

POLITICAL PULSE

Half a Loaf?

Thursday, April 17, 2003

David Gitlitz

The shape of possible tax-cut compromise is beginning to emerge from the fog of legislative war.

The tax bill that emerges from a **Congress** now locked in fierce partisan warfare -- and a nasty **Republican** intra-party spat -- could still provide a much-needed lift for after-tax rewards to risk taking and capital formation. But in the bi-polar political environment now taking shape on Capitol Hill, it also remains entirely possible that a lowest-common-denominator approach to legislative action will yield up a package of palliatives with minimal effect on marginal incentives to productive economic activity.

In the wake of last Friday's **Senate** vote limiting the 10-year static revenue "cost" of any tax-cut to \$350 billion, the Washington policy scene is in a state of agitated ferment. Options are being developed to squeeze the most pro-growth potential possible out of that budget "hole." At the same time a bare-knuckles game of political hardball is being played to move a Senate vote or two into the "yes" column for a package that would have a total price tag closer to \$500 billion. **House** Republicans are furious over the cover-of-night, back-room deal worked out in the Senate to have **Finance Committee Chairman Charles Grassley** commit to the \$350 billion ceiling and bring along the recalcitrant **Senators Olympia Snowe** and **George Voinovich** on the budget resolution vote. If their sense of pique is maintained, House GOP leaders could well insist on a tax-cut package totaling at least \$500 billion (the limit in the House resolution is \$550 billion) and dare the Senate Republican "moderates" to shoot it down.

But despite the best spin control efforts of the **White House**, the centerpiece of the **Bush** proposal -- *total* elimination of double taxation of dividends and retained earnings -- may very well be a bridge too far, at least in this session of Congress. Still, half a loaf is better than none, and a consensus is developing in pro-growth circles for an alternative that is being dubbed the "50/50" plan. Under this approach, dividends would be taxed at the same rate as capital gains, with that rate set at 50% of the marginal income tax rate faced by the taxpayer. The acceleration of the marginal rate cuts set out in the 2001 tax-cut would remain as part of the package. Thus, the top rate on dividends and cap gains would be set at half the 35% top marginal rate, or 17.5%. Obviously, this wouldn't have near the incentive effects of the original Bush proposal, and it may to some extent tilt marginal incentives in favor of more risk-averse enterprises. There is much that remains to be revealed and analyzed -- but generally we would see something along these lines as an important step in the right direction, and a "down payment" on the total elimination of double taxation of corporate income.

But whether even this watered-down proposal could be made to fit within the budget's bean-counting strictures is an open question. The plan would have a 10-year static "cost" of \$575 billion, which is outside the bounds of even the more generous House limits. To reduce the estimated revenue loss, consideration is being given to a shortening of the budget-projection window; the shorter it is, the lower the cost. At seven years, the revenue loss is reduced to \$400 billion, and five years brings it down to \$350 billion. Of course **Democrats** engaged in similar budgetary sleight of hand when it suited their purposes while in control. But it would give Democratic leaders a ready rationale for lambasting the fiscal trickery of the Republican

majority, and could create more difficulties keeping the GOP bloc intact, particularly in the Senate. Thus, the possibility that a working majority could yet be assembled for a package devoted to economically useless income transfer schemes -- expansion of the kiddie credit, reduction of the marriage penalty, *etc.* -- cannot be ruled out.

In all this, one should not lose sight of the hold being exerted on the process by a budget-estimating methodology that has failed even to meet the standards that would give it the dignity of being called "guesswork." To have real political stakes riding on whether a tax relief package is estimated to have a 10-year "cost" of \$550 billion versus \$350 billion stretches the limits of credulity. A **Tax Foundation** study last year on the **Congressional Budget Office's** forecasting record found that "margins of error of 50 percent or greater and swings in deficit/surplus projections of hundreds of billions of dollars are typical. Just over the past five re-estimates by CBO of last year's surplus swung by \$448 billion and ranged between a projected deficit of \$167 billion and surplus of \$281 billion." For fiscal 2002, which ended last September, CBO had projected a surplus of as much as \$313 billion before finally forecasting a deficit of \$21 billion early last year. In the event, a deficit of \$158 billion was registered for the fiscal year. **TM**