WebMemo

Published by The Heritage Foundation

No. 1697
November 7, 2007

The End of Pro-Growth Tax Policy: How the Rangel Tax Bill Could Affect the U.S. Economy

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This week, the House of Representatives may well debate a seemingly innocuous tax bill that is likely to become law. Like many things in Washington, however, this little bill on the Alternative Minimum Tax (AMT) is just a small part of a larger approach to tax policy change that ends up putting trillions of additional tax dollars on the table over the next 10 years. At stake in this debate is a fundamental change in tax policy from emphasizing growth in the economy to emphasizing tax increases that would pay for new and expanded federal programs.

The AMT bill (H.R. 3996, the Temporary Tax Relief Act of 2007) is actually a small part of a larger tax bill (H.R. 3970, the Tax Reduction and Reform Act of 2007). The smaller bill enacts an extension of higher exemption amounts for taxpayers who file under the Alternative Minimum Tax (AMT). It also enacts dozens of individual and business tax breaks for another year (the so-called tax extenders). The House Ways and Means Committee decided to advance the "mini" version first in order to make certain that millions of taxpayers do not have to pay the AMT next year.

The larger bill, however, goes well beyond temporary tax relief bill and repeals the AMT, imposes surtaxes on middle- and high-income taxpayers, broadens the tax base, and imposes new income taxes.[1] Either approach would have negative effects on the economy.

Analysts in The Heritage Foundation's Center for Data Analysis have placed this larger bill under an economic lens to estimate how it would affect the economy. If the larger bill is enacted in its current form, consequences would include the following:

- The U.S. economy would fall significantly short of the potential forecasted for it by the Congressional Budget Office (CBO) earlier this year;
- Job creation would fall below its potential by more than 100,000 jobs per year; and
- The disposable income of households would shrink by more than $30 billion per year from forecasted levels.

H.R. 3970 is part of an even larger approach to tax policy change that focuses on repeal of the Bush tax cuts. Because the Bush tax cuts expire within Congress's current budget window and because the Ways and Means Committee is not moving now to make them permanent, one can only assume that repeal of the President's key tax policies are an unwritten part of the committee's current legislation. If so, the U.S. economy would severely weaken. The economic effects of combining H.R. 3970 with a repeal of the Bush tax cuts would likely include the following:

- The output of the economy as measured by the gross domestic product (GDP), after subtracting

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm1697.cfm

Produced by the Center for Data Analysis

Published by The Heritage Foundation
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Washington, DC 20002–4999
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inflation, would fall by an average of $60 billion per year;

- More than one million jobs would be lost in 2013, and an average of 600,000 would be lost annually over the next 10 years (most of which would be after 2011);
- Disposable income of households (after inflation is subtracted) would fall short of potential by nearly $200 billion per year; and
- Household savings would shrink, investment would decline, and the general pace of economic life would subside.

Economic Positives. Referred to by Chairman Charles Rangel (D–NY) as "the mother of all tax bills," the larger bill (H.R. 3970) contains some good points. Almost everyone supports protecting taxpayers from the AMT; the one-year patch and subsequent full repeal is a step in the right direction. So, too, is the reduction in the corporate tax rate from 35 percent to 30.5 percent beginning in 2009. Not only does the lower rate make doing business in the United States more attractive, but it frees businesses to spend more on expanding their operations, creating new jobs, and developing new products.

Corporate Rate Reduction. To estimate the economic effects of H.R. 3970, Heritage analysts employed the Global Insight U.S. Macroeconomic Model, a widely used model of the U.S. economy.[2] To estimate the independent effects of lowering the corporate tax rate, analysts ran the Global Insight (GI) model with and without the tax policy change and calculated the differences between the economic indicators. This experiment is like driving a car for one hundred miles with one blend of gasoline, driving the same car an additional one hundred miles with a different gasoline mixture, and then comparing the miles per gallon from the two runs.[3]

As Simulation 1 on Table 1 shows, the economy performs significantly better with lower corporate tax rates. The economic indicators are in the first column, and the results are shown by federal fiscal year. After tax relief, every indicator is slightly or significantly above the forecast that does not contain the policy change (what we sometimes call the baseline). Job creation particularly benefits, with more than 200,000 additional jobs (again, above the baseline growth in jobs). The same is true for GDP, disposable personal income, and so forth.

Corporate Rate Reduction Combined with Personal Income Tax Increases. Had the Ways and Means Committee stopped with an AMT repeal and corporate tax relief,[4] workers and taxpayers would be better off than they likely will be under the "mother of all tax bills" that the committee appears ready to advance as soon as the mini version is signed by President George W. Bush. However, to make up for the foregone revenues that corporate tax relief and the AMT repeal are supposed to "cost" the government,[5] the committee chose to raise new taxes.

First, taxpayers above certain income levels would pay a surtax based on their "adjusted gross income," or the income taxpayers report before they subtract their personal exemption and standard or itemized deductions. These same taxpayers (again chosen by their income) would see a cap on itemized deductions imposed and a phase-out of their personal exemptions. Other taxpayers, principally those who work in investment management compa-

1. See J.D. Foster, "The Rangel Tax Bill: Roses Among the Thorns," Heritage Foundation *WebMemo* No. 1679, October 26, 2007, at *www.heritage.org/Research/Taxes/wm1679.cfm*.
2. The Global Insight model is used by private sector and government economists to estimate how changes in the economy and public policy are likely to impact major economic indicators. The methodologies, assumptions, conclusions, and opinions presented here are entirely the work of analysts at The Heritage Foundation's Center for Data Analysis. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the Global Insight model.
3. The methods and assumptions used to develop these estimates will be contained in a methodological note that will be posted as an appendix to this *WebMemo*.
4. Simulation 1 contains just the economic estimates stemming from a lower corporate tax rate.
5. There is a serious question about whether any revenues would be "lost" after the AMT repeal. The losses are based on a forecast of AMT taxpayers and AMT revenues. But, the repeal would presumably put these taxpayers back on the regular tax system, which Congress could reform so as to avoid any significant revenue losses at all.

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Table 1 WM 1697

Economic Effects of Rangel Tax Bill*

Fiscal Years

Simulation 1: Corporate Rate Reduction Only	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real Gross Domestic Product (a)	0.0	3.4	21.4	30.5	31.8	30.3	28.6	25.6	23.9	24.5
Total Employment (b)	0.0	13.4	123.1	213.1	221.2	181.5	136.6	90.2	51.2	30.5
Real Disposable Personal Income (a)	0.0	4.8	29.0	45.8	55.1	62.7	68.6	69.5	70.4	73.1
Real Non-Residential Investment (a)	0.0	2.3	11.5	15.0	15.2	13.9	13.4	13.7	14.6	16.3

Simulation 2: Corporate Rate Reduction Combined with Personal Income Tax Increases	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real Gross Domestic Product (a)	-11.9	-18.2	5.7	3.0	-11.9	-10.6	-6.4	-5.2	-6.8	-9.5
Total Employment (b)	-57.6	-154.7	-38.9	28.1	-101.7	-171.5	-171.6	-172.3	-200.0	-243.0
Real Disposable Personal Income (a)	-27.2	-36.4	-9.3	-29.4	-51.4	-52.7	-49.2	-51.8	-56.3	-61.6
Real Non-Residential Investment (a)	-1.5	-2.2	9.9	14.3	10.4	11.6	15.7	19.0	20.5	22.0

Simulation 3: Full Rangel Tax Bill	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real Gross Domestic Product (a)	-12.0	-16.8	8.5	5.9	-11.0	-11.8	-7.1	-5.5	-6.5	-8.2
Total Employment (b)	-57.8	-148.2	-15.7	60.4	-75.0	-159.2	-157.6	-147.4	-162.5	-190.7
Real Disposable Personal Income (a)	-27.1	-31.5	-0.5	-19.3	-43.8	-46.1	-41.4	-42.4	-45.0	-47.9
Real Non-Residential Investment (a)	-1.6	-2.7	8.9	13.1	8.0	7.8	11.8	14.7	15.4	16.1

Simulation 4: Rangel Tax Bill Combined with Repeal of the Bush Tax Cuts	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real Gross Domestic Product (a)	-12.0	-16.8	8.5	-61.9	-108.2	-97.3	-85.9	-75.7	-66.7	-84.8
Total Employment (b)	-57.8	-148.2	-15.7	-507.6	-955.0	-1,029.2	-907.6	-794.4	-701.5	-899.7
Real Disposable Personal Income (a)	-27.1	-31.5	-0.5	-167.3	-246.8	-250.1	-250.4	-253.4	-253.0	-244.9
Real Non-Residential Investment (a)	-1.6	-2.7	8.9	0.3	-13.4	-3.8	7.7	13.2	13.4	7.2

* This bill repeals the Alternative Minimum Tax, lowers the corporate income tax rate, raises taxes on upper income taxpayers, imposes taxes on investment consulting partnerships, extends a myriad of personal and business tax provisions, and changes tax law on certain types of business expensing.

Notes: The economic effects of the extension plan are measured relative to the Congressional Budget Office's January 2006 baseline economic and budgetary projections. A more detailed table is available upon request.
(a) Difference in billions of inflation adjusted dollars (indexed to 2000 price levels); (b) Difference in thousands of jobs
Source: Center for Data Analysis, The Heritage Foundation

nies, would see their partnership income taxed as ordinary income, which increases their personal income taxes significantly.

While the surtax and the new taxes make up the revenues that the AMT repeal foregoes, they do so by increasing the tax rate that the taxpayers paying the surtax and partnership taxes would face. Married taxpayers in this group will likely see marriage penalties return, as the tax rate on the second income earner bears a higher effective rate. The tax rates on deductions will rise and the value of tax credits will fall when the surtax is imposed. In short, this change nudges up the tax rates faced by people who are most able to adapt their economic behavior to changes in the tax law.

Simulation 2 combines the corporate rate reduction in Simulation 1 with the increases in personal tax rates. Only these two elements of H.R. 3970 are included in this analysis, but the tax rate increases are enough to overwhelm the positive economic effects of the corporate rate reduction. The results show that nearly all of the economic indicators are negative, or growing below their potential. Investment recovers (as shown by positive numbers for Real Gross Private Domestic Investment and Real Non-Residential Investment), but this recovery primarily stems from the actions of the Federal Reserve to stimulate the economy by lowering interest rates. The GI model allows us to study how the Federal Reserve would react when faced with these types of economic changes. In this case, interest rates fall slightly (as seen by the direction of T-Bills and 10-year Treasury Bonds). Absent that help, investment, too, would have been below its potential or baseline.[6]

The Full Rangel Tax Bill. In short, the "pay" parts of the legislation undercut the "growth" parts. The economic effects of H.R. 3970 do not significantly improve when other elements in the legislation are included. On the one hand, increases in the standard deduction and expansion in the amount of the Earned Income Tax Credit that can be refunded to taxpayers put more money in the pockets of taxpayers, which strengthens savings and consumption. Further, permanent extension of an important expensing provision of the tax code (so-called Section 179 expensing) supports investment growth.

On the other hand, changes in accounting, repatriation, and amortization rules increase taxes paid by businesses, which reduces their consumption or investment activities and increases their cost of capital. As Simulation 3 shows, the tax relief components of the legislation soften some of the harsher effects of tax increases, but that is not enough to turn around generally negative economic results.

Repealing the Bush Tax Cuts. If the tax story ended with H.R. 3970, taxpayers would simply be facing another economically unhelpful action by Congress. The story, however, does not end there. Rather, "the mother of all tax bills" is based on an official assumption that the tax cuts of 2001 and 2003 will expire over the next three fiscal years. This official assumption functions like an unwritten section of H.R. 3970.

Here's how it works. Under the precedents followed by the CBO, revenue forecasts include the additional revenue that the government would receive when tax relief expires within the 10-year budget window. In developing legislation, the Ways and Means Committee starts with this assumption and makes changes in tax law that are scored relative to the CBO forecast. Thus, legislation that purports to leave the level of overall receipts unchanged actually builds this tax increase into the baseline. In the case of the expiration of the 2001 and 2003 tax relief, CBO is assuming a massive tax increase in this unwritten section of the bill.[7]

Expiration of the 2001 and 2003 tax cuts would have the following effects:

- The tax rate on dividends would go from 15 percent to the tax rate imposed on ordinary income, which today would be as high as 35 percent;
- The capital gains tax rate for long-term gains would rise from 15 percent to 20 percent;
- Key family credits would be reduced, and marriage penalties might come back for some taxpayers;
- Tax rates on ordinary income return to their levels of 2000, with the highest rate going from 35 percent to 39.6 percent; and
- Death taxes return in 2010, after being totally repealed.

These expiring tax policies will result in enormous tax increases beginning in 2009 and exploding in 2011. Many in Congress are waiting eagerly for these new revenues. These Members forget that additional taxes will be extracted from the economy at a steep price. Indeed, analysts in the Center for Data Analysis have shown that the slowdown in economic activity could be significant and that the revenues collected could thereby be far less than Congress expects.[8]

It is reasonable to assume that the committee's silence on probably the largest tax increase in U.S. history means that expiration of the 2001 and 2003 tax cuts is part of their fiscal plan. If so, Members should see the full economic effect of the so-called Tax Reduction and Reform Act of 2007, from both the explicit and unwritten parts.

6. We have followed the modeling convention of including the federal reserve reaction function in our simulation rather than excluding it. Given the size of the tax policy change if this legislation were to become law, there appears every reason to assume that the Federal Reserve will include Congress's tax policy changes in its thinking about interest rate change.
7. See J.D. Foster, "AMT Fix Becomes Massive Tax Hike Via Misleading CBO," Heritage Foundation *WebMemo* No. 1695, November 7, 2007, at *www.heritage.org/Research/Taxes/wm1695.cfm.*
8. Tracy L. Foertsch, Ph.D., and Ralph A. Rector, Ph.D., "A Dynamic Analysis of the 2001 and 2003 Bush Tax Cuts: Applying an Alternative Technique for Calibrating Macroeconomic and Microsimulation Models," Heritage Foundation *Center for Data Analysis Report* No. 06-10, November 22, 2006, at *www.heritage.org/Research/Taxes/cda06-10.cfm.*

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Simulation 4 combines the tax provision of the legislation with expiration of the 2001 and 2003 tax cuts. The relatively minor slide in economic performance through 2010 becomes an avalanche from 2011 onwards after the tax cuts fully expire. A look at the year 2013 reveals what is at stake. A drop in jobs of 1,030,000 is equal to a normal full year of job creation. A fall of $250 billion in disposable personal income is like taking $2,000 in after-tax income from every household in the country, or about the annual savings of the median household. A $100 billion decrease in GDP may not sound like all that much in a U.S.-sized economy, but it is equivalent to closing down Kansas City for a year or Omaha for two full years.[9]

Unfortunately, 2013 is not the only year when taxpayers and the economy will suffer. The economic effects of H.R. 3970 may reverberate for years. Indeed, the damage may last a lifetime for some Americans. The loss in prosperity will be particularly hard on low- and moderate-income families for whom a good-paying job and educational opportunities are the vital keys to upward mobility. Policymakers who only think about the tax policy changes of the past six years as "tax cuts for the rich" fail to recognize that jobs are created in large part by people who have money to invest in business growth. Investors don't create the economic ladder, but they shorten the distance between the rungs by creating more opportunities. These rungs are eminently more likely to be useful when the economy is growing instead of when it's stalling out.

Conclusion. What is at issue in this week's debate over the Rangel tax bill is not the one-year AMT patch or the tax extenders that have become the bread and butter of Washington lobbyists. Instead, the debate is all about the most significant change to federal tax policy proposed in over a decade. Standing behind this bill is a massive shift in tax policy thinking—from enhancing broad economic activity to broadly expanding federal revenues.

That shift starts with "the mother of all tax bills," the Tax Reduction and Reform Act of 2007, the unwritten section of which is, indeed, the end of pro-growth tax policy.

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9. According to The Bureau of Economic Analysis, Kansas City had a metropolitan area gross product of about $91 billion in 2005; Omaha's was $39 billion. See *http://bea.gov/regional/gdp.metro.*