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Policy Perspective

Tax Relief for Economic Growth

October 11, 2001

The September 11 attacks were aimed at destroying the spirit of the American people, and the strength of the world's leading free market economy.

Economists, policymakers, and President George W. Bush agree that we must address this attack on our economy by providing pro-growth tax relief. Relief through the tax system will have immediate effects and help ensure that the U.S. economy remains the most productive and innovative in the world.

Acting now will help the millions of American workers who have lost jobs or family income as a result of the attacks. These hard-working men and women don't want to join the welfare rolls; they want their jobs, their sales, their customers, and their livelihoods back. Tax relief that makes hiring workers more affordable and investment more profitable is the most effective means to wage the war on terrorism on the economic front.

Step 1: Accelerate Income Tax Relief

Making the income tax rate reductions in the Economic Growth and Tax Relief Reconciliation Act of 2001 effective immediately—instead of slowly phasing them in, as Congress planned during better times—will create immediate and sustainable economic growth.

Increasing take-home pay will put money in workers' pockets, helping them to buy more and to increase their savings. Unlike a one-time payment, which offers no incentive for more work or investment, lower income tax rates will encourage people to work harder and be more productive. Unlike the psuedo-stimulus of a one-time measure, tax rate relief will not only stimulate immediate consumption, but also provide permanent incentives.

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The currently scheduled "sunset" for tax relief must also be repealed. It was never part of an economic plan to begin with, but rather a procedural technicality. It now looms as an enormous, pre-scheduled tax increase that falls heaviest on those who can least afford it. The "sunset" is inhibiting economic growth by making household economic planning difficult, and business investment more risky. Not only must income tax rate relief be accelerated, it must be made permanent as well.

Step 2: Reduce Taxes on Investment

Investment in new technology and other machinery soared during the 1990s, helping to increase productivity and fuel economic growth. But in the past year, business investment in new capital all but dried up—a principal cause of the economic slowdown. Then September 11 hit, and much of the country's economy ground to a halt.

Reducing taxes on new investment will help reverse that trend. One of the most effective ways to do this is to eliminate the unfairness in current depreciation rules, which prevent subtracting legitimate business expenses from sales.

The tax code should not discourage firms from making investments that will boost their productivity. These same investments will also help the firms' suppliers, their suppliers' employees, and even federal, state, and local governments—since the purchase of new equipment is taxable. But under today's IRS rulings, the cost of purchasing equipment doesn't count as an expense for tax purposes. Instead, "depreciation" can take years. In many cases (such as computers and software), the depreciation period is far longer than the useful life of the equipment. Allowing taxpayers to deduct new equipment as a business expense would help the economy immediately, spur hiring, increase output, and enhance productivity.

Step 3: Eliminate the 'Alternative Minimum Tax'

The "Alternative Minimum Tax" (AMT) is a complicated and egregiously unfair provision of the Internal Revenue Code that imposes "income" tax even when a business has no income. Its onerous burden falls on employers, employees, and consumers alike. In the current economic downturn, a firm that experiences real economic losses cannot eliminate or reduce their income tax liability. Legitimate business expenses and capital losses are disallowed under the AMT, forcing financially strapped firms to shoulder an unbearably heavier federal tax burden.

The AMT is also administratively burdensome. Even businesses not liable for the tax must incur the time and expense of extra paperwork and additional calculations, just to determine whether the AMT even applies to them. Nor can this unfair tax be justified as an important federal revenue source: it currently raises only two-tenths of one percent of federal revenues. Moreover, even this paltry amount does not include any recognition of the increased tax revenue that would be generated by repeal of the AMT.

Abolishing this cumbersome, unnecessary, and grossly unfair tax will help every participant in our economy focus on what they do best: serving their customers, hiring workers, and expanding their markets.

Step 4: Reduce the Penalty Tax on Savings and Investment

Savings and investment are the lifeblood of the economy. When individuals and firms invest, businesses grow, create new products, hire more workers, and expand production. This is what makes economic growth possible.

The so-called "capital gains" tax is really a penalty tax on savings and investment. It is very often levied against after-tax income that is deposited in savings or invested for the future—and thus it constitutes double taxation. Because it is not adjusted for inflation, it often taxes "gains" when there are none. And because it applies *only* to income from savings and investment, it discriminates against the very behavior that will most help to grow the economy.

For these reasons, Federal Reserve Chairman Alan Greenspan has called the capital gains tax "counterproductive," and has repeatedly testified before Congress that the best capital gains tax rate would be zero. After every previous reduction in the capital gains tax rate in the last quarter century, the stock market has performed better, and government revenue has increased, as individuals and firms pay taxes on the assets that they sell and reinvest, although at a lower rate. Our most recent experience with cutting the capital gains rate in 1997 showed this effect quite dramatically.

Effects of Changes in Capital Gains Tax Rates—1993-2000

Reducing the capital gains tax rate will encourage savings and investment, create jobs, make our economy stronger, increase federal revenue, and sustain long-term growth.

Conclusion

These four tax reforms will help the American economy in the short term by increasing take-home pay, encouraging work, savings, and investment, and stimulating business to immediately hire new workers. They will also improve our long-term economic prospects by providing permanent, stable, and predictable tax policy for the indefinite future. The values of entrepreneurship and hard work that have made America's economy the strongest in the world are worth reasserting in the wake of the September 11 attacks. These tax law changes will do just that.