income hypothesis" correctly argued nearly forty years ago that consumers would spend according to what they believe their permanent income is. Under this scenario, a one-time, temporary rebate check would not produce any aggregate increase of economic activity.

Friedman proved to be correct in 1975 when rebate checks provided no new net economic activity as well as in 2001. In the more recent case, University of Michigan economists Matthew Shapiro and Joel Slemrod surveyed consumers before, during, and after the rebates were mailed and found that only approximately 20 percent was spent and the rest saved or used to pay down debt.

Of the money that was spent in 2001, the effect was temporary. In fact, consumer spending relative to business spending increased just in the quarter that the rebate checks were mailed out. **Accordingly, the nominal amount of money that was spent provided at best a one-time jolt to mall sales, which did virtually nothing to improve economic growth. Businesses did not invest more, no new hiring was put in place, workers wages did not increase, and economic growth remained stagnant.**

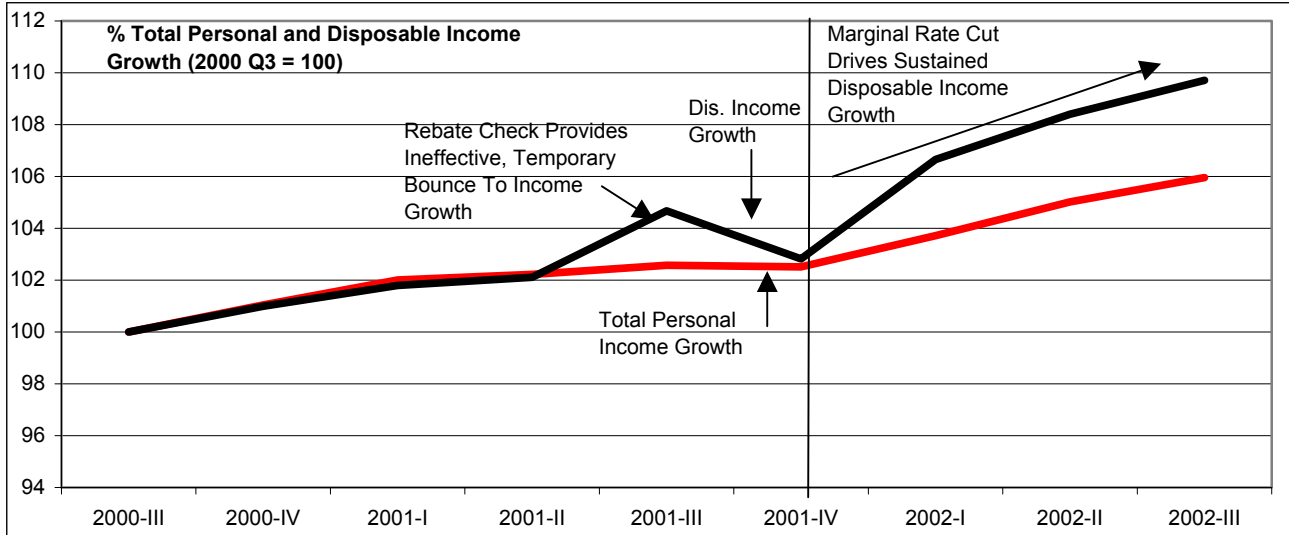
Conversely, the subsequent first round of the marginal income tax rate reductions provided short-term support to the economy's downside risks of declining business investment. As the marginal income rate cuts became phased-in, taxpayers increased their disposable income in their weekly paychecks. Essentially, the tax cut worked similar to receiving a raise by increasing the taxpayer's weekly budget and thus, the taxpayer assigned additional money to new spending (which helped business work off excessive inventories), saving (which increased the pool of money available for capital investment), capital investment (which increased productivity), and/or debt reduction (which drives long-run consumer saving and spending capacity).

Accordingly, household spending has been supported by strong income growth due to the tax cut coupled with record low interest rates (Chart 2). Without question, consumer spending and capital investment is higher today than what it would have been without the tax cut. As we look back, consumer spending is the reason the slowdown was mild. Consumers remained resilient spenders (as investment slowed), purchasing a record number of vehicles and a record number of homes, all while improving long-run household budgets.

As the chart below demonstrates, the rate reductions boosted **sustained** after tax income, which is the main driver for increased consumer spending, saving, and debt reduction. The rebate check, on the

other hand, increased disposable income **temporarily** and disposable income returned to its previous levels in the following quarter. As such, the rebate check provided no additional help to sustaining consumer spending, saving, or debt reduction.

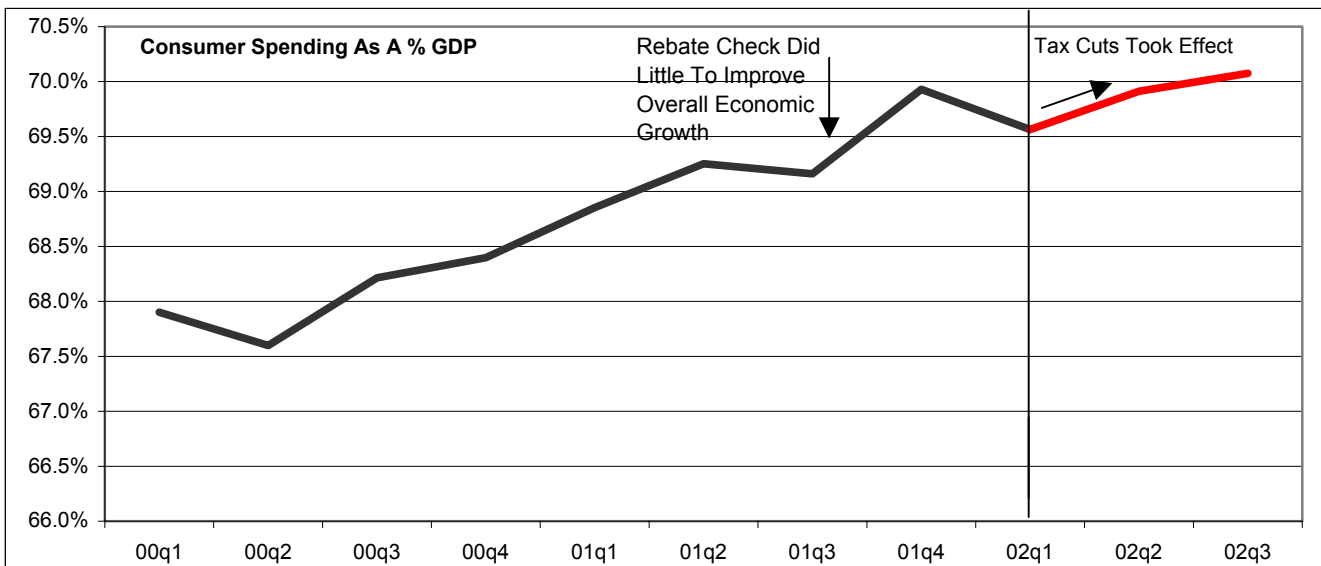
**Chart 2: Income Tax Rate Reductions Drives Income Growth**



Source: Department of Commerce – Bureau of Economic Analysis, Americans for Tax Reform

The chart below examines the consumer spending differences between the rebate checks and the marginal rate cuts. As the chart shows, consumer spending follows the growth of disposable income. The rebate checks provided a small, temporary bump to spending that quickly disappeared in the following quarter. It was not until the marginal rate cuts increased consumers’ **permanent disposable income** that sustained spending growth resumed. This effect is critically important, as consumers need to continue spending until business investment restarts.

**Chart 3: Marginal Income Tax Cuts Lead To Sustained Spending Growth**

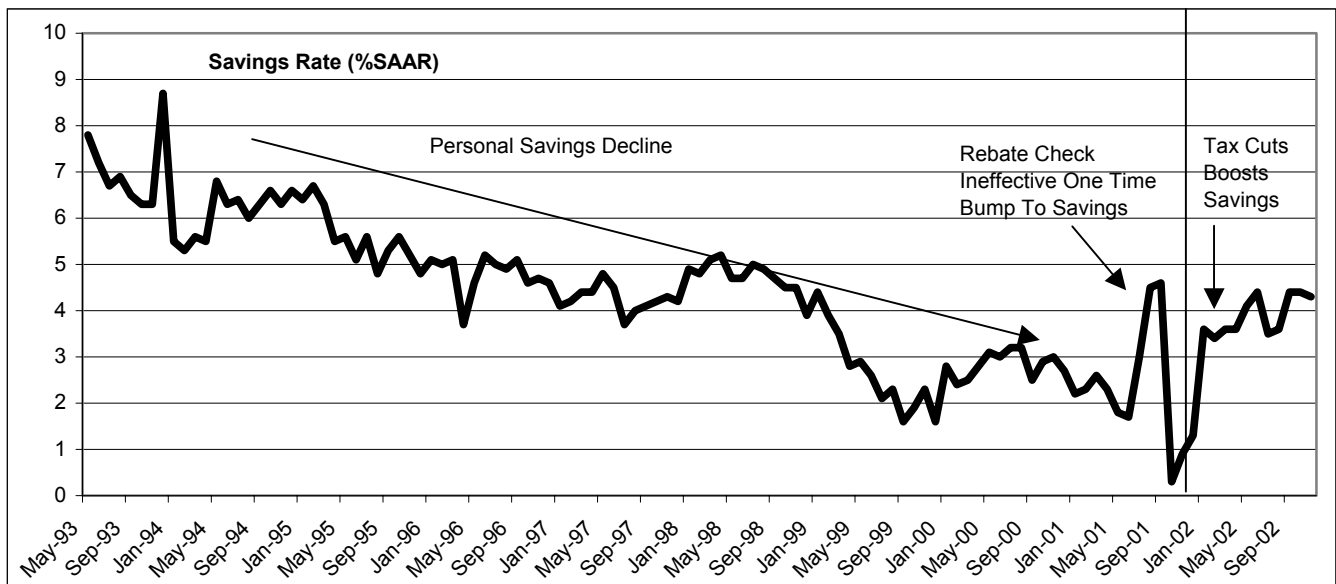


Source: Department of Commerce - Bureau of Economic Analysis, Americans for Tax Reform

The income tax rate reductions also helped to boost personal savings. Personal savings as a percent of after tax income had been steadily declining since the mid 1980's. In fact by 2000, personal savings rate had nearly reached zero. This is particularly alarming since baby boomers are quickly approaching retirement with limited non-Social Security income (and even Social Security is on the brink of insolvency.) Furthermore, reduced savings provides less money available to make capital investments, which drives productivity and subsequently, employment, wage and standard of living growth.

The Bush tax cuts helped to reverse this situation. In December 2001, personal savings stood at just 1.3 percent of disposable income. The tax cuts subsequently followed, and by November of 2002, personal savings increased to 4.3 percent of disposable income. Again, like income and spending, the rebate checks provide a one-time boost to savings but quickly reversed in the months that followed. It was not until the income tax rate reductions were implemented when sustained personal savings increased.

**Chart 4: Personal Savings Turns The Corner**



Source: Department of Commerce - Bureau of Economic Analysis, Americans for Tax Reform

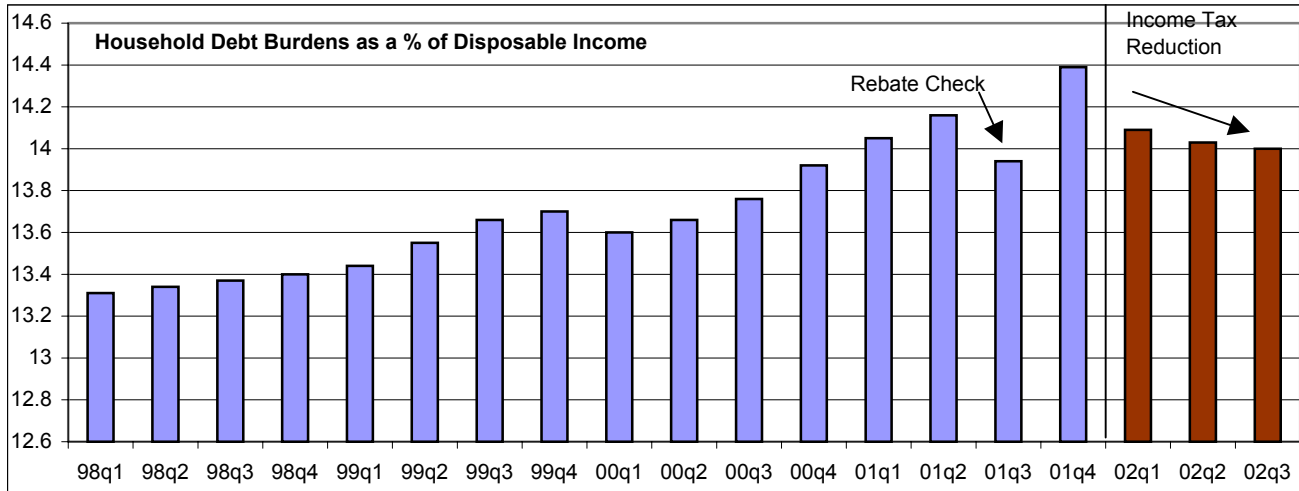
Not only did the reduced income tax rates keep consumers spending and saving, but it also worked to help consumers pay down their enormous household debt burden. In fact, household debt burdens reached nearly \$8 trillion by the end of 2001. If consumers continue to have high household debt burdens, future spending, saving, and capital investment will be severely restrained in the future, thus restricting economic growth.

Again, this time with household debt burdens, the pattern between rebate checks and marginal rate cuts mirrors income growth, spending, and saving. The rebate checks boosted disposable income for one quarter and consumers made a one-time payment to pay down debt. The quarter following the rebate checks household debts burdens significantly increased again.

It was not until the first phase of tax rate reductions effectively worked to provide a successive reduction of debt burdens relative to disposable income. Household debt burdens have now declined three straight quarters since the implementation of the first income tax rate reduction starting in 2002

(Chart 5). The proposed accelerated reductions will allow consumers to allocate more money towards debt reduction, which sets the stage for more aggressive spending and saving in the future.

**Chart 5: Income Tax Rate Cuts Reduced Household Debt Burdens**



Source: Federal Reserve Board, Americans for Tax Reform

In sum, accelerating the marginal rate cuts is necessary to sustained economic growth, both in the short and long-term. The slow rate reduction schedule is restraining taxpayers incentives to work, save, and invest, thus delaying economic activity. Furthermore, the delay is reducing the after-tax return on capital, which is stifling the economy’s long-run growth potential. Congress has already passed these reductions and there is absolutely no justification for delaying these cuts.

The first rate income tax rate reductions of the 2001 package boosted income growth which has worked to keep consumers spending, saving, and reducing their debt during the investment slowdown. Yet, the limited size of the first round of reductions will not keep resilient consumer spending lasting indefinitely. With business investment slow to recover, accelerating income tax rates are essential. Moreover, the evidence overwhelmingly demonstrates temporary rebate checks do very little to improve economic growth and the tax changes should be permanent, marginal rate reductions.

Finally, given the rate reductions proposed by the President are significantly greater than what has been implemented thus far, we can expect greater investment, income, and employment growth in the short and long term.