Where's the Bang for the Buck?

By JEFF MADRICK

Perhaps the highly unequal distribution of gains from the Bush administration's $670 billion in proposed tax cuts would be justifiable if the plan offered the prospect of significant economic growth. But this plan, more than half of which is made up of tax cuts on dividends, would have far less stimulative impact than has been promised in both the short run and the long run. What we have here is a huge tax cut for the rich without a commensurate bang for the buck for the economy.

First, let's consider the trifling short-term stimulus. Originally, the administration suggested that the package of tax cuts would result in a stimulus of more than $100 billion in 2003. But now the administration suggests that the stimulus would be in the range of only $50 billion to $60 billion in 2003, most of that a result of moving the tax cuts approved in 2001 forward, raising child allowances and a few other changes. The dividend tax cut provides almost no near-term stimulus.

In the meantime, some economists are now forecasting another decline in the gross domestic product in the fourth quarter — the dreaded double dip. Several groups, liberal and conservative, are calling for a stimulus of as much as $200 billion. The longer we wait, the further we may fall.

And the long-term benefits of the new tax package — in particular, the dividend tax cuts — are every bit as poorly thought out.

Corporate income is taxed when it is earned. If it is paid in dividends, it is taxed again as income for investors. A cut in dividend taxes should spur corporate investment and long-term growth. But many who believe that such double taxation of dividends results in an inefficient use of capital and encourages too much debt, including this writer, do not believe that the current proposals are an optimal way to encourage growth.

One of the most intriguing questions is raised by an influential group of economists who cut across the political spectrum. This "new view," best represented in the United States by Alan J. Auerbach of the University of California at Berkeley, maintains that when companies invest out of retained earnings, they are in effect deferring the tax that would have been paid by investors had they paid out the money in dividends. It is as if investors simply had the money in a tax-sheltered 401(k) plan. So a reduction in dividend taxes has no stimulative effect on business investment for these companies.

Perhaps surprisingly, research by such noted conservative economists as Kevin A. Hassett of the American Enterprise Institute and even R. Glenn Hubbard, President Bush's own chief economist, is sympathetic to this view.

How good is the theory? George R. Zodrow, an economist at Rice University, has long followed the empirical research and says that one of the most recent studies in the field, by Mr. Hassett and Mr. Auerbach, suggests that the elimination of dividend taxation would encourage only about half the
nation's corporations to invest more.

There are other, more traditional concerns. The White House just forecast that if the tax cut plan is passed, federal budget deficits will reach up to 3 percent of the G.D.P. That is a level that could almost get a member nation thrown out of the European Union.

Such deficits might be acceptable if they were based on temporary government spending, but given that they would be partly caused by permanent tax cuts, they might be with us for a long time.

Jane G. Gravelle of the Congressional Research Service argues that the deficits would probably push up interest rates on borrowing and undermine any stimulative impact of the dividend tax cut on investment or consumption.

At a time when low mortgage rates are a main prop under the economy, allowing Americans to continue to buy houses, a rise in such rates would be particularly counterproductive.

Still another impediment to getting a stimulus from the Bush tax plan is that many corporations pay no taxes at all. William G. Gale and Peter R. Orszag of the Brookings Institution argue that even though the administration is proposing a benefit for those that pay their taxes, too many loopholes would remain, and a large number of companies would still find it more attractive to avoid taxes altogether than to pay dividends. Moreover, they point out that President Bush's proposal would open new loopholes. Mr. Gale says the tax package was hastily put together and just not adequately vetted by the professionals in the Treasury Department.

Finally, many economists say stock prices would go up less than the Bush administration implied as a result of the cuts. A likely estimate is that stocks would rise no more than 4 or 5 percent, or up to $50 billion. Such a rise might induce consumers to increase spending on goods and services by about $20 billion a year, or a paltry 0.2 percent of G.D.P.

The Bush administration is, in fact, offering us, as Mr. Gale says, "a tax cut that is masquerading as tax reform."

If tax reform is what the nation needs, then we should do it right. For one thing, it should be revenue-neutral. The Democrats might consider calling the president's bluff by proposing true dividend reform, but only if the income tax on the wealthy was raised to offset it.

And any reforms of dividend taxes should also be comprehensive. All corporate profits should be taxed at least once. Finally, dividend tax reform would be fully effective only if dividends were deductible for the corporation, not the investor, thereby making them truly comparable to interest on debt.

It is hard to imagine $670 billion in tax cuts that would stimulate the economy less than the Bush proposal. By linking tax reform and a tax cut stimulus, apparently for political reasons, the administration is likely to fail at both.