PROTECTING SENIORS FROM DOUBLE-TAXATION

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Mr. Chairman and members of the Committee, thank you for this opportunity to testify. My name is Dan Mitchell and I am a Senior Fellow in Political Economy at the Heritage Foundation. The views expressed here are my own.

President Bush has proposed to eliminate the double-taxation of dividends. Under his plan, businesses will pay tax on corporate income, but individual stockholders no longer would have to pay a second layer of tax on that income when it is distributed in the form of dividends. This proposal is good for America, and it is good for seniors.

The President is addressing a very serious problem. The internal revenue code routinely imposes extra layers of taxation on productive behavior such as saving and investment, and the double-taxation of dividends is just the tip of the iceberg. Capital gains taxes are a form of double-taxation, as is the death tax. Interest payments also are double-taxed, and the 1993 tax bill even instituted an extra layer of tax on Social Security benefits.

Removing or reducing double-taxation will lead to more jobs and higher living standards. These policies will make America more competitive. Eliminating extra layers of tax will simplify the tax code. Perhaps most important, ending double-taxation is the right thing to do. People who contribute to our nation's prosperity by saving and investing – and this certainly includes many of the elderly – should not be punished by the tax code.

DOUBLE-TAXATION IS BAD FOR AMERICA

Tax policies that punish savings and investment are counterproductive. Every economic theory (including Marxism) teaches that capital formation is necessary to raise wages and stimulate long-term economic growth. Policymakers who want to boost savings should eliminate the anti-savings provisions in the federal tax code, preferably by replacing the code with a simple and fair flat tax that would end multiple taxation of capital. To the extent that such fundamental reform is not immediately possible, there are a number of incremental steps Congress should take to alleviate the bias against savings and move toward a flat and fair tax system in the future:

- Individual retirement accounts (IRAs) should become universal, so that all taxpayers could save as much as they want without being taxed twice;
- The double taxation on non-retirement savings should be eliminated;
- The 1993 tax increase on Social Security benefits should be repealed;
- Tax penalties on dividends, estates, capital gains, and other forms of capital should be eliminated.

This hearing is designed to address two issues. First, what is the impact on the elderly of the death tax, the Social Security benefit tax, and the second layer of tax on dividend income? Second, what are the potential economic benefits of the President's economic plan?

DOUBLE TAXATION AND THE ELDERLY

While certain taxes – such as the death tax and double-tax on dividends – are not explicitly designed to hit seniors, the elderly bear a disproportionate share of the burden. Seniors have higher levels of saving and investment. In part, this is simply because they have had the opportunity to accumulate capital during their working years. But there also are specific reasons why the elderly save, including the desire for economic security and the desire to provide a nest egg for their families.

Unfortunately, these goals are sabotaged by the tax code. Here are the specific forms of double-taxation that the committee is examining today, along with an explanation of why they are improper.

Death tax – The death tax is imposed when a taxpayer dies and his or her assets are above a certain value. Yet since assets generally are purchased with after-tax income, the death tax clearly qualifies as double taxation. Indeed, many financial assets in a taxpayer's estate may already have been subject to extra layers of tax, so the death tax often is a form of triple- or even quadruple taxation.

Tax on Social Security benefits – There is one form of double-taxation that specifically targets the elderly. Thanks to the 1993 tax increase, single retirees with income above $34,000 and couples with income over $44,000 now must pay tax on 85 percent of their Social Security benefits. Yet since Social Security taxes are only 50 percent deductible (the so-called employer share of the tax is paid in pre-tax dollars), it is double taxation to tax more than 50 percent of benefits.

Dividend tax – Returns to corporate equity are subject to double-taxation. First, the income is subject to the corporate income tax – and the U.S. has the fourth highest rate in the industrialized world. Then the same income is taxed a second time at the individual level thanks to the personal income tax.

TAX RELIEF FOR THE ELDERLY

Fixing these flaws in the tax code is good for economic growth, good for American competitiveness, and good for the elderly. The White House has announced that "[a]lmost half of all savings from the dividend exclusion under the President's plan would go to taxpayers 65 and older. The average tax savings for the 9.8 million seniors receiving dividends would be $936."

One of my Heritage Foundation colleagues has combed through the data and also found that the elderly are big beneficiaries of dividend tax reform. Among post-retirement age taxpayers who receive dividends, the median taxpayers' (single, married, and combined) dividend income is $2,406, with an after-tax income of $35,544. The median single taxpayer in this group has a lower after-tax income of $21,844 and a higher dividend income of $3,184. The median married taxpayer in this group has an after-tax income of $44,921 and a dividend income of just under $2,000.

The death tax is scheduled to disappear in 2010. That is the good news. The bad news is that it reappears in 2011. This tax reform must be made permanent to boost

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economic growth and to rescue older Americans from this pernicious form of double-taxation. Last but not least, the double-tax on Social Security benefits currently is part of the tax code and it does not appear that this black mark will be erased anytime soon.

GOOD TAX POLICY WILL BOOST ECONOMY AND INCREASE WAGES

Dividend Double-Tax

Many economists have long argued that the double taxation of dividends reduces the after-tax return on capital in the nation's economy and thus discourages corporate investment.[1] This reduced corporate investment, such as purchases of new business equipment and machinery, weakens economic growth. Consequently, these economists would argue that eliminating this double taxation would spur corporate investment and improve the economy's long-term growth.

Empirical evidence indicates that eliminating the double taxation of dividends would lower the cost of capital and, in turn, increase investment and economic growth. Since the United States is one of only three developed countries without some form of protection from the double taxation of dividends, much of the empirical evidence examines the experiences of other countries.

In 1987, New Zealand and Australia both implemented a dividend "imputation credit" mechanism to eliminate the double tax on dividends.[2] This method, which has the effect of adding back the corporate layer of tax to the dividend received by the shareholder, was found to increase capital investment in both New Zealand and Australia.[3] Furthermore, the imputation credit employed in Australia was found to offset the investment dampening effects of a capital gains tax increase.[4]

In a 1984 paper, James Poterba and Lawrence Summers tested several competing hypotheses regarding the economic effects of dividend taxation using data from Great Britain.[5] Unlike the United States, Great Britain has experienced several dividend tax reforms since the 1950's, a condition which makes empirical testing more straightforward. The authors found that the double taxation of dividends in Great Britain did lower corporate investment and worsen distortions in the capital markets.

One of the only recent U.S. tax reforms that lends itself to this type of empirical study is the Tax Reform Act of 1986 (TRA86). A 1991 paper by Nadeau and Strauss notes that TRA86 significantly reduced the tax advantage of retained earnings over

[1]For more on the economic effects of federal double taxation of dividends, see James M. Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity* No. 2, 1987, pp. 455–515; Peter Birch Sorensen, "Changing Views of the Corporate Income Tax," *National Tax Journal*, Vol. 48, Issue 2 (June 1995), pp. 279–294; and James M. Poterba and Lawrence H. Summers, "New Evidence that Taxes Affect the Valuation of Dividends," *The Journal of Finance*, Vol. 39, Issue 5 (December 1984), pp. 1397–1415.

[2] For a complete discussion of the imputation credit, as well as other methods for eliminating the double taxation of dividends, see Deborah Thomas and Keith Sellers, "Eliminate the Double Tax on Dividends," *Journal of Accountancy*, November 1994.

[3] See Ervin Black, Joseph Legoria and Keith Sellers, "Capital Investment Effects of Dividend Imputation," *Journal of the American Taxation Association*, Vol. 22, No. 2, Fall 2000, pp. 40-59.

[4] See Black, Legoria and Sellers, 2000.

[5] See James Poterba and Lawrence Summers, "The Economic Effects of Dividend Taxation," *NBER Working Paper*, No. 1353, May 1984.

dividends.[6] The authors' model estimated this tax reform reduced the cost of equity capital by about 30%. Later, Cummins and Hassett (1992) studied TRA86 and found that it lowered the cost of capital and increased investment.[7] Recently, Heritage Foundation economists simulated the President's dividend tax reform bill and found that ending the double tax on dividends would lead to higher investment and economic growth. It would:

1. Increase the employment level by an average of 311,000 taxpaying jobs per year;
2. Increase Gross Domestic Product (GDP) by an average of $40 billion;
3. Increase purchases of business equipment by an average of $32 billion.

Interestingly, this added economic growth will generate revenue for the government. The revenue feedback – or supply-side effect – almost surely won't be enough to offset the static revenue loss, but my colleagues estimate that the President's proposal will reduce revenues to the Treasury by only 30 percent of the so-called static cost. Instead of a static cost of $367 billion, the ending of the double taxation of dividends so stimulates the economy that Treasury revenues only fall by $102 billion over 10 years.

Death Tax

The death tax is imposed at death, but the actual tax burden falls on saving and investment. It is quite likely that no tax does more damage to the economy in comparison to the relatively small amount of tax revenue that is generated. This is because of the tax simultaneously discourages the accumulation of new capital and encourages the misallocation of existing capital. Repealing the tax therefore would have enormously positive consequences.

Congress' Joint Economic Committee, for instance, estimates that the death tax has slashed available capital stock by $497 billion, or 3.2 percent. Economists for the Institute for Policy Innovation project that annual gross domestic product would be $117.3 billion, or 0.9 percent, above the baseline and that the economy would create almost 236,000 more jobs than in the baseline.

My Heritage Foundation colleagues estimate permanent repeal of the death tax this year would have the following beneficial effects by 2012:

- Add $14.7 billion (adjusted for inflation) to the GDP;
- Add 118,000 jobs to the U.S. economy;
- Raise U.S. personal disposable income by an inflation-adjusted $11 billion;

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[6] See Serge Nadeau and Robert Strauss, "Tax Policies and The Real And Financial Decisions of the Firm: The Effects of The Tax Reform Act of 1986," *Public Finance Quarterly*, Vol. 19, No. 3, July 1991, pp. 251-292.

[7] See Jason Cummins and Kevin Hassett, "The Effects of Taxation on Investment: New Evidence From Firm Level Panel Data," *National Tax Journal*, Vol. 45, No. 3, 1992, pp. 243-251.

Double-Tax on Social Security Benefits

Unfortunately, we don't have much economic evidence regarding the damage caused by the double-tax on Social Security benefits. But we can safely state that repeal will yield benefits. And while those benefits will be modest compared to death tax repeal and eliminating the double-tax on dividends, they should not be ignored.

The double-tax on benefits is anti-growth because it actually falls on a senior citizen's non-Social Security income. In other words, the tax only takes effect if a Social Security recipient has a certain level of income from either providing labor or providing capital to the market. The tax on that behavior is high. The senior citizen is subject to regular tax rates plus the added tax burden that results from throwing more Social Security benefits into taxable income. And since the tax on Social Security benefits results in a high marginal tax rate for people with incomes above the threshold, this means a very high marginal tax rate on productive behavior.

MAKE AMERICA MORE COMPETITIVE

There are a few other features of the Bush tax plan that are worth discussing, particularly the positive consequences of eliminating the double-tax on dividends. The Bush plan, for instance, would boost U.S. competitiveness abroad. According to a Cato Institute survey, only three of the world's 30 developed nations — America, Switzerland and Ireland — double-tax corporate income. And since Switzerland and Ireland have much lower corporate tax rates, this means America may have the most punitive and anti-growth dividend tax in the industrialized world.

This is an embarrassment — and it clearly puts America in a disadvantageous position. About one-fourth of our competitors don't impose any double-taxation on dividends, while almost all the rest have policies that provide at least partial protection from double-taxation. Only Japan – which is hardly a role model – has a top dividend tax rate above America.

HELP AMERICANS BUILD WEALTH AND SAVE FOR RETIREMENT

Another benefit of eliminating the double-tax on dividends is an increase in wealth. The value of a financial asset is determined by how much after-tax income an investment will generate over time. Removing the second tax on dividends will increase that future income flow and therefore help the stock market. Financial experts say the stock market could expand by about 10 percent under the Bush plan, boosting national wealth by nearly $1 trillion — welcome news for workers who have watched their IRAs and 401(k) accounts shrink.

IMPROVE CORPORATE GOVERNANCE

The Bush plan promises several other benefits. Under current tax law, for instance, companies are encouraged to use debt, not equity, to finance investments. Why? Because dividends are taxed twice and interest on corporate bonds is taxed only once. If Mr. Bush's plan is approved, this bias disappears and companies will have a strong incentive to strengthen their balance sheets. This would mean fewer bankruptcies.

The tax code also creates a perverse incentive for companies to hoard earnings. Why? Because the double-tax on the earnings they keep (capital gains) is lower than the double-tax on the earnings they distribute (dividends). The president's plan would end this anti-dividend bias, giving companies an incentive to attract investors by offering dividends instead of promising capital gains. This would improve corporate governance since firms no longer would feel as much pressure to boost share prices by making unwarranted claims about future revenue. Instead, investors would judge a company by the amount of cold, hard cash it pays its shareholders.

CONCLUSION

The Internal Revenue Code imposes two layers of tax on corporate income. Companies must pay a 35 percent tax on profits. If the remaining after-tax income is then distributed to shareholders, it is subject to another layer of tax since individuals must include dividends in their taxable income. Depending on an individual's tax rate, the effective tax rate on corporate income can exceed 60 percent – even higher once state and local taxes are added to the mix.

The Administration proposes to end the double taxation of dividends by allowing individuals to "exclude" dividends from their tax return, while preserving the current 35 percent corporate tax that is imposed on this income. The President's plan recognizes that dividends are after-tax payments and puts an end to the discriminatory and unfair practice of making individuals pay a second layer of tax on this income.

Eliminating the double tax on dividend income will increase growth by dramatically lowering the effective tax rate on business equity investment. President Bush understands that economic growth is the first priority. His plan to eliminate the double-tax on dividends is a bold and visionary step, and it is part of an overall economic plan will make our nation stronger and improve the living standards of all Americans.