



## **Recovery With More Bang for the Buck**

**The Washington Times**

**December 17, 2002**

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President Bush will soon ask the new Congress to act quickly on a package of tax changes designed to revive a flagging economy. Achieving that goal involves more than swapping a dollar of lower taxes for a dollar of higher deficit. Instead of just "cutting taxes" in a generic sense, the idea is to change those parts of the tax code that impede economic growth far out of proportion to the amount of tax revenue they raise - in other words, those that do more harm than good.

Also, the correct choices need to be made among the several potential tax changes that produce a lot of economic growth for relatively little revenue cost. Priority should be given to those remedies most directly related to the particular ills from which the economy is now trying to recover.

Step One on the road to recovery should be to stimulate business investment in capital goods. After all, it is a lack of business purchases, not a lack of consumer spending, that has characterized the current economic doldrums. Consumption has continued to grow for the past two years. But, investment has actually fallen. As a consequence, the growth rate in gross domestic production has declined by a whopping one-third.

The best way to encourage a business to make a capital goods purchase is simple: First, reduce the price the business must pay for the capital item and, second, help finance the purchase. The best tax change to accomplish this double whammy is also simple: Allow the business to deduct the full cost of capital goods in the year of purchase instead of requiring it to defer depreciation deductions into the future. For example, allowing full first-year expensing reduces the after-tax cost of a new high-tech machine tool by 4 percent. Further, the company that purchases the machine for, say, \$1 million, would have a tax deduction worth \$350,000, which it could immediately "take to the bank" to help finance its new capital goods purchase.

Cash-flow help in financing capital goods purchases is important to all business, but is vital to the vast array of "middle class" companies who are not ultra large, but are not necessarily small either. Many of these companies make big-dollar capital investment as fast as they can afford it. They grow very rapidly, often quickly doubling in size, and, in a broad sense, create most of the new jobs in the United States.

As a remedy for what ails the economy, first-year expensing ought to be a slam-dunk. It enjoys bipartisan support in the Congress, is correct tax policy that moves the tax code one

step closer to tax reform and, among all alternatives, provides the highest bang-for-the-buck boost to the economy.

Because capital goods purchases by businesses increase worker productivity and wages, first-year expensing is probably the only "business tax cut" that can garner a large bipartisan majority in both the House and the Senate. Further, because first-year expensing just moves forward in time deductions that would be allowed later anyway, the long-term budget cost is close to zero - even though, during the official 10-year budget window, expensing can get a little costly. The way to hold down the budget impact, while still providing an ample boost to investment, is to enact first-year expensing only for a temporary period. For example, allowing first-year expensing for all capital goods orders between Jan. 1, 2003 and Dec. 31, 2005 would have a total 10-year budget cost of less than \$100 billion.

The best companion for first-year expensing - on the road recovery and on the road to tax reform - is to exclude dividends paid by corporations from the second tax presently payable by shareholders when they receive the dividends. Today, when a corporation earns \$1, it pays a 35 cents tax. If it then distributes a 65 cents dividend to a shareholder, that shareholder is often required to pay an additional 39 percent tax on the dividend. After paying all this tax, there is only 40 cents left out of the original dollar.

Because of a nearly confiscatory 60 percent double tax, dividends have almost gone out of style over the last several decades. From the corporation's standpoint, it has been better to retain cash, even to the point of going out and acquiring some other line of business, rather than a large portion of the cash going to the government when the shareholders receive a dividend. From the standpoint of a shareholder, it has been better to buy stock of companies that "project" large earnings in the future and, then, to sell the stock and pay a tax on the profit at a maximum 20 percent capital gains rate.

As recent scandals have illustrated, excessive reliance on the "projected earnings" puts enormous pressure on a company's financial accountants as well as its own internal financial management. In contrast, investors can be pretty well certain that a cash dividend represents real earnings and real money.

Eliminating the second shareholder-level tax on dividends would greatly increase the real rate of return on all dividend-paying stocks. For example, a dividend-paying stock that had provided a 3 percent tax yield would all of a sudden yield 5 percent. Higher yields will give a major boost to stock values, thereby adding to wealth in the economy. Each dollar of tax relief for dividends will boost the economy by roughly \$2.70, even after taking into account that dividend tax relief applies to old capital as well as to new and, therefore, has a relatively high revenue cost.

Taken together, dollar-for-dollar, first-year expensing and dividend tax relief are the perfect synergistic combination to restart the economic engine quickly and keep it going for the long term. Both are mainstream tax reforms with impeccable policy credentials. Now is the time to enact them both.

If a choice must be made, first-year expensing should come first. It rewards only investments

in new capital, therefore providing the largest bang for the buck, and is most clearly and immediately related to higher worker productivity and wages.

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