

## First, Do No Harm

By John S. Irons

With Congress reconvening this week and two very different tax reconciliation bills pending in the House and Senate, Tax Analysts asked two prominent members of the tax policy community to face off on the issue of Congress's tax priorities. In the first installment of what we hope will become a regular point/counterpoint feature in *Tax Notes* we present the views of Stephen J. Entin, president of the Institute for Research on the Economics of Taxation, and John S. Irons, director of tax and budget policy for the Center for American Progress.

In this article, Irons urges Congress to begin the debate over fundamental tax reform and do little else this year regarding taxes. On p. 521, Entin urges Congress to pass extensions of several expiring tax cuts he believes are necessary to continue the country's economic expansion.

They say addicts have to hit rock bottom before a healthy recovery can begin. On tax policy, we may not have hit bottom yet, but we're getting close. The Congressional Budget Office last week projected an increase in the deficit for 2006 to \$360 billion once money for some Iraq-related military spending and some hurricane relief is included. Without any legislative changes, \$1.1 trillion will be added to the national debt over the next five years. Extending expiring tax provisions and reforming the alternative minimum tax would add a whopping \$3.4 trillion to the debt over the next 10 years.<sup>1</sup>

Given the nation's current fiscal needs, and the need to prepare for future expenses like the retirement of the baby-boom generation, the current path is unsustainable. Furthermore, the tax cuts since 2001 may have been a boon to the wealthy, but have done little to help middle-income America and the economy.

This year Congress should stop digging and enact as few tax changes as possible, specifically by avoiding making permanent changes to the code. Instead, Congress needs to admit that it has a problem — the tax code is badly in need of an overhaul — and begin the long road to recovery.

### First Up: Last Year's Business

Late last year, Congress adjourned without finishing two partner reconciliation bills. The budget bill would cut a range of entitlement programs, including Medicaid, student loans, child support enforcement, and others. Nominally billed as a budget reduction effort — \$40 billion over five years in savings — the bill really puts

only the most minor of dents into a \$350 billion to \$400 billion a year deficit. Regardless, anxious conservatives in Congress who are worried about their small-government base are eager to hold it up as evidence of "fiscal responsibility."

Passage of the budget reconciliation bill seems to be a foregone conclusion. However, the associated tax bill — which spends about twice the amount of the budget savings on tax cuts — is still an open issue. The main point of contention is whether the final legislation will contain an extension of the reduction in capital gains and dividend taxes, or a temporary fix to the AMT. There is likely not enough budgetary room to include both in the reconciliation bill.

I will take up each issue in turn and then turn to the broader question of what Congress should be doing this year.

### Capital Gains

There are two clear reasons to oppose further reductions in the capital gains and dividend tax rates: equity and growth. Usually there is a perceived trade-off between those two goals of economic policy, but not in this case.

First, as a matter of fairness, the tax code should treat income from work in a similar way as income from wealth. Currently, someone in the 15 percent tax bracket who derives his income from his labor must pay about twice that rate once the payroll tax is added in.<sup>2</sup> By contrast, millionaires must pay only 15 percent on their realized capital gains. Competent compensation packages will shift as much labor income into capital gains for highly paid executives, further lowering the effective tax rates on high-income individuals.

Estimates by the Tax Policy Center show that in 2005 nearly half (46 percent) of all the benefits from the recent capital gains and dividend tax cuts went to those making more than \$1 million per year.<sup>3</sup> With middle-class incomes falling, real wages stagnating, and poverty increasing, further tax cuts for wealthy individuals is poor economic policy.

Proponents of those cuts argue that reducing, or eliminating, capital gains and dividend taxes will encourage growth by increasing the after-tax return to capital investment. However, we must realize that we live in a modern, technologically driven economy in which skills, knowledge, and education have never been more important to the success of both individuals and entire economies. A tax-induced bias in favor of capital income tips the playing field and punishes income derived from work, education, and skills — and is thus not in the best interest of long-run economic performance.

Older economic models typically highlighted the role of capital accumulation in economic growth and output.<sup>4</sup>

<sup>2</sup>Add to the 15 percent federal income tax the 6.2 percent employee-side Social Security tax and 1.45 percent Medicare tax, and double those since most economists believe labor bears the burden of the employer side of the tax as well.

<sup>3</sup>Tax Policy Center, Table T05-003.

<sup>4</sup>Starting with early Ramsey- and Solow-style models, and continuing with endogenous growth theory and other growth (Footnote continued on next page.)

<sup>1</sup>Estimates are from the CBO, "The Budget and Economic Outlook: Fiscal Years 2007 to 2016," January 2006. The AMT reform estimates assume indexation of the exemption to inflation from current levels.

## COMMENTARY / VIEWPOINTS

Much of that economic theory therefore, and not surprisingly, suggested that reducing taxes on capital would lead to more growth.<sup>5</sup> However, as the economy has evolved and changed to emphasize skills (in part due to what has been called “skill-biased technological change”), those models — and the tax implications one draws from them — are not as convincing. In fact, augmenting those models for more complicated economic environments and tax systems, or for human capital accumulation, tends to reverse early findings that the optimal tax on capital is zero.<sup>6</sup>

From an empirical standpoint, the recent reductions of capital gains and dividend taxes have done little for the economy. Savings rates have continued to drop, and real wages and median incomes have stagnated. Job growth has been weak. Perhaps an investment and economic boom is right around the corner, but there is certainly no evidence yet that the capital income tax cuts have worked to spur the economy.

### Alternative Minimum Tax

The AMT is one of the few issues on which a wide range of politicians and experts can agree. The AMT has strayed from its original purpose of making sure those at the very top of the income scale cannot avoid paying taxes. The AMT, if not changed, will affect nearly 30 million taxpayers by 2010, according to Tax Policy Center estimates.

Everyone seems to agree that the AMT adds an unnecessary level of complexity to an already complicated tax code, and that — if not changed — the AMT will begin to affect more and more middle-income taxpayers.<sup>7</sup>

But here’s the problem: Eliminating the AMT will cost \$1.2 trillion over the next 10 years if we assume the president’s tax policy is extended beyond 2010.<sup>8</sup> And

---

models that rely on a standard production function taking capital and labor as inputs. Many of those models have been extended to include human capital accumulation as well.

<sup>5</sup>Two often-cited articles are C. Chamley, “Optimal Taxation of Capital Income in General Equilibrium With Infinite Lives,” 54(3) *Econometrica* 607-622 (1986), and K. Judd, “Redistributive Taxation in a Simple Perfect Foresight Model,” 28 *Journal of Public Economics* 59-83 (1985), both of which suggest zero taxation of capital income is optimal in the long run.

<sup>6</sup>See, e.g., J. Hamilton, “Optimal Wage and Income Taxation With Wage Uncertainty,” 28(2) *International Economic Review* 373-388 (1987); E. Saez (2002), “Optimal Progressive Capital Income Taxes in the Infinite Horizon Model,” NBER Working Paper No. 9046; S. Imrohorglu, “A Quantitative Analysis of Capital Income Taxation,” 39(2) *International Economic Review* 307-328 (May 1998); and Jones, Larry E., Manuelli, Rodolfo E., and Rossi, Peter E., “On the Optimal Taxation of Capital Income,” 73(1) *Journal of Economic Theory* 93-117 (Elsevier 1997). See also recent working paper by Jacobs and Bovenberg (2005), “Human Capital and Optimal Positive Taxation of Capital Income,” Tinbergen Institute Discussion Paper #TI2005-035/3.

<sup>7</sup>The 2001-2003 tax changes have made the AMT problem worse by not adjusting the AMT. The AMT thus made the 2001-2003 tax changes appear to lose less revenue than they would lose if the AMT had been adjusted at the same time.

<sup>8</sup>This estimate is from the Treasury Department as cited in the tax reform panel’s final report.

simply eliminating the AMT will again give rise to the problem that it was designed to solve: We might expect thousands of high-income, zero-tax individuals if the AMT were simply eliminated.

Permanently eliminating the AMT must be done as part of a comprehensive reform package. Simply patching the problem with one-year fixes, while perhaps politically unavoidable in the short run, is simply not sound policymaking for the long term.

### Start the Tax Reform Debate . . .

And that brings us to comprehensive tax reform. The President’s Advisory Panel on Federal Tax Reform’s final recommendations were not exactly greeted with open arms by the two political parties, and the president looks increasingly reticent to bring up the issue. Instead, it seems, he will focus on extending his 2001-2003 tax changes and will propose minor tweaks to the system, particularly in the area of healthcare.

But the need for broad reform has not subsided. Are there real prospects for an overhaul this year? Not likely. When Congress and the president do take up broader tax reform (as eventually they must) there will need to be a bipartisan approach, and a one-party town is not conducive to bipartisanship.<sup>9</sup>

Toward that end, Republicans need to accept that the president’s tax policy has led to \$400 billion deficits with no end in sight. They need to realize that middle- and low-income taxpayers are not doing well. Incomes are down, wages are stagnating, and poverty is up. Modest tax breaks for most Americans have been overwhelmed by a weak job market, rising fuel prices, and healthcare costs. For their part, Democrats need to clearly state a positive and comprehensive tax reform vision and make concrete proposals. If they think the nation is not raising adequate revenue to fund vital priorities, they need to vote against bills that are revenue losers — even if those bills have some positive aspects.

In the meantime, Congress needs to stop playing political games with tax changes that won’t take place for years to come. Congressional Republican leadership needs to stop loading popular tax bills with as many controversial tax cuts as possible. They should instead focus on what needs to — and can — be done now with bipartisan support.

---

<sup>9</sup>There appears to be some agreement on this across the ideological spectrum. During a recent Tax Analysts round table, Daniel Mitchell of the Heritage Foundation said Republicans have lost some ideological purity as a result of being in charge, “so there probably is something to the fact that if we had bipartisan government, and even though I obviously wouldn’t ever want a tax increase, but at least if that was going to happen I’d want to get something out of it and I certainly wouldn’t trust Republicans to do it right if they were in complete control of the process.” William Niskanen of the Cato Institute expressed a similar sentiment: “My preference is to address the question of revenues in conjunction with addressing what we do about Social Security and Medicare and so forth. When we either have a Democratic president or the Democrats control at least one house of Congress. Those are the only conditions, I think, in which the Democrats will acknowledge there’s a problem.” *Doc 2005-21607, 2005 TNT 206-25.*

More concretely, the pending tax reconciliation bill should be stopped. The reconciliation process was designed to reduce the deficit, not grease the wheels for deficit-increasing tax changes. The need for federal revenue, especially in the next decade, means the president's tax changes — including the lower rates on capital gains and dividends — should not be extended.

An AMT patch should be put in place for the next year or two (and it can be done outside of reconciliation with bipartisan support), but only in conjunction with other revenue raisers that would make the package either revenue-neutral or a net revenue gain. To pay for the patch, Congress should revisit revenue-losing provisions in the American Jobs Creation Act of 2004, and also in last year's energy legislation — especially in light of the recent lobbying/corruption scandals. And Bush's income tax reductions for the richest should be reversed to pay for the AMT fix and to reduce the deficit.

And most importantly, Congress needs to start the debate on broad-based tax reform. Just because the president has decided to abandon reform doesn't mean Congress or the tax community should do so as well. Reform is not in the cards for 2006, but perhaps the groundwork can be laid for 2007 and beyond.

## Domestic Production Provisions Affect Utility Operations

By Robert Feinschreiber and Margaret Kent

Robert Feinschreiber and Margaret Kent are attorneys and counselors for productionincentive.com.

Section 199, the domestic production activities deduction, provides taxpayers with an incentive for producing products in the United States. Congress specifically designed the domestic production deduction to favor domestic rather than foreign activities. With that objective firmly in mind, Congress would now be surprised to learn that it has enacted a tax break that treats foreign oil producers in the same manner as domestic producers when it comes to their sales to domestic electric utilities.

Congress made the utility domestic production deduction benefits available both to regulated utilities and to independent producers. The statute and the regulations differentiate production activities — which are eligible — from transmission activities and distribution activities — which are ineligible.

### Production, Transmission and Distribution

Section 199(c)(4)(A)(i)(III) and prop. reg. section 1.199-3(k) provide the taxpayer with no frame of reference as to the differentiation between production, transmission, or distribution in the utility context. In fact, the origin of the distinction is a 50-year-old Supreme Court case, *Philips Petroleum Co. v. Wisconsin*.<sup>1</sup> There, Justice Clark observed, "The natural gas industry, like ancient Gaul, is divided into three parts. These parts are production and gathering, interstate transmission by pipeline, and distribution to consumers by local distribution companies."

It is unclear whether Congress intended that section 199 be viewed the same as utility industry criteria defined within the scope of the Federal Energy Regulation Commission (FERC) rules. Section 199 and its legislative history provide no cross-reference to the FERC provisions.

FERC regulates four specific energy utility industries: natural gas, electric utility, hydroelectric, and oil pipeline. FERC, relying on its interstate commerce functions for the most part, regulates interstate transmission activities. In simple terms, the reader might compare the scope of the FERC provisions with the section 199 domestic production deduction provisions as follows:

- Natural gas — The domestic production deduction provisions and the FERC provisions both include natural gas activities within their scope.
- Electricity — The domestic production deduction provisions include electricity production; the FERC

<sup>1</sup>347 U.S. 672, 691 (1954).