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Bush's $674 Billion Plan

Stimulus for Re-election or Building Block for Radical Tax Reform?

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With the presentation of his "Growth and Jobs Plan" on 7 January 2003, George W. Bush demonstrated his determination to avoid the fate of his father, whose neglect of the economy led to the failure of his 1992 presidential re-election bid. At the same time, however, Bush seeks to dramatically reduce the economic role played by the state; if he succeeds, he will stand as the man who completed the mission initiated by Ronald Reagan. Rather than substituting public demand for insufficient private demand in a Keynesian fashion, Bush seeks above all to provide far-reaching tax relief on private capital investments. Such a process of fundamental tax reform, which would presumably reach its climax during a second Bush administration, would give the U.S. international status as a low-tax country, thereby allowing it to attract the massive influx of private capital necessary for financing its ever-increasing current account deficit. Whether or not this succeeds in stimulating the U.S. economy, Bush's plan will heighten the reform pressure on Germany and other industrial nations experiencing sluggish economic growth.

The scope of Bush's program appears impressive. However, the amount of $674 billion in and of itself says little about the plan's short-term impact on the economy, and even less about its long-term growth effects. Like the large tax reform package of 2001 (which experts estimated would lead to tax revenue reductions of $1.4–2.1 billion over 10 years), the newest reform plan is also being presented to the public as a means to combat recession. However, the plan's creators and supporters view it above all as a crucial step, in the tradition of Ronald Reagan, toward achieving a significant rollback in the state's share of national income. In any event, this is not a case of additional public spending to compensate for a growth-crippling lack of demand. Only 0.5 percent of the plan involves direct budgetary expenditures. This amount, $3.6 billion, would be directed toward states for the specific purpose of financing state-administered "personal re-employment accounts:" up to $3,000 per recipient will be provided to unemployed persons to defray occupational training, job search, and relocation expenses.

The remaining 99.5 percent of the program is derived from a calculation of tax revenue reductions that may result from the plan's proposed measures over the coming 10 years.

- The greatest share by far, projected at approximately $364 billion, would result from the proposed elimination of personal income taxes on corporate dividends.
- The subjection of fewer taxpayers to the imposition of the so-called Alternative Minimum Tax is expected to achieve tax relief totaling $29 billion.
- Expanded opportunities for tax write-offs by small businesses are expected to result in additional tax reductions of $16 billion.

The remainder of the package is based on an acceleration of several tax cuts which, according to the Tax Reform Act of 2001, were originally scheduled to take effect between 2004 and 2009. These include:

- Reduced income tax rates (approximately $112 billion);
- An increase in the Child Tax Credit from $600 to $1,000 per child (approximately $91 billion); and
- The elimination of the so-called "marriage penalty," i.e., tax disadvantages experienced by two-earner couples ($50 billion).

According to the government's plans, approximately $100 billion out of the total of $670 billion in tax reductions will take effect this year. This would correspond to just under one percent of U.S. gross domestic product (GDP), which stands at $10.5 trillion.

Tax Policy Assessment

Viewed purely from a tax policy perspective, the president's newest program is less than spectacular. To the extent that it simply calls for tax cuts enacted by the 2001 Tax Reform Act to be implemented retroactively to 1 January 2003, the plan merely uphold the 2001 law's emphasis on providing tax relief for higher incomes, not least by lowering the maximum tax rate to 35 percent.

The one element of the plan that has garnered the most attention and that accounts for the greatest financial volume is the proposed elimination of personal income taxes on corporate dividends. By implementing this proposal, however, the U.S. would be enacting a policy that already applies in all other leading industrial nations; the elimination of double taxation on distributed corporate profits (first through corporate income taxes and again through personal income taxes) seeks to end tax discrimination against distributed dividends as compared to retained profits. The 50 percent tax exemption first considered by the Bush administration would have corresponded to the German "half-income system" (*Halbeinkünfteverfahren*). All other industrial nations either allow the corporate income tax paid on dividends to be set off partially or fully against the individual shareholder's tax liability (the so-called "imputation system"), or they employ a mixture of both the imputation system and tax exemption.

The double taxation of dividends as currently practiced in the U.S. is given partial responsibility for recent negative developments that can be attributed to the principle of "shareholder value." Accordingly, it was in the tax interests of shareholders for corporations not to distribute dividends, but rather to take out loans in order to buy back their own stock. These corporate buybacks increased the value of company stock, and the interest from the loans could be deducted from corporate taxes. Repurchased stocks could be used in turn for stock option plans that benefited top-level management; these stock option plans thereby created an added incentive for corporate executives to buy back stocks in order to drive their company's stock prices even higher. The promotion of such a culture of active stock price manipulation ultimately gave rise to a climate in which illegal and purely deceptive manipulations of stock prices and corporate balances flourished, as is demonstrated by the cases of Enron, Tyco, and WorldCom. The tax reductions currently planned by the Bush administration could therefore contribute significantly to more responsible corporate financial behavior.

However, by fully eliminating the dividend tax for individual investors rather than for corporations, the Bush administration is pursuing a course that favors those who earn high-level incomes. This regressive effect is reinforced by the fact that dividends on stocks held by pension funds or by medium-wage earners in private retirement accounts are already tax-exempt. The new tax exemption proposal would therefore primarily benefit holders of significant stock assets. Over half of the tax relief arising from the elimination of the dividend tax would accrue to that small segment of the population earning over $150,000 per year, with an average annual income of $350,000.

An elimination of corporate income taxes on distributed profits would have provided a tax incentive for corporations to distribute more of their profits to shareholders rather than accumulate them. This solution had been considered by recently dismissed Treasury Secretary Paul O'Neill. However, it appeared too costly to the Bush administration, because then those 40 percent of dividend payments that go to already tax-exempt non-profit foundations, pension funds, and individual retirement accounts would no longer even be subject to taxation at the corporate level. Moreover, given the current situation, this option not only appeared too costly but also had the potential to be politically controversial and risky for the president in the wake of recent corporate financial scandals.

Above all, however, it may be the administration's political intent to benefit extremely wealthy taxpayers by making income from stock assets tax-exempt. This would, it is hoped, create an incentive for this small yet financially powerful group of people to increase their stock purchases and thereby drive the stock market upward.

The proposed elimination of the dividend tax only appears to be a simplification of tax policy. Highly complex regulations will be required to prevent corporate profits from going completely untaxed at both the corporate and shareholder level, a situation which could arise from the exploitation of numerous current corporate income tax privileges. In this respect, the tax-exemption of dividends could invite abuse in the form of new tactics of tax evasion.

Budgetary Effects

In terms of economics, it is reasonable to increase budget deficits in order to stimulate a weak economy, even by means of targeted tax reductions. In two respects, however, the Bush administration's new program would prove ineffective, and even counterproductive, in promoting economic growth.

1. The individual states – which are experiencing severe budgetary problems due to drastic declines in tax revenues, particularly in revenues from state income taxes – are left on their own by the plan. Overall, state budget deficits are presently estimated at nearly $60 billion for the current fiscal year (California alone accounts for about half of the total amount). In the current year, these deficits may cause a downturn in private and public demand, thereby neutralizing up to more than half of the Bush plan's short-term tax reductions. Because most states are required to balance their budgets at the end of each fiscal year, they will be forced to cut expenditures and possibly even raise taxes.

An allocation of $10 billion from the federal budget to state budgets, an option taken into consideration during preliminary discussions of the Bush plan, would have mitigated this effect. However, the president clearly rejected this idea. The reason: it would make no sense to shift funds from one public treasury to another.

In contrast to state budgets, however, there is definitely room for maneuver at the federal level to allow for increased budget deficits. In fiscal year 2002 (1 October 2001–30 September 2002), the U.S.

federal budget deficit stood at $157 billion, or 1.5 percent of GDP, a modest percentage according to European standards. However, if the considerable surpluses in social security were excluded from this calculation, the federal budget deficit would tally $314 billion and thereby exceed 3 percent of GDP.

2. The current problem is less the absolute amount but rather the extraordinarily rapid reversal in the balance of the federal budget. And this forms the basis of the second foreseeable counterproductive effect of the new tax cut plan. In fiscal year 2000, which still lay fully within President Clinton's term of office, the federal budget (not including social security) exhibited a surplus of $87 billion. This surplus disappeared in fiscal year 2001 (during the last weeks of which the September 11 attacks occurred), primarily due to the recession, the effects of the May 2001 tax reform, and the emergency assistance programs implemented in the wake of September 11. Given current increases in defense spending, if one includes the $100 billion in costs from the newest round of tax cuts, the deficit for fiscal year 2003 can be expected to climb to $450 billion (or approximately $300 billion if social security surpluses are included in the calculation).

This amount does not include the budgetary effects of a potential war with Iraq, which current estimates expect to cost at least $50–100 billion (assuming that the war is both brief and successful). Neither does it include, of course, the budgetary repercussions from such a war's indirect effects on global economic development, including its effects on oil markets.

As was the case during the Reagan administration, the U.S. thereby again confronts the problem of a twin deficit, i.e., both a federal budget deficit and a current account deficit (the latter, continuing its upward trend, currently stands at nearly 5 percent of GDP). The medium-term consequences of this twin deficit hold considerable economic risk, not least due to the fact that the federal budget will be burdened by increased debt-servicing expenditures. And this in turn could result in higher interest rates in capital markets. Economists close to the Bush administration dispute this latter assertion by pointing to the fact that current interest rates remain extremely low despite increasing budget deficits. Yet this argument is too strongly reminiscent of proclamations made at the peak of the "new economy" boom that the business cycle was dead.

A Program for Growth?

The plan unveiled on 7 January 2003 rigorously upholds the supply-side orientation that has characterized the Bush administration's economic policy to date. Rather than increasing government demand, it reduces the tax burden on corporations and private households in the belief that these actors will use their increased demand strength to purchase investment and consumer goods. However, the plan's emphasis on the elimination of the dividend tax seeks above all to boost stock market values that have collapsed during the Bush presidency, and thereby targets the wealth of private households. The Bush program follows the assumption that if private household wealth improves, then the negative wealth effect (a decline in wealth reduces the willingness to consume) that has been a cause of concern in recent years can be reversed in a positive direction.

However, these assumptions are questionable. The current weak investment climate is not caused by a high price of capital or by excessive taxes on profits. Rather, it is the consequence of massive overinvestment during the period from 1997–2000, which led to a very low level of capacity utilization within U.S. industries. Under these circumstances, tax incentives and tax reductions for entrepreneurs and investors can have little if any effect on investment.

It is equally doubtful that tax reductions for private households will lead to a corresponding increase in consumer spending.

As a rule, this close correlation between tax cuts and increased consumer spending applies only to the lowest income groups. Yet it is precisely these groups that are completely overlooked by the newest round of proposed tax reductions. The higher income groups favored by the proposals will most likely use the tax cuts to increase their savings. In light of the tax-exemption of dividends, this may strengthen the demand for stocks and thereby lead to an increase in stock market values. This would bring about an improvement in private household wealth, which has suffered under the stock market losses of the past three years. However, after the experiences of recent years, one cannot expect the positive wealth effect that characterized the boom years through 2000 to repeat itself. During that period, private household savings even temporarily took on negative values, i.e., private consumers, spirited by the increased value of their stock holdings, spent more than their disposable income.

Against this background, even the modest growth effect of the Bush plan predicted by experts (approximately 0.4 percent of GDP) appears doubtful. The economist Paul Krugman, a columnist for the *New York Times* who has become one of the sharpest critics of the Bush administration, is correct in arguing that the new tax reduction plan is not a "stimulus program" for the economy. Rather, according to Krugman, the president's strategy is apparently based on the conviction that the U.S. economy will recover on its own. At most, Krugman argues, the goal of stimulating the economy merely serves as a pretext for pursuing the administration's *real* tax policy objectives.

Social Impact

The program's distributive effects highlight its social impact. Nevertheless, the Bush government aggressively defends the obvious social imbalance of the proposed tax cuts. In a 10 January speech at the U.S. Chamber of Commerce, Vice President Cheney explained the strategy as follows: "Our administration's pro-growth initiatives were the products of a very clear economic philosophy. The President and I understand that the government does not create wealth and it does not create jobs, but government policies can and should create the environment in which firms and entrepreneurs will take risk, innovate, invest, and hire more people."

This economic philosophy, which involves a fundamental rejection of any form of redistributive policy on the part of the state, is characterized in American economic debates as the "trickle down" theory. Its proponents argue that, in the capitalist system, the best social policy is one that enables businesses and entrepreneurs to reap the highest possible after-tax profits on their investments. Then, it is believed, firms and entrepreneurs will be that much more willing to invest and consume, thereby creating jobs and income for everybody else.

One of the reasons that the "trickle down" theory has such a convincing effect in the U.S. is that social inequality and distributive justice have hardly played a role in public discourse to date. The journalist David Brooks recently recalled a poll that was conducted by *Time* magazine during election year 2000. Asked whether they belonged to the top one percent of income earners, 19 percent of respondents answered yes, while another 20 percent stated that they expected to belong to that category someday.

In light of such optimistic misperceptions, the criticism that the new tax measures will primarily benefit the wealthiest one percent of the U.S. population is unlikely to catch on. Nevertheless, social inequality in the U.S. has increased dramatically in the past 20 years. While in 1980 the top five percent of income earners had incomes 11 times greater than the bottom five percent, this discrepancy had grown to 16 times as much by 2000. In addition, compared to the group of medium income earners, the income of the top 20 percent grew three times as quickly over the same period. The subjective perception of this unequal development – which until 2000 (the year in which the above-mentioned poll was conducted) was still covered up by the "new economy" euphoria – may have become more acute in the meantime.

Chances of Success in Congress

Democratic Party leaders appear to want to make the theme of "social inequality" a focal point of their opposition to the Bush administration's economic policies. In the coming weeks, congressional debates on the new tax cut program will show whether the Democrats have accurately assessed the domestic political urgency of this theme.

The Bush administration basically stands a good chance of pushing the plan through Congress without significant alterations, particularly since the November 2002 elections. Domestic political criticism that the plan is socially inequitable – expressed by many Democrats as well as the liberal media and expert commentators – is being preemptively denounced by the Bush administration as class warfare and therefore as deeply un-American.

However, criticism from within the Republican camp could present a problem for the government. For example, Senator John McCain, Bush's fiercest Republican opponent in the run-up to the 2000 elections, views the president's tax policies as a betrayal of the ideas of "compassionate conservatism," a political concept in the U.S. that probably comes closest to the continental European model of a social market economy founded on the principle of subsidiarity.

Ultimately, however, the policy debates in Congress will likely concentrate on the plan's foreseeable ineffectiveness in stimulating growth in the face of an economy that will likely continue to stagnate.

Thus if the Bush administration wants to make legislative progress in fulfilling its long-term tax policy objectives, it will probably have to augment its proposals by including additional economic incentives to strengthen demand.

Short-term Political Calculations…

In order to understand the Bush program's "real" political motives, one must distinguish its *packaging* from its *content*.

Both the plan's packaging and the objectives it pursues reflect the calculations of Karl Rove, the president's senior political advisor and chief strategist of his reelection campaign. Rove had already steered the apparently abrupt dismissal of Paul O'Neill, Secretary of the Treasury, and Lawrence Lindsey, Director of the National Economic Council and top economic advisor to the White House, on 6 December 2002. And it was Rove who organized the one-day economic forum that the president held on 13 August 2002 in Waco, Texas, with over 200 corporate leaders, economists, and business association representatives. This forum was meant as a public demonstration of the president's clear recognition that "It's the economy, stupid!," a message that had helped his father's opponent, Bill Clinton, to electoral success in 1992. The *demonstration* of determination in formulating economic policy is an important common denominator that characterizes all of the Bush administration's policy initiatives to date.

The success of these efforts remains uncertain. Even after Bush unveiled his $674 billion plan, 55 percent of respondents in a Gallup Poll of 14 January 2003 felt that the president was paying too little attention to the economy. 47 percent of respondents disapproved of Bush's handling of the economy, just one percent fewer than the 48 percent who approved. In addition, the president's overall approval rating fell below 60 percent for the first time since 11 September 2001. If Bush does not succeed in upholding the "war against terror" as the dominant theme of public discussions into the election year of 2004, only an autonomous cyclical recovery of the economy may be able to save him.

... and Long-term Ideological Plans

And that is precisely what the government is betting on. This is because the *content* of the program is not focused primarily on stimulating the economy, but rather on a policy concept that is nothing short of ideological: the completion of the Reagan era tax policy program, as understood by think tank economists close to the Bush administration.

One of the *leitmotifs* of neoconservative fiscal policy since the Reagan era is the rejection of "big government." Proponents of this line of thinking argue that the state should play no active role in the economy, possibly not even in the provision of social welfare. They seek to undermine the role of the state through massive tax cuts that constrain the ability of Congress to enact costly government spending programs.

This approach is grounded in a concept of the state that rejects any type of state intervention in markets to the furthest possible extent, and that views taxes and regulations as fundamental violations of individual property rights. The only areas in which the state should play a role – and a significant one at that – is in guaranteeing international and domestic security and safeguarding property rights in the broadest sense. There is no place in this school of thought for Keynesian programs of increased, credit-financed government spending, unless this increased spending is directed toward the core tasks of security policy. The latter is currently the case in the U.S.

According to this philosophy, to the extent that the imposition of taxes is necessary to enable the state to fulfill its core tasks, such taxes should have no distributive goals whatsoever. Above all, taxes should not be imposed on savings – which of course occurs primarily among higher income groups – but rather on consumption, if anything. In current tax policy debates, the hard-line proponents of this approach therefore advocate a single proportional tax rate (flat tax) on all income rather than a progressive income tax, or even a gradual transition to a tax system that taxes consumption rather than income.

There is considerable leeway in the U.S. with regard to taxes on consumption. This applies both to the general sales tax – which currently ranges from 0–7.5 percent and is levied by individual states – as well as to specific excise taxes such as the fuel tax, which remains at a very low rate by international standards.

It is difficult to judge whether George W. Bush has fundamentally embraced this orientation and all its ramifications, so that the tax reduction plan of 7 January 2003 represents a further inconspicuous step toward radical tax reform, or whether he is simply taking advantage of a favorable political situation to make a pragmatic *ad hoc* move. Some specifics support the former interpretation. A five-step plan for achieving radical tax reform is circulating among proponents of this approach. The steps are as follows:

1. Reduce marginal tax rates;
2. Eliminate double taxation on dividends;
3. Allow all business investments to be fully tax deductible in the year of completion;
4. Expand the tax-exempt status of income from savings, such as that applied to Individual Retirement Accounts (IRAs), to all savings accounts;
5. Establish tax-exempt status for profits from exports.

The passage of the newest tax cut plan would complete the first two steps, and the other three steps are either already partially implemented or in preparation. Yet it remains to be seen whether the political interaction between the Bush administration and Congress results in a program of fundamental tax reform in which income from savings, or even unconsumed income, are given full tax-exempt status.

International Effects

If the president's latest tax reduction plan becomes law, it will probably have a negligible *short-term* effect in stimulating the economy. Therefore, the plan will hardly help the U.S. to reassume its role as the locomotive of the world economy. At most, stimulus for the U.S. economy will come from increased defense and "homeland security" expenditures, from a continued decline in the value of the dollar, and possibly from a successful war against Iraq.

However, the plan's *medium-term* international economic effects should not be underestimated. On the one hand, the 2001 tax reforms and the newly proposed tax reductions will heighten international tax competition. And this is certainly intentional. One may recall that the Bush administration, in the summer of 2001, blocked progress on the OECD's project on harmful tax practices. This project seeks to curb the abuse of so-called tax havens, primarily by expanding the mutual cross-border information-sharing obligations of tax authorities. The justification for the U.S. government's position at the time was that low taxes are good, not bad. Therefore, the Bush administration claimed, it did not agree that nations with low tax rates should be subject to political and economic pressure to support the tax policies of high-tax countries.

Bush's new plan turns up the heat of international pressure to reduce direct taxes on high incomes and corporate profits, a process initiated 20 years ago by Ronald Reagan in the U.S. and Margaret Thatcher in Great Britain. The pressure to replace the direct and progressive taxation of income with indirect and more regressive taxes on consumption will continue to increase.

On the other hand, a significant increase in the U.S. federal budget deficit – accelerated by the new round of tax cuts – could have severe international consequences. The emphasis of the Bush administration's fiscal policy on long-term, structural, and possibly irreversible tax cuts heightens the risk of a progressively expanding budget deficit, and financing this deficit through capital markets may drive interest rates increasingly higher. This possibility is already being reflected in the expectations of international financial markets, as has been demonstrated by both the cautious reaction of stock markets to the Bush program as well as the decline in the value of the dollar.

There is a distinct possibility that continued economic sluggishness, exacerbated by growing defense and domestic security expenditures, will cause the U.S. to experience increasing difficulty in managing an ever-expanding "twin deficit." Should this prove to be the case during the run-up to the 2004 presidential elections, the Bush administration may choose to exercise considerable pressure on the remaining G-7 nations to provide assistance similar to the economic and currency-related agreements of the mid-1980s that sought to relieve pressure on the U.S. economy: through massive participation in the costs of U.S. foreign policy, through trade concessions and, if necessary, through currency support.

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