Tax Briefing Book

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I. Burden of Taxation

Tax Burden Rising

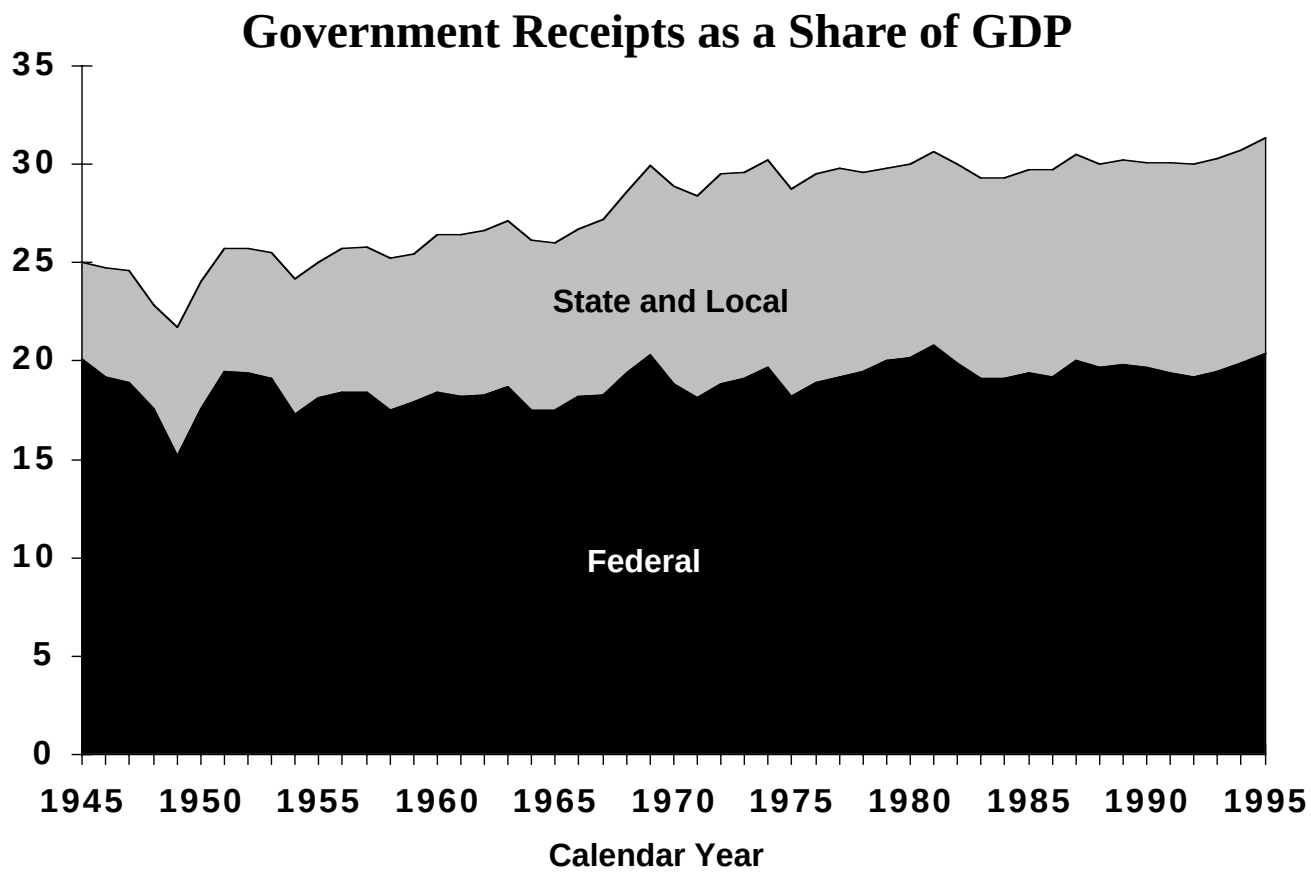
Data from the Department of Commerce reveal that federal, state and local taxes combined consumed a record 31.3 percent of gross domestic product in 1995 — the highest level in U.S. history. And in the second quarter of 1996, federal taxes reached their highest level ever: 20.8 percent of GDP. Even at the height of World War II in 1945, total taxes consumed only 25 percent of GDP. (See Figure I-1.)

Total taxes rose by 1.3 percent of GDP in the first three years of the Clinton administration. The federal tax burden grew by 1.8 percentage points in President Clinton's first three and a half years in office. (See Figure I-2.)

"The rising tax burden is due to federal — not state and local — tax increases."

Highest Tax Burden in History. Although some of the increase in the total tax burden has occurred at the state and local levels, total state and local taxes in 1995 were only 0.1 percentage point higher than in 1992. Virtually all of the recent growth is federal.

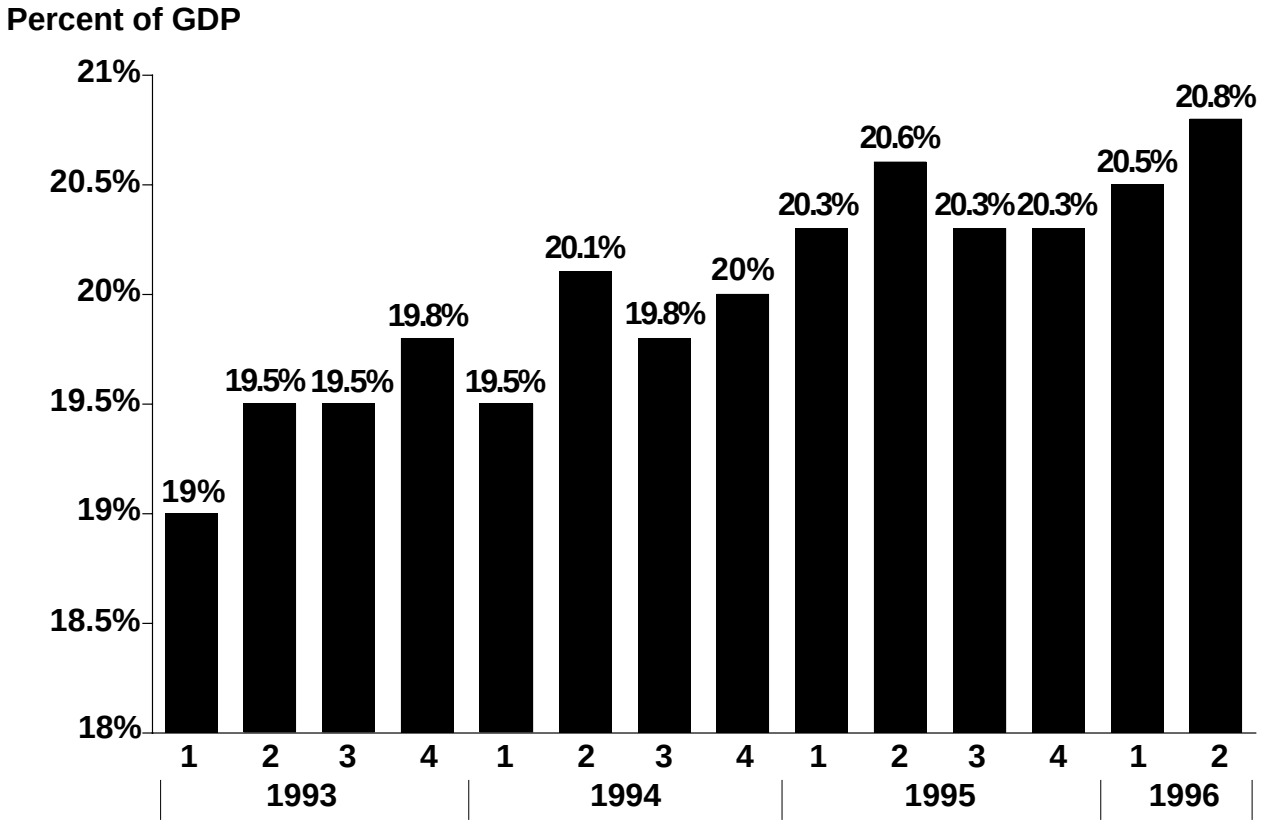
FIGURE I-1



Source: Department of Commerce.

FIGURE I-2

The Growth of Federal Taxes under Bill Clinton



Source: Department of Commerce.

"Federal taxes just reached their highest level ever: 20.8 percent of GDP."

Calculations of tax revenues as a share of GDP for every period for which there are data show that federal revenues have never been higher. Annual GDP data go back to 1929, and quarterly data exist from 1946 to the present. In all that time, in only four years have federal taxes been as high as 20.5 percent of GDP, and three of those were war years.

- Revenues reached 20.5 percent of GDP in 1943 at the peak of World War II.
- They reached 20.6 percent of GDP in the first quarter of 1951 during the Korean War.
- And revenues got as high as 20.7 percent of GDP in the second quarter of 1969, when the Vietnam War surtax was in effect.

The only other time before the Clinton administration when revenues were as high was in 1981, when they reached 20.7 percent of GDP in the first half of the year. That was due to the double-digit inflation of the Carter administration, which pushed people into higher tax brackets. Thus there has never been a period in which the federal government took as much out of the economy in taxes. There has been a rising trend since the 1993 federal tax increase.

Some groups, like the Center on Budget and Policy Priorities, claim taxes on individuals really have not risen because much of the increased revenue comes from corporations or nontax sources such as Medicare premiums. But taxes on corporations are always passed through to people in the form of lower wages, higher prices or lower dividends. And higher Medicare premiums lower disposable income the same way higher taxes do. Therefore, taxes as a share of GDP is still the best overall measure of the tax burden.

Historically, tax levels even close to these have triggered major tax cuts. State and local government receipts (now 10.9 percent of GDP) reached 10.6 percent in 1977. The following year Proposition 13 in California led a nationwide tax revolt at state and local government levels. Rising federal tax burdens in the 1970s resulting from bracket creep led to the Reagan tax cut.

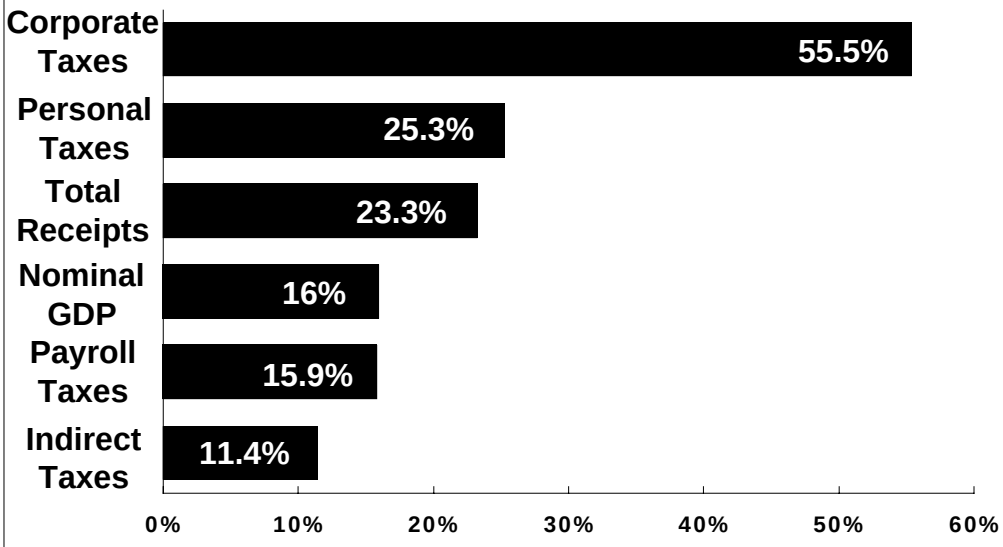
"Personal taxes have risen faster than output — and corporate taxes even faster."

Who Is Paying More. The biggest precentage increase since 1992 has come from higher taxes on corporations — 55.5 percent (see Figure I-3). The next largest increase has come from personal taxes, which have risen 25.3 percent since 1992. Since GDP rose only 16 percent from 1993 to 1995, this means that personal taxes have risen 1.6 times faster than GDP and corporate taxes have risen 3.5 times faster.

- Had corporate taxes increased only as fast as GDP, they would have equaled $138 billion in 1995 rather than the actual $184 billion.
- Had individual income taxes risen at the same rate as GDP, they would have grown to $555 billion by 1995, or $43 billion less than the actual $598 billion.

FIGURE I-3

Percent Increases, 1992-95



Source: Department of Commerce.

- Federal taxes could have been cut $88 billion in 1995, and the ratio of receipts to GDP would have been no lower than in George Bush's last year.

Payroll taxes have risen at almost exactly the same rate as GDP. Indirect taxes, including federal excise taxes, have risen more slowly.

Why Taxes Rose. This vast increase in federal taxes is the result of two factors: the 1990 and 1993 tax rate increases and the effect of progressive tax rates. The latter may be more important. While tax rates are indexed to inflation, they are not adjusted for real growth in the economy. This means that even without legislated tax increases, taxes must be cut periodically to keep the tax burden from rising.

"A 15 percent tax cut would bring taxpayers the relief they need — quickly."

According to the Senate Budget Committee, the median family had an effective federal tax rate of 12 percent to 13 percent in the early 1960s — income and payroll taxes combined. By 1995, this rate had roughly doubled to about 25 percent and was up two percentage points since 1987.

As workers achieve some growth in their real incomes, they are pushed into higher tax brackets. A single worker with a taxable income of just $24,000, for example, will go from a federal income tax rate of 15 percent to 28 percent on the next dollar he or she earns. With Social Security taxes on top of that on all earnings up to $62,700, workers with incomes between $20,000 and $60,000 are among the most heavily taxed people in America.

Taxpayer Relief Before Tax Reform. A 15 percent across-the-board cut in personal income taxes would reduce total federal receipts as a share of GDP to a level no lower than they were in 1992. Such a tax cut could take effect — and provide taxpayer relief — quickly. By contrast, it would take Congress a minimum of two years to reform the overall tax system, once the process was started — and the process has yet to begin.

While Republicans have talked about tax cuts for more than two years, they have scaled back their proposals. Now nothing is left but the $500 child tax credit. Yet the child tax credit does nothing for the economy, and it divides taxpayers into two groups. Those with children and modest incomes get a big tax cut, while everyone else gets nothing. But the tax burden has risen for everyone, and an across-the-board tax cut would affect every taxpayer by an equal percentage.

A 15 percent cut not only would be good politics, but also would be good economics. It would lower marginal tax rates — the tax on each additional dollar earned — and thus stimulate work, saving and investment.

The Growth of the Tax Burden

A low tax rate was a major contributor to America's early economic growth.

TABLE I-1

The Growth of Federal Income Taxation

Year	Minimum Tax Rate	Income Subject to Minimum Tax Rate[1]	Maximum Tax Rate	Income Subject to Maximum Tax Rate[1] (millions)	Tax Returns (millions)	Returns/ Labor Force
1913	1%	$300,000	7%	$7.5	0.36	0.009%
1917	2	23,000	67	23.0	3.5	8.5
1921	4	32,800	73	8.2	6.7	15.7
1941	10	20,000	81	50.0	25.8	44.8
1942	19	18,000	88	1.8	36.5	60.4
1944	23	16,700	94	1.7	47.1	71.3
1954	20	11,000	91	1.1	56.7	84.7
1964	16	2,400	77	.9	65.4	86.2
1970	14	1,900	72	.4	74.3	86.5
1992	15	10,000	31	.75	113.7	89.6

[1] 1993 dollars.

- In the 18th century, federal, state and local taxes were less than 5 percent of gross national product, and 95 percent of federal revenue came from tariffs.
- In the 19th century, tax revenue as a share of GNP gradually rose, but it never exceeded 10 percent.

"The first income tax was just 1 percent, and only the very rich paid."

The personal income tax, introduced by the federal government in 1913, was the instrument that made possible the transformation of the United States from a low-tax to a high-tax economy, and two world wars supplied the impetus. Most state and some city governments have since enacted their own income taxes — essentially piggybacking on the federal tax system.

Table I-1 helps to explain the transformation in federal taxes. The table shows the minimum and maximum marginal income tax rates in selected years, the income in 1993 dollars necessary to trigger those tax rates, the number of returns filed and the number of tax returns as a percentage of the labor force, which is a crude measure of the size of the tax base.

The Personal Income Tax: Early Stages. In 1913, the minimum marginal tax rate was 1 percent on income of $300,000 or more (measured in 1993 dollars). The top marginal tax rate was 7 percent on income above $7.5 million. Very few people had incomes that met the filing requirement. As a

fraction of the labor force, far less than one-tenth of 1 percent had to file. Is it any wonder that political opposition to the federal income tax was not widespread? The tax was imposed only on the very rich, and the rate they paid was modest.

Provoked by World War I, within four years marginal tax rates were increased, the level of income subject to taxation was lowered and the tax base was expanded. In 1917 a tax of 2 percent was imposed on incomes above $23,000 and 67 percent on incomes above $23 million. About 8.5 percent of the labor force filed a tax return that year.

World War II: A Majority Become Income Tax Payers. Prior to World War II, a tax of 10 percent was imposed on incomes above $20,000 and a rate of 81 percent on incomes above $50 million in 1993 dollars. With the advent of war, the minimum marginal tax rate nearly doubled and the maximum marginal tax grew to 88 percent on incomes above $1.8 million. Presumably, patriotism overcame tax resistance. For the first time, employers were required to withhold income tax from wages. This increased compliance and 60.4 percent of the labor force filed returns. At this point, the majority of Americans were paying income taxes, leaving only the bottom third or so of the labor force free of taxation.

After the war, marginal tax rates fell, but so did the level of income subject to tax. By 1970, the minimum marginal tax rate was 14 percent on incomes above $1,900 and the maximum rate was 72 percent on incomes above $380,000; and 86.5 percent of the labor force filed returns. Since 1970 a creeping incrementalism has widened the tax base somewhat. During the Reagan administration, the top marginal rate was reduced to 28 percent. As a result, people were encouraged to realize more taxable income, and the share of total income taxes paid by the wealthiest 1 percent of taxpayers rose from 18 percent to 27 percent.

"Today's top income tax rate is 39.6 percent, and some taxpayers face marginal rates to 43 percent."

Some of the gains achieved during the Reagan years have been reversed by the Bush and Clinton administrations. Today, the top income tax rate is 39.6 percent and, when the phase-out of the standard deduction and the personal exemption are figured in, the marginal tax rate on income reaches 43 percent for some taxpayers.

State and Local Taxes. State and local governments also have become inventive in devising taxes. No state had a sales tax in the early 20th century; now few states lack one. In some cases, their rates reach 8 percent of consumption expenditures. All but a few states have an income tax as well. In some cases, states take 10 percent or more of income. More than 30 states sanction gambling as a source of tax revenue. Further, some cities have enacted their own sales and income taxes. And state and local governments also impose property taxes.

Future Tax Burden

Generational Accounting. While serving as George Bush's Director of the Office of Management and Budget, Richard Darman initiated a section in the budget dealing with generational accounting. Beginning with the 1993 budget, issued in January 1992, calculations were made on what the lifetime net tax rate would be for Americans born in different years. The net tax rate is defined as total taxes paid over one's lifetime less government transfers received as a percentage of total labor income, all in present value terms (i.e., adjusted for the rate of interest).

"The older one is, the lower one's lifetime net tax burden."

The technique, developed by Professors Alan Auerbach of the University of California at Berkeley, Jagadeesh Gokhale of the Federal Reserve Bank of Cleveland and Laurence Kotlikoff of Boston University, shows how federal fiscal policies affect different generations. It shows that the older one is, the lower one's lifetime net tax burden. This is because tax rates tended to be much lower during the working lives of current retirees, while Social Security benefits are very high relative to their contributions.

The original Social Security tax rate was just 1 percent in 1937 (on both employer and employee) on the first $3,000 of earnings, and benefits began being paid out as early as 1940. Obviously, everyone retiring in the early years of the program received a huge windfall, having paid in virtually nothing. As time has gone by, Social Security tax rates have risen sharply to the current rate of 7.65 percent on the first $61,200. As a result, each succeeding generation is paying more into the system and getting back relatively less.

Lifetime Net Tax Rate. The generational accounts essentially work out this relationship and quantify it. For someone born in the early part of the century the combination of lower tax rates during their working lives and more generous retirement benefits gave them a lifetime net tax rate in the 20 percent to 25 percent range (see Figure I-4). Those born since World War II will pay 30 percent to 35 percent. Generations yet unborn can expect to pay lifetime net tax rates more than twice as high unless current policies are changed.

According to calculations published by the Federal Reserve Bank of Cleveland, the lifetime tax rate for every age group has risen in recent years. The lifetime tax rate on future generations has risen from 71 percent to over 84 percent. Thus it is not surprising that generational accounting was dropped from the 1996 budget.

The Moral Dimension

After Bob Dole announced his proposal for a 15 percent across-the-board tax rate reduction in 1996, virtually all of the discussion of it was about

the economic dimension. Who will get it? How much will it increase growth? How will it be paid for?

But the more important aspect of the Dole plan was the moral dimension. What he really asked us to consider was the morality of allowing the federal government to take out of the paychecks and pockets of the American people a greater percentage of earnings than ever before. What justification is there for the American people to bear a heavier tax burden, in terms of federal revenues as a share of the gross domestic product, than during World War II, the Korean War or the Vietnam War?

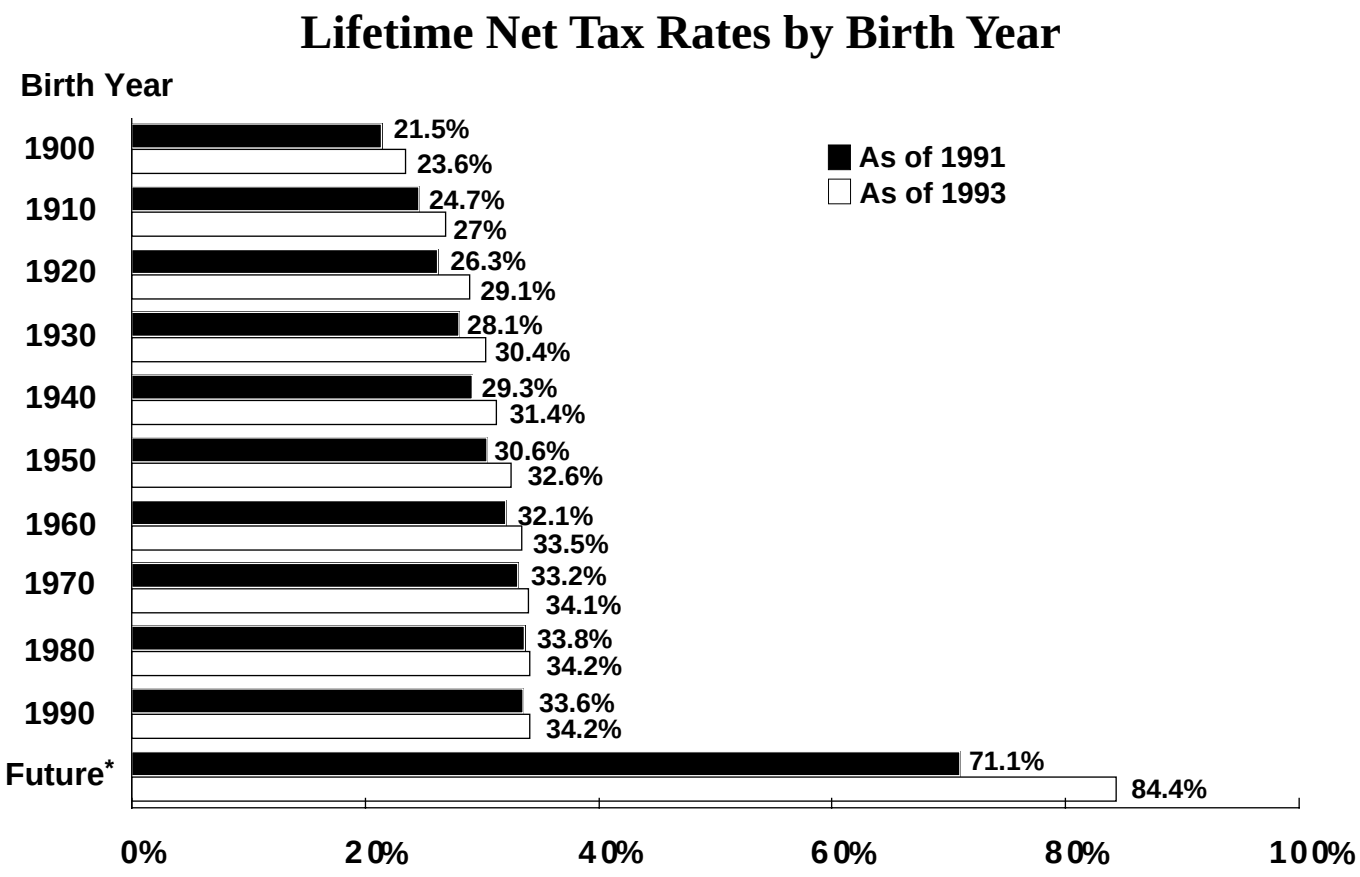
We are at peace, the Defense Department has been sharply downsized and the United States faces no major or immediate threats. Instead of paying more taxes, we ought to be enjoying a peace dividend. Taxes ought to be falling, not rising.

But since the end of the Cold War, taxes have increased, and no end is in sight.

"The lifetime net tax rate on future generations is now 84 percent."

Some other countries impose even heavier tax burdens. But the relationship between the individual and the state in those countries is far different.

FIGURE I-4



* Born in 1994 and after.

Source: Auerbach, Gokhale & Kotlikoff.

"Americans have never tolerated such high taxes for long."

The United States was founded by people who yearned for the freedom to live their lives and spend their money as they saw fit. In fact, high taxes imposed by Britain were the spark plug that ignited the American Revolution. Americans treasure liberty in a way the Russians, French and Germans never have.

Bob Dole understood this. As he said over and over again, the money is yours; not the government's. The individual does not have to justify a tax cut; the government must justify its taxes. Many people asked how the Dole tax cut would be paid for, and warned that cutting taxes would require cuts in popular government programs. They did not ask how the 1993 tax increase, often characterized as the largest in history, would be paid for or what kinds of cuts in household budgets those taxes would require.

In the late 1970s taxpayers rose up in a massive revolt that forced state and local governments to slash taxes. Eventually their voices were heard in Washington as well, when Democrats competed with Republicans to enact the largest tax cut in American history in 1981.

Again the pressure for tax reduction is building. Americans have never tolerated so great a tax burden for long. Unless the character of the American people has undergone a fundamental change, sooner or later they are going to demand their money back.

II. Taxes and Growth

Economist Adam Smith in the 18th century observed that tariff rates beyond a certain level were self-defeating because they reduced imports and hence tariff revenue. One reason was that high tariffs encouraged smuggling. Smith's interest in an inverse relationship between tax rates and government revenue reappeared in the 20th century among those who have been termed supply-side economists. Economist Arthur Laffer, who devised the Laffer Curve, popularized the idea that high tax rates give people incentives to not report or underreport income or to simply earn less taxable income.

The Laffer Curve. Laffer and his disciples noted that beyond a certain point government realizes less revenue when the tax rate rises. This new look at a 200-year-old finding was the basis of the supply-side revolution and furnished the impetus for the Reagan administration's cuts in marginal tax rates. These cuts were responsible for a tremendous expansion of the economy during the 1980s. Both tax compliance and tax revenue rose. At lower tax rates, people are encouraged to realize more taxable income, base their investments on economic rather than tax considerations and spend less on wasteful tax avoidance.

"We should tax just enough to maximize economic growth."

But the thrust of supply-side economics was misfocused. Rather than determining what rates would maximize tax revenues to the government, conservative economists should have concerned themselves with what levels of taxation would maximize economic growth. Economists have done comparatively little work on this subject, and much of the research that has been done has concentrated on the various disincentives and distorting effects of taxation that cause efficiency losses. However, determining the tax rates that lead to the greatest creation of private wealth is the key to solving some of the major economic problems of our time.

Why Taxes Matter

That American productivity has slid since the 1950s is a fact. Annual productivity growth rates that were in the 3.0 to 3.5 percent range have fallen below 1 percent. As a result, many Americans have suffered a decline in their living standard.

Many excuses and rationalizations for the productivity slowdown have been offered, including inadequate physical and human capital formation, too much regulation (especially environmental regulation), low research and development expenditures and the energy crisis. There is considerable evidence, however, that the underlying cause is the growth in the size of government since World War II and the accompanying increase in taxes.

How Taxes Affect Saving and Investment. In our tax code, interest on savings is taxed as ordinary income (rare among industrial nations). This lowers the return on saving and tends to reduce the amount saved. Until recently we subsidized consumer credit by making it deductible. We heavily subsidize home ownership by making interest payments deductible. While perhaps laudable as social policy, this leads to more investment in housing and less in other productive activities than would be the case in the absence of the subsidy. On the investment side, if capital expenditures are financed with borrowed money, the interest is deductible. If they are financed with equity issues, they are not deductible. This leads to a distortion in debt-equity ratios for business. Also, tax depreciation schedules differ for different assets and bear little relationship to economic depreciation. And since these schedules are not indexed for inflation, investment in long-lived assets is discouraged.

How Taxes Affect Labor. Taxes drive a wedge between work and leisure. Moreover, the U.S. taxes effort (income) progressively, so that the income from the last hour worked is taxed more heavily than the income from the first hour worked. The net effect is to discourage people from working. In addition, antipoverty programs that subsidize not working have consumed $5 trillion (constant 1992 dollars) since the War on Poverty began during the Johnson administration.

"Tax the last hour worked more heavily than the first and the result is: less work."

The Effects of Regulations. Further distortions arise because different assets are subject to different regulations. A regulation is an implicit tax on an asset. For example, current regulations require gasoline stations to bury gasoline tanks in concrete bunkers and provide access to continuous inspection and monitoring. This adds about $250,000 to the cost of being in the business, not a small sum for a marginal business. Partly as a result of stiffer environmental regulation, the number of gas stations has dropped by half in a generation or so. In general, air and water quality standards have differing impacts on different industries. As a result, less polluting industries yield more output and more polluting ones yield less.

The Costs vs. the Benefits of Government Activities. Most people acknowledge that at least a minimum of government is necessary to the functioning of a free society and a growing economy. By providing a common defense against foreign enemies, a criminal justice system that promotes law and order and perhaps other "public goods," government expenditures contribute positively to private economic activity.

Beyond some level, however, government becomes a net drain on the private sector. Resources in a society may be allocated privately through the market system or politically through government. When resources are allocated privately, they tend to be allocated to the highest-valued use as entrepreneurs and capitalists seek the highest economic rate of return on their assets.

When politicians (or central planners) allocate resources, they seek the highest political return (e.g., votes and campaign contributions).

Additionally, public choice literature shows that collective choice (through government) leads to the overproduction of public goods and the expansion of "rent-seeking" activities. The government is the only entity that can use legal coercion to create a right that can be licensed or sold (e.g., a monopoly, tariff or subsidy). Those activities create permanent rents for special interests — a source of income that would be competed away in an unregulated market. Government-sanctioned exclusivity in a line of business can lead to a very high rate of return in that activity. For example, until recent years network-affiliated television stations in the 100 top markets had annual operating profits in excess of 35 percent.

"The optimal size of government is the size that maximizes growth."

The Growth Curve. Thus government expenditures and the taxes necessary to finance them both benefit and cost the economy. National defense, a legal system, roads, airports and harbors are likely to make private economic activity more productive. Therefore, taxes collected to pay for these public expenditures are likely to increase the rate of economic growth over some range (see Figure II-1). However, beyond some level taxes lower the rate of economic growth.

This line of reasoning suggests that there is an optimal size of government. It further suggests that the optimal size is defined by the level of taxation that maximizes economic growth (or what is the same thing, private wealth creation).

Estimating the Tax Rate That Maximizes Growth

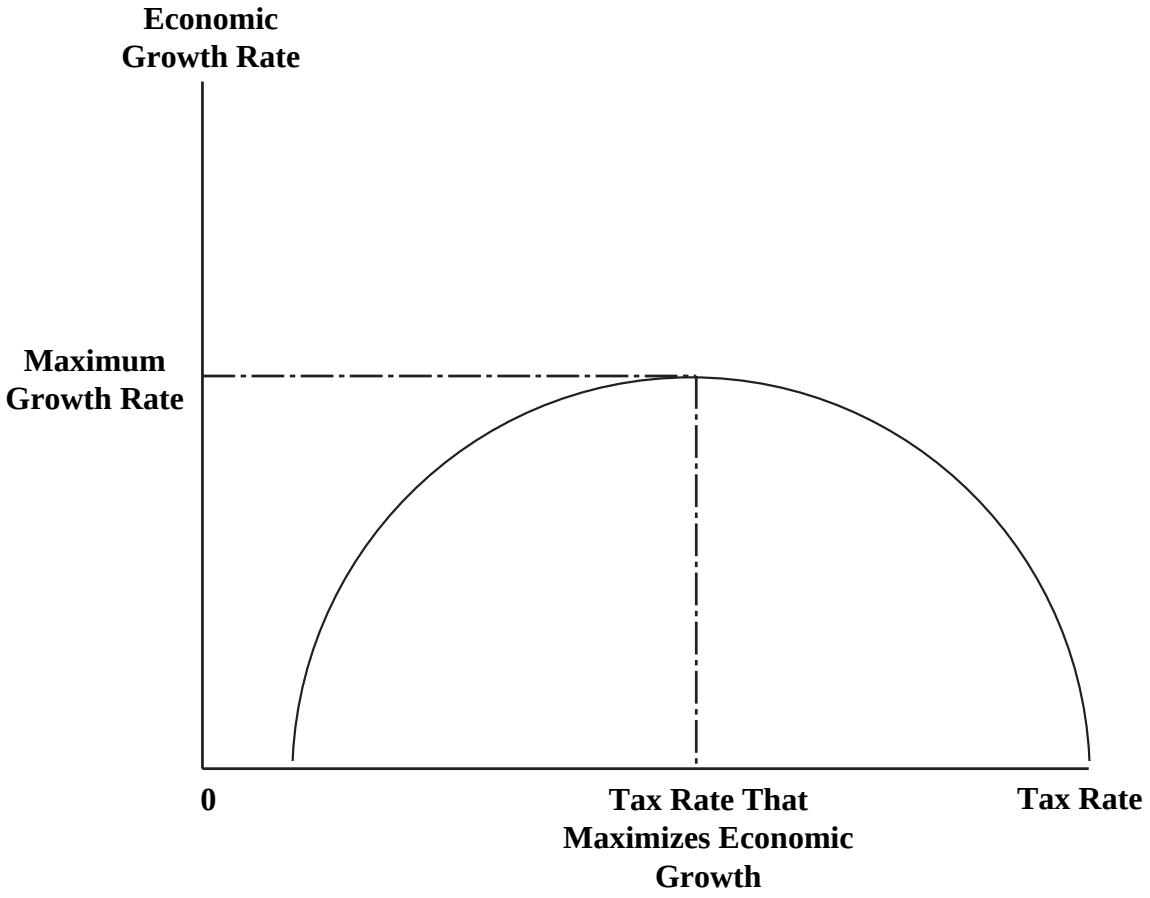
Using data from standard statistical sources, economist Gerald Scully has developed a simple but reliable econometric model to calculate the growth-maximizing tax rate — the rate at which increased taxes and spending cease to increase economic growth and begin to decrease it. The parameters of the model were estimated using established econometric techniques, and the equations of the model can then be solved. For the United States, the model found that:

- The optimal (growth-maximizing) average rate for federal, state and local taxes combined is between 21.5 percent and 22.9 percent of GNP.
- Taxes as a share of GNP were at the optimal rate in 1949 and have not been there since.

The optimal tax rates derived from this model are consistent with previous studies that concluded that an optimal size of government is 19

FIGURE II-1

Economic Growth and Taxation



"Our economy is not growing as fast — or producing as much — as it could have."

percent of GNP and that government spending of 20 percent of GNP maximizes productivity. All of these estimates imply that the economic growth rate and hence the level of GNP is far below what would have been achieved had the nation's total tax rate been kept at its 1949 level.

How Americans Could Have Been Twice as Wealthy

In 1929 federal, state and local taxes combined consumed a 10.9 percent share of GNP. In 1949, they were 21.7 percent of GNP — roughly the optimal tax rate calculated from the econometric model. By 1969 the tax share broke the 30 percent barrier, and it has been rising slowly since then. Real GNP was $1.563 trillion in 1949 (in 1993 dollars). By 1989, real GNP was near $6.2 trillion, reflecting a compound growth rate of 3.5 percent per year. The path of real GNP is shown in Figure II-2.

Loss of Personal Income. The model shows that the optimal tax rate is at most 22.9 percent of GNP. At the 22.9 percent level, the corresponding

real compound economic growth rate would have been 5.56 percent instead of the actual 3.5 percent.

- Had the optimal tax rate been in effect throughout the 40-year period, real GNP (1993 dollars) would have been $13.6 trillion rather than $6.2 trillion in 1989.
- As a result, the average American family would have twice as much real income as it has today.

Cumulative Loss of Income. From the time the tax rate exceeded the optimal point, more and more American resources have been devoted to less and less productive uses. The annual loss of income accumulates over time. Because taxes have been too high since 1949, the resulting lower economic growth and failure to maximize wealth have robbed the nation of almost *$95 trillion worth of output*. Specifically:

- The accumulated real GNP from 1949 to 1989 was $146.5 trillion.
- At the 1949 tax rate, however, accumulated real GNP from 1949-89 would have been $240.7 trillion — a difference of $94.2 trillion from the actual amount. (See Figure II-2.)
- On the average, this represents roughly $750,000 in lost income over the lifetime of every American family.

In general, the U.S. economy has sacrificed $2 worth of income for every $1 of tax paid beyond the level of optimal taxation. The implications of this finding are staggering.

"We have lost the equivalent of $100,000 for each American household."

Loss of Personal Wealth. If received, most of the lost income would have been consumed. But a fraction would have been saved, adding to the average family's wealth over time. Because the wealth that would have been generated will never be seen, it is difficult to visualize what it would have meant. To put it into perspective, consider that:

- The total wealth of the nation, estimated at $12 trillion to $15 trillion, would be closer to $25 trillion today.
- This higher national wealth would mean that every American family would have $100,000 more personal wealth than it has today, on the average.

Government Tax Revenues Lost. Exceeding optimal size has been costly to government at all levels, too. Over the period from 1949 to 1989, federal, state and local governments collected a real total of $43.5 trillion in taxes. But if the total tax rate had been limited to 22.9 percent of GNP, government would have been collecting taxes on a far larger GNP, thanks to a higher growth rate. As a result, the combined governments would have collected a real total of $55.1 trillion. This implies that:

- Had the nation's total tax rate been limited to 22.9 percent of GNP, government would have collected $11.6 trillion more in taxes.
- This additional revenue would equal the total of all deficits in real terms since 1949.
- *Not only would government have had enough revenue to fund all spending programs enacted but the U.S. would have no public debt.*

Why Have Voters Allowed Such Private Wealth Destruction?

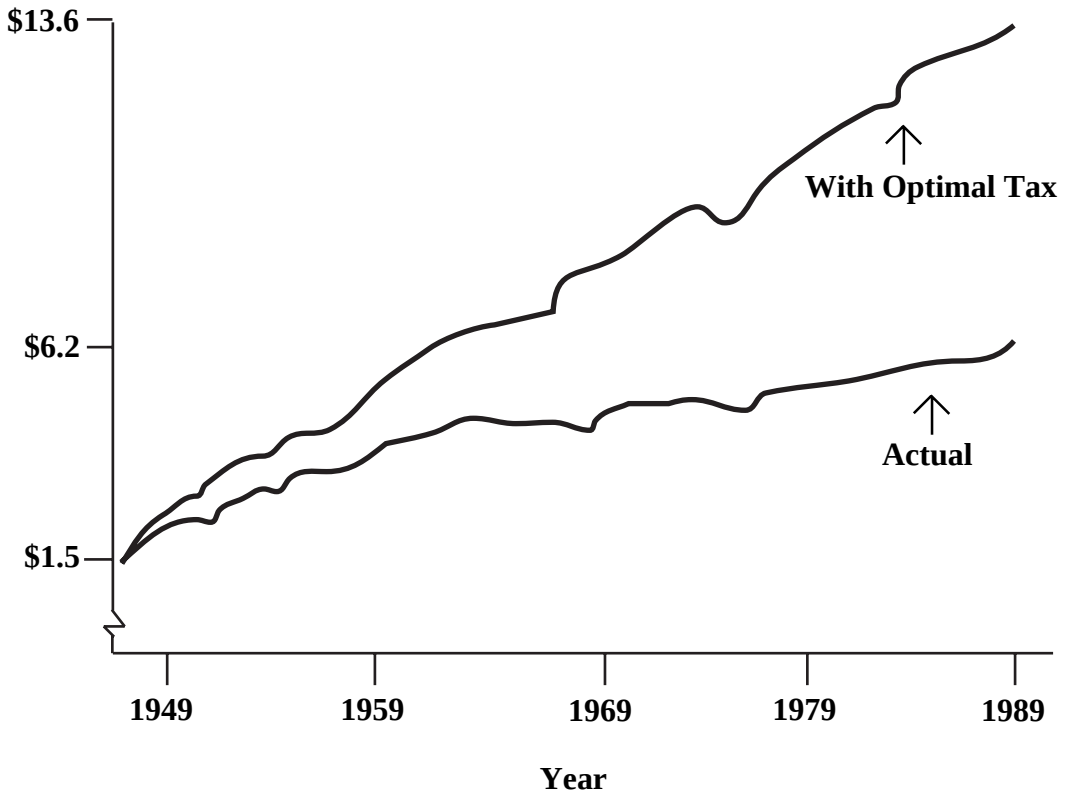
"If the optimal tax rate had been in effect, we would have no federal debt."

One might ask why citizens have allowed this destruction of private wealth through excessive taxation and why politicians have given up $11.6 trillion in real taxes since 1949. There are several explanations.

Taxpayers Are Unaware. First, and perhaps foremost, people generally are cognizant only of their actual earnings, not of their potential earnings. They do not miss the lost 2.1 percent growth in real output because they never

FIGURE II-2

Path of Real Gross National Product
(Trillions of 1993 dollars)



had it. Also, many are ignorant of the intimate link between taxation, incentives and economic efficiency. Moreover, because of the compulsory deduction of taxes from wages, many workers are unaware of their actual tax burden. Most people have no idea how much of their total income goes to taxes because the taxes are hidden or are a negligible portion of an individual transaction.

Growing Demand for Government. Second, we do not have a very good theory of why government grows. As mentioned above, government has grown at times by distinct jumps (World War I and World War II each yielded a permanent 50 percent or so increase in the tax burden) and at times incrementally (e.g., the Roosevelt years, 1932-40, and during Johnson's Great Society of the 1960s). Patriotism silenced objections to higher tax rates and expansion of the tax base during the wars. The Great Depression conditioned people to the idea of a larger role for government. New and expanded government redistribution programs tend toward what might be called creeping incrementalism. For example, the food stamp program began in the early 1960s as a modest $175 million effort and now costs $28 billion. Another discrete jump in the size of government is on the horizon if it assimilates the $1 trillion health industry — an act equivalent to government absorption of the fifth largest economy in the world.

Politicians' Priorities. Third, politicians face a different set of priorities than do other citizens and often fail to appreciate how the world works. Since most politicians are lawyers, whose function is to redistribute income between the equivalent of plaintiffs and defendants, they misunderstand how productive activities occur and how their decisions affect such activities. For example, for 200 years politicians have been told of the benefits of free trade, yet with a couple of exceptions (e.g., Britain in the 19th century and the United States after World War II), politicians and the public have preferred protectionism. For 200 years, from Adam Smith's observations about tariffs and smuggling to the supply-siders' observations about marginal tax rates, politicians have been warned that excessive taxation promotes inefficiency and discourages compliance. The deleterious effect of massive regulation on productivity is well known, yet the burden grows. Henry Manne, dean of the law school at George Mason University, has suggested that the amount of law, mainly statutes, is 100 to 1,000 times greater today than in 1933.

Tax Rates Tend Toward Political Equilibrium. Most Americans, scholars included, subscribe to the Anglo-American public finance tradition of thinking of government as benign. From this point of view, policy choices often seem irrational and enigmatic. Public choice theorists see the behavior of politicians and the constituencies that elect them as rational, self-interested and self-serving, having more to do with reelection and rent-seeking than with economic efficiency. In this view, excessive taxation may arise simply be-

"Politicians impose taxes to fund programs to please special interest groups — to get reelected."

cause the tax rate consistent with political equilibrium among competing special interest groups exceeds the rate that maximizes economic growth.

Effect of the 1993 Tax Increase on Income

During debate on President Clinton's 1993 tax increase, prominent economists such as Professor Martin Feldstein of Harvard predicted that the legislation would raise little, if any, additional revenue. People would adjust their behavior, they said, to minimize the tax bite by working fewer hours, taking longer vacations, investing less and making greater use of tax shelters. People could not fully adjust their behavior because the tax increases were retroactive to the beginning of 1993. However, IRS data on tax collections in 1993 confirm the economists' predictions.

According to the IRS, adjusted gross income (AGI) increased just 2.3 percent in 1993 after rising by 4.8 percent in 1992, and taxable income increased just 2.2 percent. By contrast, gross domestic product (GDP) rose by 5.4 percent and personal income increased 4.3 percent. And because prices went up by 2.7 percent, this means that both AGI and taxable income actually fell in real terms.

"After the 1993 tax increase, millionaires paid taxes on 11.4 percent less income."

The falloff in real taxable income was greatest among those most affected by the higher tax rates. (The top tax rate went from 31 percent to 36 percent for couples earning over $140,000 and to 39.6 percent for those earning more than $250,000.) Thus while real taxable income rose by 8.6 percent for those earning between $100,000 and $200,000, it rose just 0.2 percent for those earning between $200,000 and $500,000. For those earning between $500,000 and $1 million, real taxable income actually declined by 4.7 percent, and for those earning over $1 million it fell by 11.4 percent.

During the tax-cutting years of the 1980s, when the top tax rate fell from 70 percent to 28 percent, real AGI and taxable income rose sharply. The tax base expanded as people worked more, invested more, took money out of tax shelters and put it into taxable investments. Between 1983 and 1989 real AGI expanded by an average of 4.6 percent per year.

Unfortunately, in 1990 President Bush reversed President Reagan's tax-cutting strategy and unwisely attempted to balance the budget by raising tax rates. In 1993 President Clinton compounded President Bush's error. As a result, real AGI was flat for four straight years. In fact, real AGI was actually lower in 1993 than it was in 1989, and taxable income fell from 49.6 percent of personal income in 1989 to just 43 percent in 1993. Over this same period real GDP rose by more than 6 percent.

Despite a decline in the tax base, however, tax revenue did increase in 1993. This is mainly because the tax hike was retroactive, making it harder for people to adjust their behavior.

Effect of Taxes on Savings

The fraction of income that Americans save is well below the saving rate of other countries. We also save less than the amount we need to invest in order to sustain even moderate economic growth. Given that we want economic growth, we have two choices. Americans must either import funds for investment from other countries or increase our saving rate.

"We must either save more or hope foreigners keep investing in America."

Decline in Saving Rate. In recent years the domestic saving rate in the United States has been inadequate to finance domestic investment. In 1993, for example, gross saving (including the retained earnings of corporations) amounted to $787.5 billion and gross private domestic investment came to $882 billion. Thus the United States was forced to import $92.3 billion in investment funds from other countries.

The decline in personal saving has been going on for some time. The personal saving rate in the United States fell from more than 8 percent in the early 1980s to about half that level by 1994. (See Figure II-3.) Getting the saving rate back up to 8 percent — which would still be low by international standards (see Figure II-4) — would add more than $180 billion annually to the supply of national savings. This would eliminate the need for capital imports and add close to $100 billion to the capital stock annually.

Role of Government Deficits. The federal budget deficit usually receives the blame for our saving problem, on the theory that government borrowing to finance the deficit takes funds that otherwise could have been invested and diverts these funds to spending programs that mainly expand consumption. However, saving decisions by households are more important than the deficit. For example, personal savings fell from $247.9 billion in 1992 to $192.6 billion in 1993. This $55.3 billion decline was greater than the $42.8 billion decline in the budget deficit over the same period.

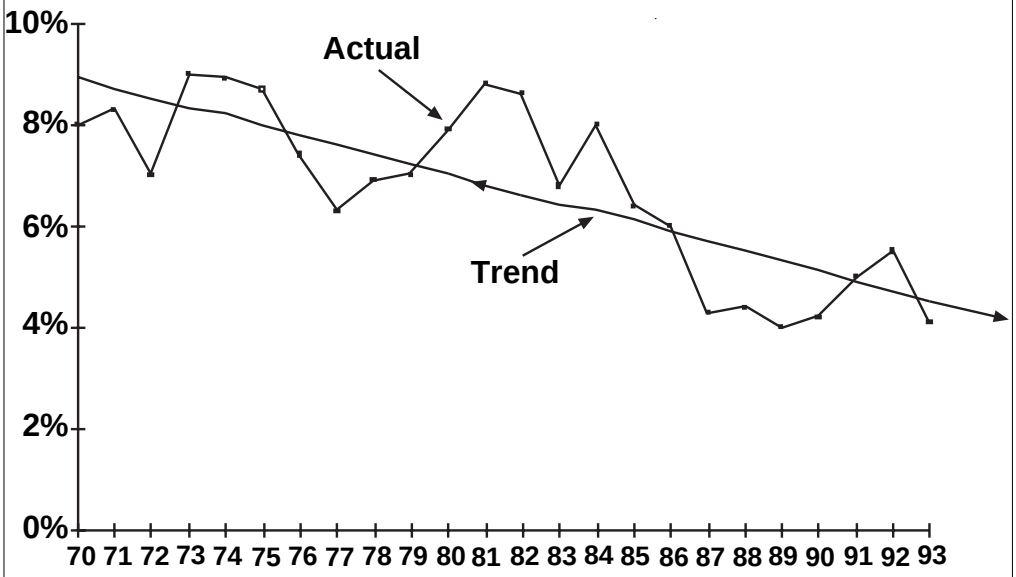
Less saving was available to finance investment in 1993 than in 1992, despite a 17 percent decline in the deficit. As a consequence, U.S. imports of foreign capital increased.

Role of Tax Policy. Although there are many reasons for our low saving rate, including social and demographic factors, economists have identified tax policy as a major culprit. In particular, the income tax greatly increases the cost of saving relative to consumption. This is because the benefits of consumption — pleasure, satisfaction or well-being — are not taxed, whereas the returns on savings (interest, dividends, etc.) are taxed. Thus there is an inherent tax bias against saving.

In order to eliminate this bias and treat saving and consumption equally, individuals should be allowed either to deduct savings from their taxable income or to receive the income from savings tax-free. Either method would

FIGURE II-3

Personal Saving Rate[1]



[1] Saving as a percent of disposable personal income.

Source: Department of Commerce.

provide tax neutrality — ensuring that the decision to save or consume one's income would not be affected by the tax law.

Expanded opportunities to make deposits to Individual Retirement Accounts (IRAs) are a proven way of encouraging more savings.

"Individual Retirement Accounts increase the rate at which people save."

Have IRAs Increased Savings? Under current law, contributions to IRAs are deducted from gross income, and the return on IRA savings is allowed to grow tax free. Note that even IRAs do not fully provide tax neutrality because contributions are limited to $2,000 per year and restricted by income. In addition, all withdrawals are fully taxable and withdrawals before age 59-1/2 are penalized.

Critics claim that individuals shift funds from taxable accounts to IRAs without increasing their total savings. While some shifting may occur, especially among those with high incomes, it is limited because most people don't have many financial assets to begin with. According to the Federal Reserve, the median value of financial assets for all U.S. families is just $13,100 — a figure that includes IRAs. Consequently, the vast majority of Americans have a limited capacity to shift funds into IRAs from other savings. Although they may shift funds initially, after a few years they would have to increase their saving rate in order to get the maximum tax saving from an IRA.

Studies by Professors Steven Venti of Dartmouth, David Wise of Harvard, Glenn Hubbard of Columbia and Jonathan Skinner of the University of Virginia have clearly shown that IRAs increase the rate of personal saving. These studies show that as much as 80 cents of each dollar deposited to IRAs represents new savings.

Do IRA Deposits Cause Revenue Losses for Government? NCPA studies show that IRA tax incentives more than pay for themselves. The initial loss of tax revenue is more than offset by additional revenue produced by the greater output that results from increased investment.

Tax Rates Affect Evasion and Avoidance

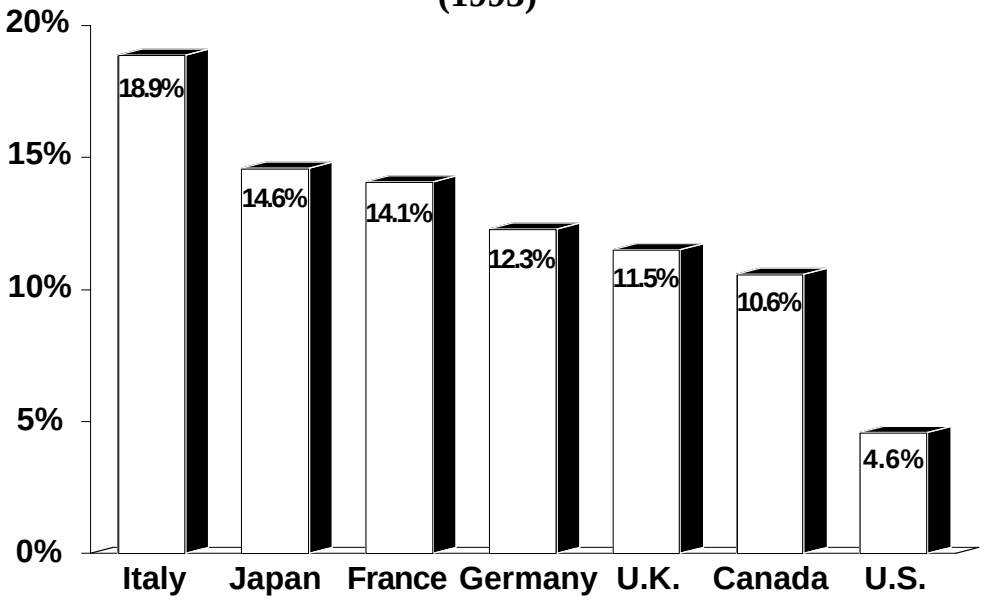
The Internal Revenue Service is an agency under siege. On the one hand, it is under continuous pressure from Congress to collect every last dollar owed to Uncle Sam, in order to reduce the deficit and lower the burden on law-abiding taxpayers. On the other hand, it is continually criticized by Congress for using heavy-handed tactics, bullying and harassing taxpayers and overstepping its bounds.

Clearly, the IRS is caught between the proverbial rock and a hard place. If it is to increase the compliance rate for tax collections, it must use ever more draconian methods. But when it such employs methods, it faces a backlash from irate taxpayers and their elected representatives.

"By international standards, our saving rate is pathetic"

FIGURE II-4

Household Saving Rates[1]
(1993)



[1] Saving as a percent of disposable personal income.

Source: OECD.

According to the latest estimates, in 1992 the IRS collected between 83.1 and 83.6 percent of the individual income tax revenue it believes it was entitled to, and between 81.1 and 88.1 percent of the corporate revenue. This left a tax gap of between $110 billion and $127 billion uncollected. Three-quarters of the individual tax gap came from unreported income, mainly from self-employment.

While much of the debate over tax compliance involves questions about audit rates, modernization of IRS computers and other technical issues, tax rates also play a critical role. A number of academic studies have shown that the higher tax rates are, the greater evasion is. This stands to reason because the higher tax rates are, the greater the *profit* in tax evasion.

"When tax rates are cut, fewer people evade or avoid paying."

Conversely, lower tax rates reduce the incentive to evade. And increased enforcement of high tax rates may be self-defeating. As James Alm of the University of Colorado put it in a January 1988 article in the *Public Finance Quarterly*, "Government policies that reduce evasion may not increase the tax base because the individual may respond by increasing the amount of tax preferences, and tax rate reductions may be a more powerful tool for generating tax base increases because rate reductions make both evasion and avoidance less attractive."

The relationship between tax rates and unreported income is illustrated in Figure II-5. It is based on the differences between Department of Commerce calculations of AGI derived from the National Income and Product Accounts, and IRS data on AGI reported on tax returns. It shows that as the income tax rate rises, unreported income tends to rise; and as tax rates fall, so does unreported income.

This suggests that tax cuts might do more to increase compliance than hordes of new IRS agents. Tax amnesties have also been shown to be effective in reducing tax evasion.

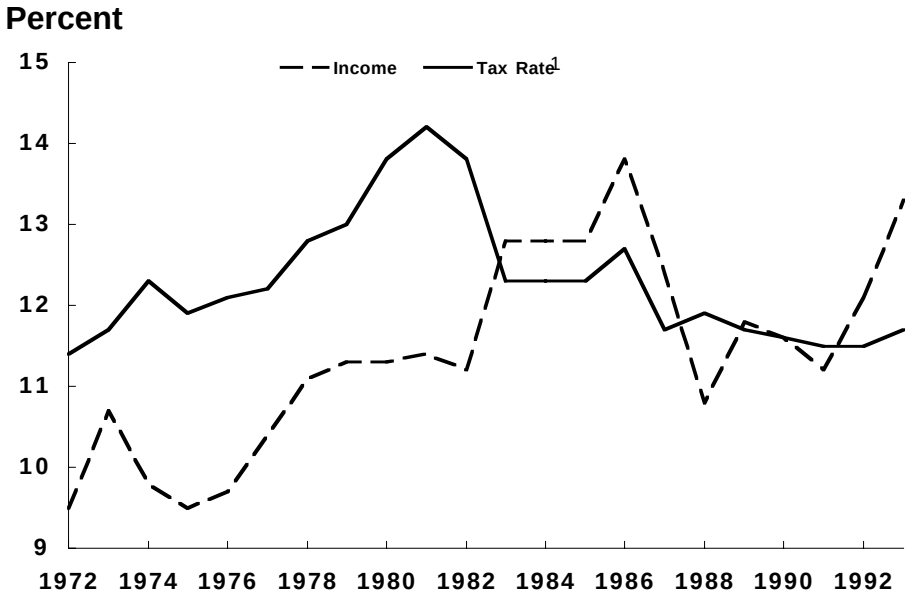
Tax Policy Key to Growth

For almost 200 years, the principal concern of economics was growth. From Adam Smith to John Maynard Keynes, economics was basically about how to increase the economic growth rate and thereby improve living standards.

Why Growth Was Ignored. However, beginning in the mid-1950s — under the influence of Robert Solow of the Massachusetts Institute of Technology, who won Nobel Prize for his work in 1987 and advised Bill Clinton in 1992 — economic growth was no longer central to economic theory. Concerns such as business cycles and inflation increasingly moved to center stage.

FIGURE II-5

Unreported Income as a Share of AGI and Effective Tax Rate



[1] Income taxes as a share of Adjusted Gross Income.

Source: Department of Commerce and Internal Revenue Service.

Economic growth ceased to be the main concern of economists because Solow showed that little if anything could be done to raise the long-run growth rate. In his model, long-run growth is mainly a function of technological changes, which government has little to do with. Economists say they are "exogenous," coming from outside the system.

"For a generation many academics believed we could not boost long-term growth."

Thus in the Solow model virtually all government policies are impotent in affecting long-term growth rates. Growth rates can be affected over the short-run and policies can affect the overall size of the economy, but the growth rate is essentially given. This view was incorporated into textbooks and has dominated academic thinking about economic growth for a generation.

Growth Theory. In recent years, growing numbers of economists have become dissatisfied with the Solow view. They have argued that policies such as taxation and education can affect long-term growth. Their growth theory is called "endogenous" — meaning from within the system. Proponents such as Paul Romer of Stanford point to dynamic Asian economies in which domestic policies appear to have sharply raised growth rates for many years.

An article in the December 1996 issue of the *National Tax Journal* looks at the effects of tax policy on growth in light of endogenous theory. Eric Engen of the Federal Reserve staff and Jonathan Skinner of Dartmouth describe ways taxation impacts growth.

"Tax cuts can raise long-run growth rates — and American living standards."

- They find that taxes can affect investment and the capital stock, labor supply growth, research and development, productivity and human capital (such things as education and training).
- Tax cuts can raise the long-run growth rate, they conclude, and estimate that a 5 percentage point cut in marginal tax rates would increase growth on the order of 0.2 to 0.3 percentage points per year.
- These numbers may seem small, but they compound quickly and over a period of years translate into significant increases in living standards — for example, had our economy grown 0.2 percent per year faster since 1960, real gross domestic product would be $500 billion greater today.

The Engen-Skinner results were confirmed by Congress's Joint Committee on Taxation, which asked leading economists to estimate the impact on GDP of switching to a flat-rate consumption tax system. All found significant positive effects. The median (average) estimate was an increase in real GDP of about 3 percent within a decade.

The Clinton administration takes the view that taxes do not affect growth. The Council of Economic Advisers concluded last year that Clinton's policies were already doing everything possible for economic growth. The council did not mention tax policy; but the latest research demonstrates that tax policy may be the key to growth.

Current Growth Compared to Reagan Era

Alan Blinder of Princeton, a Clinton appointee to the Council of Economic Advisers and then to the Federal Reserve Board, says that the rapid economic growth of the 1980s had nothing to do with Ronald Reagan's policies. The economy grew so rapidly between 1983 and 1990, he wrote in the *New York Times*, "because the nation was snapping back from a deep recession, not because trend growth was higher."

To prove his point, Blinder made an interesting calculation. He claimed there is a rule of thumb stating that each percentage point of unemployment costs the economy 2 percentage points of real growth. Therefore, the 4.1 percent decline in unemployment from 9.6 percent in 1983 to 5.5 percent in 1990 accounts for 8.2 percent of the total growth in real gross domestic product over that period. He then subtracted this cyclical growth to determine the underlying growth rate. Doing so lowers the average annual growth rate between 1983 and 1990 from 3.5 percent to 2.4 percent — comparable to Clinton's record, he implied.

This argument is silly because it presupposes that unemployment is independent of the GDP growth rate. But if Blinder wants to make it, then fairness dictates that we apply the same methodology to the Clinton era — something he neglected to do. Between fourth-quarter 1992 and second-

quarter 1996, real GDP grew 2.6 percent per year. But over that same period, the unemployment rate fell by 1.9 percentage points, from 7.3 percent to 5.4 percent. Therefore, using Blinder's rule of thumb, the decline in unemployment alone accounts for 3.8 percent of total GDP growth. Subtracting it out drops the underlying average annual growth rate to a minuscule 1.5 percent per year under Mr. Clinton.

Other economists have used a variation of the Blinder argument. The 1981-82 recession, they say, was the deepest of the postwar period, whereas the 1990-91 recession was the shallowest. Therefore, one would expect a more rapid recovery after 1982 than after 1991, thus explaining the more rapid growth of the 1980s and the slower growth of the 1990s. But in fact the 1990-91 recession was comparable to the 1981-82 recession, with real GDP declining by a total of 2 percent in the former and 2.8 percent in the latter.

By contrast, real GDP declined by 1.6 percent during the 1960-61 recession and 3.6 percent during the 1973-75 recession. In short, this focus on the business cycle is nothing but a smoke screen to obscure the poor record of growth during the current recovery.

The Growth Principle

At the heart of the 1994 Republican Contract With America was a firm commitment to economic growth. At the heart of the opposition to the Contract was a commitment to the politics of redistribution of income.

Opponents succeeded in the 104th Congress because they kept the focus on redistribution, not growth, and they have won on substance as well. In their efforts to compromise, the Republicans gave up more than half of their pro-growth tax cuts measured in static terms (that is, ignoring the economic effects of growth). And they gave up much more than half when measured by the dynamic ability of the tax cuts to stimulate the economy. In addition, Republicans who believe that balancing the budget should take priority over measures to increase economic growth were willing to reduce the tax cuts further to get a budget deal.

This is unfortunate for both sides. There is no way to reduce the deficit more efficiently and more painlessly than with a higher rate of economic growth. And there is no way of reducing the need for welfare spending more rapidly and more permanently than by achieving higher incomes for everyone. It would be politically catastrophic to give up the principle of economic growth in exchange for a patchwork of spending reduction promises spread over seven years.

"The best way to reduce welfare spending is to increase everyone's income."

The administration is committed to a growth path of 2.5 percent per year, compared with the 3.3 percent growth rate registered in the last five years of the 1980s. The difference between 2.5 and 3.3 may not seem like much, but it amounts to $2.3 trillion of additional output over the next five years, including $520 billion of additional revenue for the federal government.

A rising tide really does lift all boats. The additional revenue a 0.8 percent higher growth rate would generate would pay for all the tax cuts in the 1995 House Republican plan, including the $500 per child tax credit — and leave about $150 billion for deficit reduction or new spending. An even higher economic growth rate is not out of the question. By some estimates, the original tax reduction proposals in the Contract would have increased the economic growth rate by 2 full percentage points.

A successful budgeting process must include two elements. Slowing the growth of government spending is one. But encouraging economic growth is a higher priority, for it creates jobs and increases take-home pay, while also reducing the deficit through greater tax receipts.

Spending, Not Tax Cut, Caused Reagan Deficits

"With tax economic growth from a tax cut, we can shrink the deficit and grow personal wealth."

Tax cut opponents cite the Reagan tax cuts as budget busters. But the Reagan tax cuts had nothing to do with the increase in federal budget deficits during the 1980s.

- On average, federal receipts as a share of gross domestic product were higher in the 1980s than in the 1970s — 19 percent of GDP versus 18.5 percent, respectively.
- But federal spending as a share of GDP actually rose from 20.6 percent of GDP in the 1970s to 23.1 percent in the 1980s.
- Inflation, which had risen to double-digit levels during the Carter administration, virtually disappeared by 1986.
- The sharp but brief 1981-82 recession effectively broke the back of inflation, setting the stage for the longest peacetime economic expansion in our nation's history — 92 months of continuous real growth.

While real growth averaged 3.9 percent per year in the 1982-89 period, it has crept at a snail's pace in the 1990s — just 1.6 percent per year.

The American people were better off during the low-tax l980s than they are in the high-tax 1990s.

- Real median family income increased by $4,564 during the 1982-89 period — an increase of 12.6 percent.
- But it has fallen by $2,108 during the 1990s — a decline of 5.2 percent.

Although the budget deficit has been reduced in the 1990s, increasing real incomes is vastly more important. And if a future tax cut stimulates the economy, as tax cuts almost always do, the nation can have deficit reduction coupled with a renewed increase in household wealth.

State Taxes and Growth

A study from the Federal Reserve Bank of Atlanta provides evidence that high taxes are bad for a state's economic health. In the March/April 1996 issue of the bank's *Economic Review*, economist Zsolt Becsi overcomes many of the obstacles that have prevented earlier analysts from drawing firm conclusions on the relationship between taxes and growth. He found that "relative marginal tax rates have a statistically significant negative relationship with relative state growth."

Many previous studies had failed to find a strong relationship between taxes and growth because they were unable to isolate the impact of tax rates from other factors affecting growth. For example, some people and businesses may not mind paying high taxes if they get quality services in return. But not all tax increases lead to increases in government services. It is necessary to separate taxes from the budget in order to study the tax effect alone.

Another problem analysts have had is separating the effects of marginal tax rates and average tax rates. The average tax rate is simply taxes paid as a share of income, while the marginal rate is the rate on each additional dollar earned. In states with progressive tax rates the marginal rate will always be higher than the average rate. Since the marginal rate is the one that affects economic incentives, it is important analytically to focus on marginal tax rates.

Once Becsi was able to isolate taxes from the budget and marginal tax rates from average tax rates, he found that taxes have large and permanent effects on economic growth. Becsi concludes that "lowering aggregate state and local marginal tax rates is likely to have a positive effect on long-term growth rates."

This conclusion is consistent with the latest research on state taxation. For example:

"Personal income growth slows by 3.5 percent for every 1 percent hike in state and local taxes."

- A 1991 study by Leslie Papke in the *Journal of Public Economics* found that state tax rates had a significant impact of new business start-ups.
- A 1994 *Business Week* study found that job growth in low-tax states was 65 percent higher than in high-tax states.
- And a 1995 study by Richard Vedder of Ohio University found that on average a 1 percent increase in state and local taxation lowered personal income growth by 3.5 percent.

One reason taxes affect growth is that investors increasingly look at tax rates to guide not only direct investment decisions but portfolio investment as well. In other words, many investors now look at taxes in a particular state in deciding whether or not to buy the stock of a company located there.

"States are fine test facilities for economic policies."

Investment advisors A.B. Laffer, V.A. Canto & Associates recently published an analysis of the impact of recent state tax changes on particular stocks. They concluded that companies based in Arizona, Connecticut, Georgia, Indiana, Mississippi, New Jersey, New York, Ohio and Utah would tend to outperform those in other states because of declining tax burdens in those states. At the other end of the spectrum, companies based in Idaho, Louisiana, Missouri, New Mexico, North Dakota, Rhode Island and Vermont are likely to underperform the market due to rising tax burdens. In all other states, taxes were unchanged.

The states are important laboratories for testing different economic policies. The evidence from these labs increasingly suggests that states that allow their taxes and spending to get out of line with their neighbors will suffer as a result.

III. Taxes, Spending and Deficits

The monumental effort now under way to balance the federal budget is only the latest in a long series. Indeed, this is the third major effort since 1990 to get the United States deficit under control. Many other countries have undertaken similar efforts in recent years.

Other Countries' Efforts to Reduce Deficits

In an October 1995 article in the journal *Economic Policy*, Professors Alberto Alesina of Harvard and Roberto Perotti of Columbia reviewed the experiences of 20 different countries since 1960 in trying to get their deficits under control. The lessons of this review strongly support the approach that Republicans have taken in budget battles with the Clinton administration.

First, Alesina and Perotti look at the various fiscal adjustment efforts and try to determine which were ultimately successful and which were not. Successful efforts were defined as those that reduced the ratio of debt to gross domestic product after three years.

"Other countries have cut their deficits by cutting spending — not by raising taxes."

Those that were successful shared important characteristics, Alesina and Perotti found, as did those that were unsucessful. Most important, they found that sucessful deficit reductions relied largely on spending cuts rather than tax increases. Conversely, unsuccessful efforts relied largely on tax increases. Spending cuts constituted more than 80 percent of the deficit reduction in sucessful efforts and less than 30 percent in unsuccessful efforts.

Furthermore, Alesina and Perotti found that the composition of spending cuts was critical to the ultimate success or failure of the deficit reduction effort. Successful efforts relied heavily on cuts in transfer programs, cuts in government employment and wages of government workers.

As they put it, "Any fiscal adjustment hoping to be successful cannot avoid dealing with cuts in the welfare state and in government wages and employment." This is consistent with Alesina and Perotti's finding that deficits result primarily from increased spending on transfers and pay for government employees. Deficits seldom result from tax cuts.

And contrary to conventional wisdom, it turns out that tax cuts are often a critical element of successful deficit reductions. Alesina and Perotti found that "direct taxes on households are actually cut during successful adjustments!"

Lastly, Alesina and Perotti found that the economic payoff from successful deficit reduction can be large. It can lead to a "credibility effect" on interest rates that reduces risk premiums and improves investors' expectations. This in turn leads to a "crowding-in" effect in which investment and consump-

tion both rise. And this leads to faster growth, low unemployment and improved competitiveness.

These findings strongly suggest that Republicans are on the right track by demanding cuts in entitlements and taxes.

Deficits Don't Cure Recessions

Treasury Secretary Robert Rubin strongly opposes the Balanced Budget Amendment to the Constitution. His main concern is that it will hamper the government's ability to respond to an economic downturn. While this is a valid concern, it is overstated. Congress can always abandon the balanced budget requirement by a super-majority vote, which it certainly would do in the event of an economic crisis. More importantly, there is no evidence that deficit spending has been necessary to recover from past recessions.

Congress passes some sort of antirecession legislation every time there is an economic slowdown. But the history of such legislation is that it always comes too late to do any good. Often, the date that antirecession legislation becomes law often corresponds to the date the recession ends.

"Antirecession spending always comes too late to do any good."

Even more often, the legislation comes well after the recession's trough. And since the actual spending does not come into effect immediately, antirecession spending has never had an impact on the economy until long after the recession's end — sometimes many years afterward.

Looking at every major postwar recession as defined by the National Bureau of Economic Research (see Table III-1), one finds not a single case in which antirecession legislation was enacted in a timely fashion so as to miti-

TABLE III-1

Dates of Recessions and Anti-Recession Legislation

Beginning	End	Legislation
Nov. 1948	Oct. 1949	Oct. 1949
Aug. 1957	Apr. 1958	Apr.-July 1958
Apr. 1960	Feb. 1961	May 1961, Sept. 1962
Dec. 1969	Nov. 1970	Aug. 1971
Nov. 1973	Mar. 1975	Mar. 1975, July 1976 and May 1977
July 1981	Nov. 1982	Jan.-Mar. 1983
July 1990	Nov. 1991	Nov. 1991, Apr. 1993

Source: *The Public Interest*, Summer 1993.

gate the economic downturn. In fact, one can argue that such legislation may have made matters worse. By overstimulating the economy during upturns, it may have sown the seeds of future recessions.

The problem is that for antirecession spending to work, forecasters would have to see a recession coming. Legislation would have to be enacted well in advance and programs implemented to coincide with the beginning of the downturn. This is virtually impossible. Forecasters seldom if ever accurately predict turning points in the economy. If they did, it is doubtful they would be able to convince Congress and the administration to act in time. And even if they were, it usually takes a year or more to get programs implemented and money flowing.

Thus it is absurd to argue that the Balanced Budget Amendment should be defeated because it will hamstring the government's ability to respond to economic downturns. Recessions give politicians an excuse to enact pork-barrel public works programs. If the amendment prevents such wasteful spending, it will serve a useful purpose.

Dynamic Scoring: Accounting for Growth Effects of Tax Changes

"Government revenue estimates almost always get it wrong."

Changes in tax rates affect how hard and long people work and how much they save and invest. But the official revenue-estimating arms of government ignore this fact in making their calculations. They assume that earning and saving behaviors stay exactly the same, regardless of the tax rate.

Because of this assumption, the government's revenue estimates usually overstate both the amount of revenue a tax increase will raise and the amount a tax reduction will lose.

Perhaps the most ridiculous example of what this can lead to occurred when former Sen. Bob Packwood (R-OR) asked the Joint Committee on Taxation (JCT) to forecast the revenue increase from raising the top tax rate to 100 percent on all income over $200,000 in 1989. The answer: tax revenue would increase by $204 billion in 1990 and by $299 billion in 1993. Even if all income over $200,000 were confiscated, the JCT assumed, people would work and save as before!

Static vs. Dynamic Scoring. The JCT used what is known as static scoring in making its estimate. Whether revenue estimators should employ static or dynamic methods — that is, methods that take into account behavioral reactions to tax changes — is at the heart of a major debate in Washington. Many leaders of Congress believe that the government's use of static methods and its failure to take into account taxpayer behavior have created a bias in favor of tax increases and against tax cuts. They want to incorporate dynamic

effects in the estimates. Others oppose such a change as potentially undermining budget discipline.

"Under current law, tax cuts must be offset but tax increases need not be."

This argument is important because the budget laws are very restrictive. Under current law, any tax cut brought up for consideration in Congress must be "paid for" with spending cuts or tax increases. On the other hand, tax increases do not require any offsetting tax cuts or spending increases. The result is that it is almost impossible to cut taxes, and deficit reduction efforts must rely heavily on tax increases.

Bob Dole used dynamic scoring to estimate the fiscal effects of the tax cut he proposed during the 1996 presidential campaign. According to a *Washington Post* story, Dole's advisers believed that the Treasury could recoup 40 percent of the tax cut through higher growth. Predictably, liberals cried "voodoo economics," claiming that dynamic scoring is an eccentric economic theory and that it gave us the massive deficits of the 1980s. In truth, dynamic scoring is perfectly respectable, has been used on occasion by the Congressional Budget Office and had nothing to do with the 1980s deficits.

Dynamic scoring predicts the effect of a change in tax policy on government revenues by taking into account how the new policies will affect macroeconomic behavior. In contrast, the static procedures that Congress's Joint Committee on Taxation now uses are based on fixed estimates of gross domestic product, total employment, aggregate investment, interest rates and the overall price index — all based on the assumption that tax policy will have no effect on any of them.

The Treasury Department's Office of Tax Analysis uses dynamic scoring — in theory. In practice, Treasury economists often must produce their economic forecast before the administration has settled on its tax plans — so they cannot always account for the effect of administration proposals.

Estimates of Revenue Feedback. In the case of the 1981 Reagan tax cut, the administration did modify its GDP forecast to account for the tax cut's effects. But because the administration also lowered its inflation forecast, its dynamic estimate of the revenue cost of the 1981 tax cut was almost identical to the Congressional Budget Office's static estimate. The administration estimated that by 1984 total federal revenues would equal $772 billion; CBO predicted $769 billion. Both estimates turned out to be far off; actual revenues were $666 billion. It's clear, though, that dynamic scoring was no more inaccurate than the static estimate and thus is not the cause of the deficit.

And it is not true, as some critics continue to charge, that the Reagan administration predicted that its tax cut would pay for itself. Every official document the Reagan administration produced predicted large revenue losses from its tax cut. That's not to say the tax cut brought no revenue feedback. In testimony before the Joint Economic Committee in February 1981, Professor

Richard Musgrave of Harvard estimated that 30 percent to 35 percent of the revenue loss might be recouped, based on standard Keynesian assumptions. Later, Lawrence Lindsey, another Harvard economist (and later a Federal Reserve governor), calculated that by 1985, 70 percent of the direct revenue loss had been recovered through higher growth and other changes in economic behavior.

No one has ever seriously argued that an across-the-board tax rate reduction such as that enacted in 1981 would recoup 100 percent of lost revenue through higher growth. What tax cut advocates have said is that some specific tax cuts such as a reduction in the capital gains tax might pay for themselves. They also have said that tax rate reductions do not lose as much revenue as static estimates predict.

This is the generally accepted view of most economists.

- An October 1978 CBO report, "An Analysis of the Roth-Kemp Tax Cut Proposal," estimated that a one-third reduction in income tax rates would produce a static revenue loss of $21 billion the first year, but a net cost of just $16 billion. By the fifth year after enactment, the predicted static cost rose to $164.6 billion, with a net of cost $79.1 billion. Thus even the CBO, then headed by Alice Rivlin, thought that the Kemp-Roth tax cut plan would produce 24 percent revenue feedback the first year, rising to 52 percent after five years.

"Most economists now agree that tax cuts produce revenue feedback."

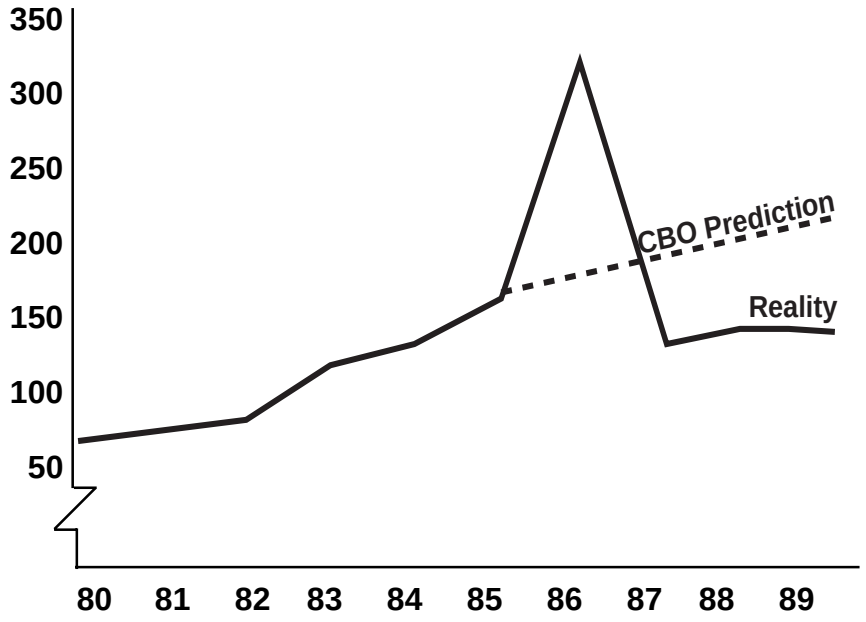
- In 1982 the CBO discussed in detail the dynamic effect of tax cuts on revenues in a publication entitled, "How Changes in Fiscal Policy Affect the Budget: the Feedback Issue." It concluded that "the figures suggest that between roughly one-tenth and two-tenths of the static revenue loss from [an across-the-board] tax cut may be recouped through induced increases in revenues during the first fiscal year after the tax change, and that roughly one-third to one-half of the static revenue loss may be recovered in later years."
- Even the Clinton administration has argued for dynamic scoring. During debate on the General Agreement on Tariffs and Trade, Mickey Kantor, then the U.S. trade representative, argued that GATT's $11 billion tariff reduction would pay for itself. "I think everyone here would agree ... because of the increase in exports, because of the growing jobs here, the Federal Treasury would gain many, many more dollars than it will lose in terms of the tarriff cuts," Kantor told the House Ways and Means Committee.
- And Lawrence Chimerine, chief economist for the liberal Economic Strategy Institute, wrote in the *Washington Post* that "credible evidence overwhelmingly indicates that revenue feedback from tax cuts" may be as high as 35 percent.

"The CBO used static scoring to forecast taxable capital gains and missed the mark by nearly 50 percent."

FIGURE III-1

Capital Gains Income

($ billions)



Source: Joint Economic Committee.

Among economists, there is a near-consensus spanning the political spectrum that tax cuts can produce substantial revenue feedback. And the impact on growth need not be large to produce an effect. The 1997 federal budget contains a table entitled, "Sensitivity of the Budget to Economic Assumptions," according to which a sustained increase in growth of 1 percent per year would increase federal revenues cumulatively by $420 billion between 1996 and 2002. It also would lower spending by $183 billion. Thus even an increase in growth of just 0.1 percent per year would lower the deficit by some $60 billion over seven years.

Static Scoring Errors. Static scoring has led the revenue-estimating agencies into huge forecasting errors.

- When the capital gains tax rate was raised from 20 to 28 percent in 1986, the CBO forecast that taxable capital gains would rise to $225 billion by 1989. The actual figure was $150 billion — an error of $75 billion or 50 percent (see Figure III-1). (The CBO failed to tell members of Congress or the news media about this error until Rep. Dick Armey, an economist, asked.)
- Between 1988 and 1991, taxable capital gains fell below the 1985 level in every single year. By 1991 they were just half of what they were in 1985 (after adjusting for inflation) and lower than in any year since 1978. Still, as late as 1988 the CBO claimed that its computer simulations showed "a net revenue increase from the 1986 Act."

- In January 1990, the CBO estimated that Americans would realize capital gains of $269 billion for 1991. They missed the mark by about 150 percent, as capital gains realizations reached $108 billion.
- The CBO forecast that the 1986 tax rate increase would raise corporate tax revenue from $89 billion to $101 billion the following year. Instead, corporations shifted from equity financing to debt financing to reduce taxes, and corporate revenue *fell* to $84 billion.

"Not cutting the capital gains tax in 1989 and increasing taxes in 1990 brought on our decade's malaise."

How Static Scoring Damaged Bush. In 1989 President Bush's plan to cut the capital gains tax was blocked, in part because the estimators said it would lose too much revenue. A year later, the president was encouraged to abrogate his solemn campaign promise not to raise taxes, in part because the same estimators said it was the best way to cut the deficit.

Many economists now believe that the 1990-91 recession and the general economic malaise of the 1990s can be traced directly to the failure to cut the capital gains tax in 1989 and to the 1990 tax increase. Flawed revenue-estimating methods led to these policy errors. Had the estimators taken into account past experiences with cutting the capital gains tax in 1978 and 1981 — both of which *raised* government revenue — they might have predicted a similar response to President Bush's proposal and aided its passage. And had they considered the negative effects of numerous tax increases in recent years, they might have encouraged the president and Congress to rely more on spending cuts and less on tax increases in 1990. As it turned out, the tax increases of 1990 raised far less revenue than estimated and, for that reason, several were ultimately repealed.

For 12 years the Reagan and Bush administrations failed to force the Treasury Department's career bureaucrats to change their estimating methods, despite strong evidence that the methods are flawed. The administrations faced criticism from their opponents and from the media. Yet such methods are not new or untried — except in government. Private businesses use them daily.

Why Static Scoring Is Wrong. Static scoring operates from the principle that no tax increase will reduce net investment and no tax reduction will increase it. In this view, since tax policy cannot change investment in the U. S. economy, tax policy cannot increase output or create jobs. Both logic and research reject this argument.

If investors did not change their behavior in response to tax changes, then a tax increase on investment income would permanently lower the aftertax rate of return investors receive. Conversely, a tax reduction would permanently increase the rate of return. In fact, National Center for Policy Analysis studies have shown investors to be highly and consistently sensitive to tax changes — so much so that the real aftertax rate of return on capital tends to stay constant over time.

Investors respond to increases in taxes on capital by lowering their rate of investment and increasing their consumption — thus reducing the supply of capital until the real aftertax rate of return rises to the historic average of about 3.3 percent per year. Conversely, investors respond to lower taxes on capital by increasing their rate of investment and hence the supply of capital until the rate of return falls to the average.

Time to Change. Republican control of Congress presents another opportunity to introduce dynamic revenue-estimating methods. Republicans now control the JCT and the CBO, the two congressional forecasting agencies. They should move to institute new estimating procedures that will accurately reflect the disincentive effects of tax increases and the stimulative effects of tax cuts. Failure to do so could lead to policy errors such as those made by President Bush.

"It the CBO and the JCT estimators used dynamic scoring, they could get the numbers right."

If dynamic scoring is a reasonable approach and a more accurate way of calculating the impact of tax changes on actual revenues, why isn't it used today? For one thing, the majority of proposed tax changes have such small macroeconomic effects there is no point in calculating the dynamic revenue effect.

And when a large tax change is contemplated, the effort to calculate the dynamic effect would be cumbersome. First a baseline economic forecast would have to be prepared and a static revenue estimate made. Then a new economic forecast would have to be made on the basis of the static estimate and a new revenue estimate prepared incorporating the macroeconomic effects of the tax change.

Worth the Effort. Yet it is worth the extra effort and manpower to ensure that tax policy is informed by the best analysis. Respected authorities such as economists Alan Auerbach and Andrew Lyon have written academic papers urging the use of dynamic scoring, at least for major policy changes. And in a February 1995 poll 52 percent of the members of the National Association of Business Economists said they supported dynamic scoring.

IV. Tax Fairness

Who Pays Income Taxes?

"Couples who earn above $43,000 a year are in the top 25 percent of all taxpayers."

Internal Revenue Service data for 1994 on the distribution of the tax burden make clear again that the vast bulk of the federal income tax burden is borne by the rich. (See Figure IV-1.)

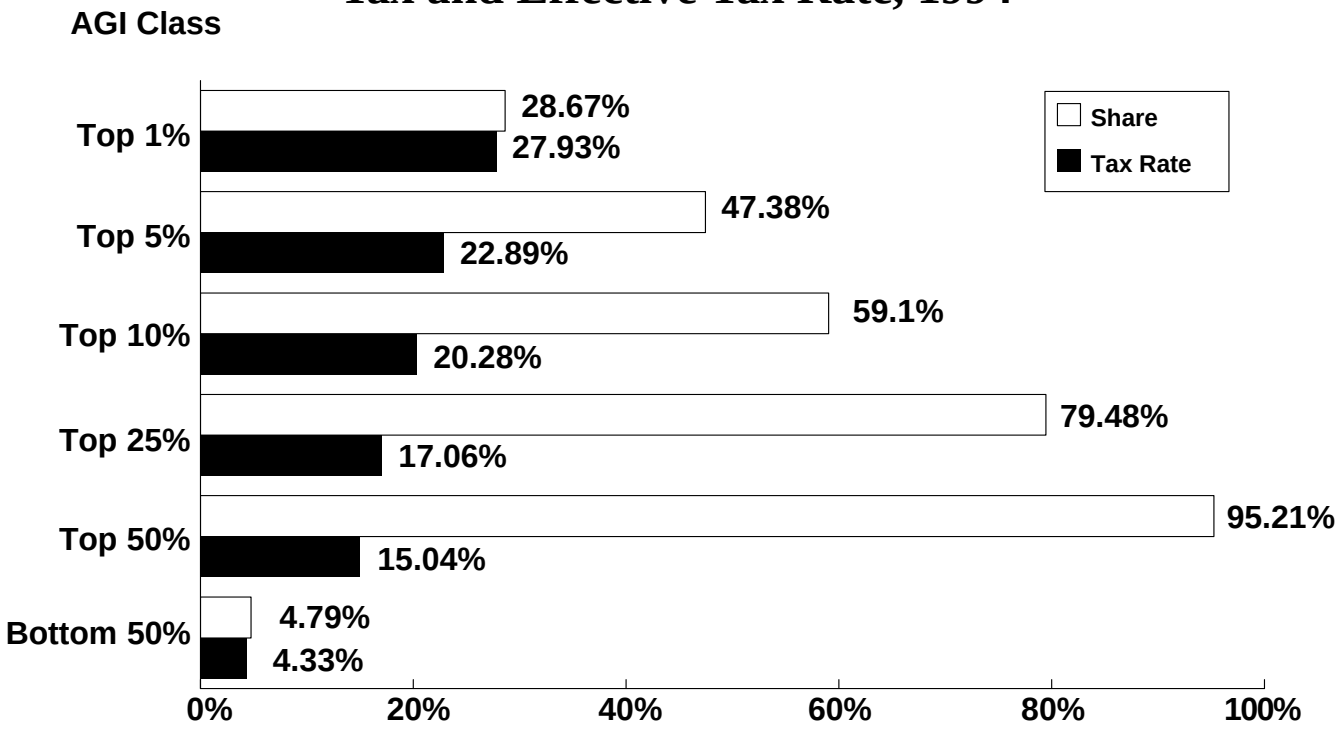
- The top 1 percent of taxpayers, those with adjusted gross incomes (AGI) above $196,000, paid 29 percent of all income taxes.
- The top 5 percent of taxpayers, with incomes above $91,000, bore almost half of the federal income tax burden.
- By contrast, the bottom 50 percent of taxpayers, those with incomes below $22,000, paid less than 5 percent of all income taxes.

Who is rich? Many people would consider the top 10 percent or top 25 percent of taxpayers to be rich. The former included all taxpayers with incomes above $69,000, the latter those with incomes above $43,000. Since these income figures are per return, they include two-earner couples.

Thus a single person earning $22,000 would probably be considered poor — being in the lower 50 percent of taxpayers. But a married couple each

FIGURE IV-1

Share of Total Federal Income Tax and Effective Tax Rate, 1994



Source: Internal Revenue Service.

making $22,000 would be considered rich, because they would be in the top 25 percent of taxpayers.

The IRS also produced data on effective tax rates — taxes paid as a share of AGI. They confirm that the federal income tax is steeply progressive.

- The top 1 percent of taxpayers paid 28 percent of their income in taxes on average and the top 5 percent of taxpayers paid 23 percent.
- The top 10 percent of taxpayers paid a little over 20 percent, while the top 25 percent of taxpayers paid 17 percent.
- The bottom 50 percent of taxpayers paid an effective income tax rate of just 4 percent.

Tax Cuts and the Rich

For the past 20 years federal tax revenues have remained roughly constant as a percent of national income. In 1974 receipts were 18.8 percent of GDP; in 1994 they were 19 percent. By contrast, spending increased from 19.2 percent of GDP in 1974 to 22 percent in 1994. Thus all of the increase in the deficit can be accounted for by higher spending, not lower taxes.

That does not mean that changes in federal tax policy have no effect. From the harshness of tax policy debates in recent years, one might suppose that the tax burden had been shifted from the rich to the poor. In fact, major tax cuts in the 1980s did just the opposite. They shifted an increasing share of tax payments to the wealthiest taxpayers.

Before the Reagan Tax Cuts: Bracket Creep. From 1976 to 1981 federal receipts rose from 17.7 percent to 20.2 percent of gross domestic product. Such a sharp increase in federal revenues over such a short period of time is unprecedented in peacetime. Its principal cause was bracket creep, which results when inflation increases nominal incomes and pushes people into higher tax brackets even though their real incomes have not risen. It was estimated at the time that federal revenues increased 1.6 times the inflation rate. Thus the faster the inflation, the more revenue the government received.

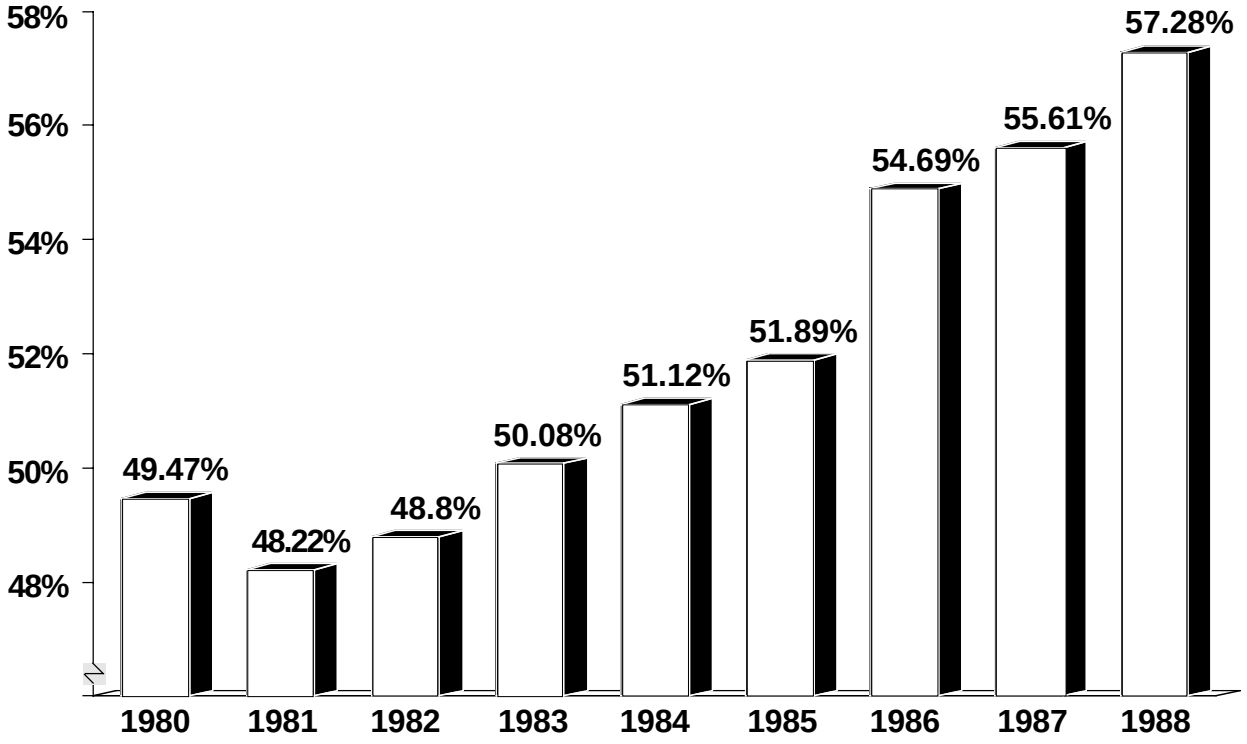
"Bracket creep shifts the tax burden onto the backs of lower-income families."

For the most part, bracket creep tends to shift the burden of taxation from higher- to lower-income families. Since the highest-income families are already in the highest tax bracket, they can not be pushed into a higher bracket by the effects of inflation alone. This of course is not true of middle- and lower-income families.

Progressive Effects of Reducing the Highest Tax Rates. The Reagan-era tax cuts were based on the premise that the government should never take more than 50 percent of an additional dollar of anyone's income, no matter how rich that person might be. Indexing was adopted to prevent bracket creep. Reagan also pushed for repeal of many tax credits, exemptions

FIGURE IV-2

Share of Total Federal Income Taxes Paid by Top 10 Percent of Taxpayers



Source: Internal Revenue Service.

"When their marginal tax rate fell 60 percent, the wealthy paid almost 20 percent more in federal taxes."

and loopholes in the tax code in order to reduce rates further. By the time he left office, the top tax rate was just 28 percent — its lowest level since the 1920s.

Evidence continues to mount that the lower rates actually increased the amount and share of taxes paid by the rich. The share of total federal income taxes paid by the top 10 percent of taxpayers, ranked by adjusted gross income, rose from just under 50 percent in 1980 to more than 57 percent by 1988. (See Figure IV-2.) Thus during a period in which their marginal tax rate fell by 60 percent, the wealthy paid almost 19 percent more in federal taxes.

An analysis by Ed Rubenstein, "When Less Is More: Tax Lessons of the 1990s," in the October 31, 1996 edition of the on-line public policy weekly *Intellectual Capital.com* reached just this conclusion: reduce tax rates on the wealthy and their share of tax payments will increase.

Rubenstein's data demonstrate that four years after the Reagan tax cuts of 1981 "overall tax collections increased by 16 percent," but "people making more than $200,000 were paying 127 percent more taxes in 1985 than they had been in 1981." IRS data show that people with incomes of $100,000 to

$200,000 were paying 41 percent more; those receiving $200,000 to $500,000, 76 percent more; and those with incomes above $500,000, 201 percent more. All this while marginal tax rates on these people were dropping from 70 percent to 28 percent.

"After the Reagan tax cuts, many more people reported incomes of $200,000."

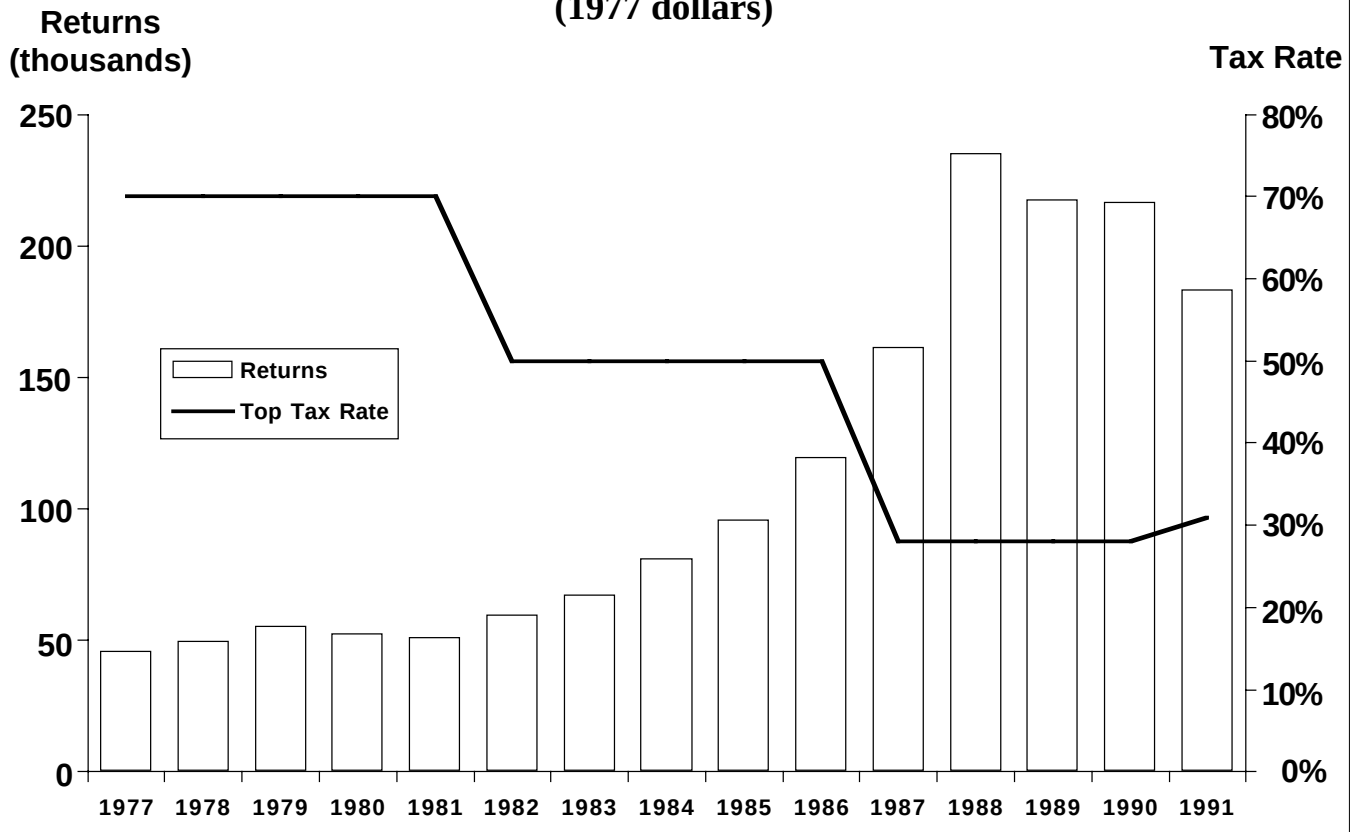
The reason was that the wealthy increased their taxable income by much more than the cut in rates. Instead of clipping coupons on government bonds, some invested in venture capital funds; instead of buying tax-free municipal bonds, they bought stocks; instead of investing in exotic tax shelters, they started new businesses; instead of taking their income in the form of vacations or tax-free benefits, they asked for higher cash wages; and instead of spending time figuring out how to limit their tax liability, they concentrated on increasing their wealth. In many high-income families, a spouse who had not been working outside the home was enticed into the workforce by the prospect of not paying 70 cents of every dollar earned in taxes.

Thus, the number of taxpayers reporting an income of more than $200,000 (in constant 1977 dollars) dramatically increased following the Reagan tax cuts, after remaining stable for many years. (See Figure IV-3.)

FIGURE IV-3

Returns Reporting Real Income of $200,000 or More and Top Tax Rate

(1977 dollars)



Source: Internal Revenue Service.

Effects of Increasing Tax Rates. As evidence that the tax cuts made the difference, after the 1990 tax increase raised the top rate, the number of taxpayers reporting an income of more than $200,000 dropped significantly.

"After Bush raised the top tax rate, revenue from people making more than $200,000 dropped."

Bush's new 31 percent tax bracket for people making $200,000 or more reduced tax payments for those taxpayers by $2.5 billion, or about 2.4 percent. Rubenstein explains: "But for everyone else [those with incomes less than $200,000], tax payments actually rose by $3.6 billion, or 1 percent. This odd dichotomy makes it difficult to blame the entire reduction in income tax revenues on a weak economy. The rich didn't have a bad year, they merely changed their behavior in response to higher tax rates. They bought more municipal bonds, converted ordinary income to capital gains, worked less and shifted discretionary income to 1990, when rates were lower. In the process, they foisted a larger share of the tax burden on less affluent taxpayers."

Like Bush, Clinton created a new, higher rate bracket for the wealthy: 39.6 percent instead of 31 percent on individuals earning more than $200,000. One would think that this higher rate would have produced higher tax payments by the very wealthy. It did: 11.4 percent more revenue in 1993 than in 1992. But tax revenues from the $100,000-$200,000 income individuals — to whom the new rate did not apply — rose about the same amount, 11.7 percent. So "instead of collecting an extra $16 billion from taxpayers in the $200,000+ income group, as was forecast, Uncle Sam received just $5 billion."

Rubenstein reports that "in analyzing the tax results, Harvard economist Martin Feldstein finds that affluent people reported nearly 9 percent less taxable income in 1993 than they would have at the old tax rates. This was accomplished in many ways. High-income taxpayers made more aggressive use of existing tax loopholes. Or they simply worked less. Working wives seemed especially affected by higher tax rates. The percentage of families with two or more earners fell from 58.2 percent in 1989 to 56.4 percent in 1993.

"At the end of the day," Rubenstein concludes, "income tax revenues fell to 9.3 percent of personal income in 1993, down from 9.6 percent in 1989, when the top rate was still 28 percent."

The Debate Over Tax Fairness. Robert S. McIntyre of Citizens for Tax Justice said, "Tax cuts for the very richest people and interest on the debt that was built up to pay for those cuts can explain the entire increase in the federal deficit over the past 15 years." Yet as we have seen, nothing could be further from the truth. The tax burden for the country as a whole did not go down, and the *lowering of tax rates* caused the share paid by the highest-income families to go up.

Far from increasing the deficit, the Reagan tax cuts reduced it. Had tax rates not been cut, rich people would have had no reason to change their behavior. Their incomes and their share of tax payments would not have risen.

If the wealthiest taxpayers' percentage of federal income taxes had remained constant through the 1980s, by 1988 the group would have paid the federal government $32.2 billion *less* than it actually did.

The most affluent Americans have great flexibility in how they receive income and whether they work less or not at all. High tax rates on the wealthy may make the promoters of economic class warfare feel good, but they do not raise revenue for the federal government.

Tax Burden and Income Inequality

In late October 1995 the Organization for Economic Cooperation and Development (OECD) published a new study of income distribution in major countries.

"The rich pay a higher share of the total tax burden in America than in any other major country."

The *New York Times* explained the importance of this study: "The income gap between rich and poor was wider in the United States during the 1980s than in any other large industrialized country, according to the most comprehensive international study ever released on income distribution... The results seem likely to provoke considerable controversy, as the Clinton administration and Democrats in Congress have spent the last few weeks accusing Republicans of trying to cut welfare to help finance tax cuts for the wealthy."

Leaving aside limitations and potential biases in these data, they do show the United States with the most unequal distribution of income.

The main reason lower-income groups appear to fare better in foreign countries is much more extensive welfare benefits. In Europe, benefits generally are not limited to the poor, as they are here, but are paid out to everyone. The result is that government spending and taxes are substantially higher in virtually every other country in the OECD study.

It does not follow that cuts in taxes increase income inequality or that tax increases reduce it. Buried in the OECD report are some very interesting data on this point.

The rich in the United States pay a higher share of the total tax burden than in any other country in the study — despite our much lower top tax rate.

The reason is that to finance their vast welfare states, European countries must raise far more taxes from the poor and those with middle incomes than we do, especially through consumption taxes. Although all European countries have higher top tax rates, few rich people pay such rates, taking advantage of tax loopholes or hiding their money in tax havens like Monaco, which has no taxes at all.

These higher taxes and benefits, in turn, are largely responsible for the unemployment crisis in Europe. High taxes discourage work, while high

"High taxes discourage work, and high benefits reduce the need to work."

benefits reduce the need to work. In the latest month for which there are data, for example, the unemployment rate was 22.7 percent in Spain, 14.4 percent in Belgium, 11.3 percent in Italy and 11.5 percent in France.

Indeed, every European country except Switzerland has unemployment sharply higher than the rate here — which hovers just above 5 percent.

V. Taxes on Work

Taxes, Welfare and Work

The highest tax rates in the United States today are not imposed on the wealthy. They are imposed on the poor.

When people on welfare earn income, they face two types of penalties. Not only do they have to pay taxes on their earnings, but they have their welfare benefits reduced as well. This reduction in benefits is a de facto tax, because it reduces their net income the same way direct taxes do.

Depending on the precise combination of earnings, taxes and benefits, a welfare mother can easily face marginal tax rates of more than 100 percent. That is, she loses more than a dollar in taxes and benefits for each additional dollar she earns. Obviously, this is a severe disincentive to move from welfare to work.

Marginal Tax Rates for Welfare Mothers. To illustrate the problem: a single mother with two children living in Pennsylvania receives $7,548 in benefits if she has no earnings (see Figure V-1). If she earns $2,000, the combination of taxes and lower benefits raises her disposable income by just $1,375. This is equivalent to a tax rate of 31.25 percent on the earnings.

On the portion of earnings between $5,000 and $8,000 per year, her marginal tax rate rises to well over 80 percent. In other words, of each additional dollar she earns her disposable income rises by less than 20 cents. Thus a woman earning $8,000 per year in wages is just $2,408 better off than a woman who does not work at all. This is equivalent to an effective average tax rate of 70 percent on her total earnings.

"Means-tested welfare programs discourage work."

High marginal tax rates are inherent in means-tested welfare programs. The more quickly benefits are phased out, the higher the tax rate. Reducing benefits gradually makes the tax rate lower but is expensive since it raises the level of earnings one can have and still receive benefits.

Marginal Tax Rates and the EITC. Another cause of high marginal tax rates for the poor is the Earned Income Tax Credit (EITC). This program provides working families with a refundable tax credit — a check from the government equal to 40 percent of earnings in 1996, up from 36 percent in 1995. More than 18 million families benefited from the EITC in 1995, at a cost of $24 billion — $20 billion of which represents a direct budgetary outlay in the form of refunds, with the remaining cost to government coming in reduced revenue. (See Figure V-2.) In many states, more than a quarter of all families receive the EITC, according to the Treasury Department.

In the 104th Congress, Republicans proposed modest cuts in the EITC of between $10 billion and $19 billion over seven years. They were strongly

resisted by the Clinton administration, which sharply increased the EITC in 1993 in order to help the working poor.

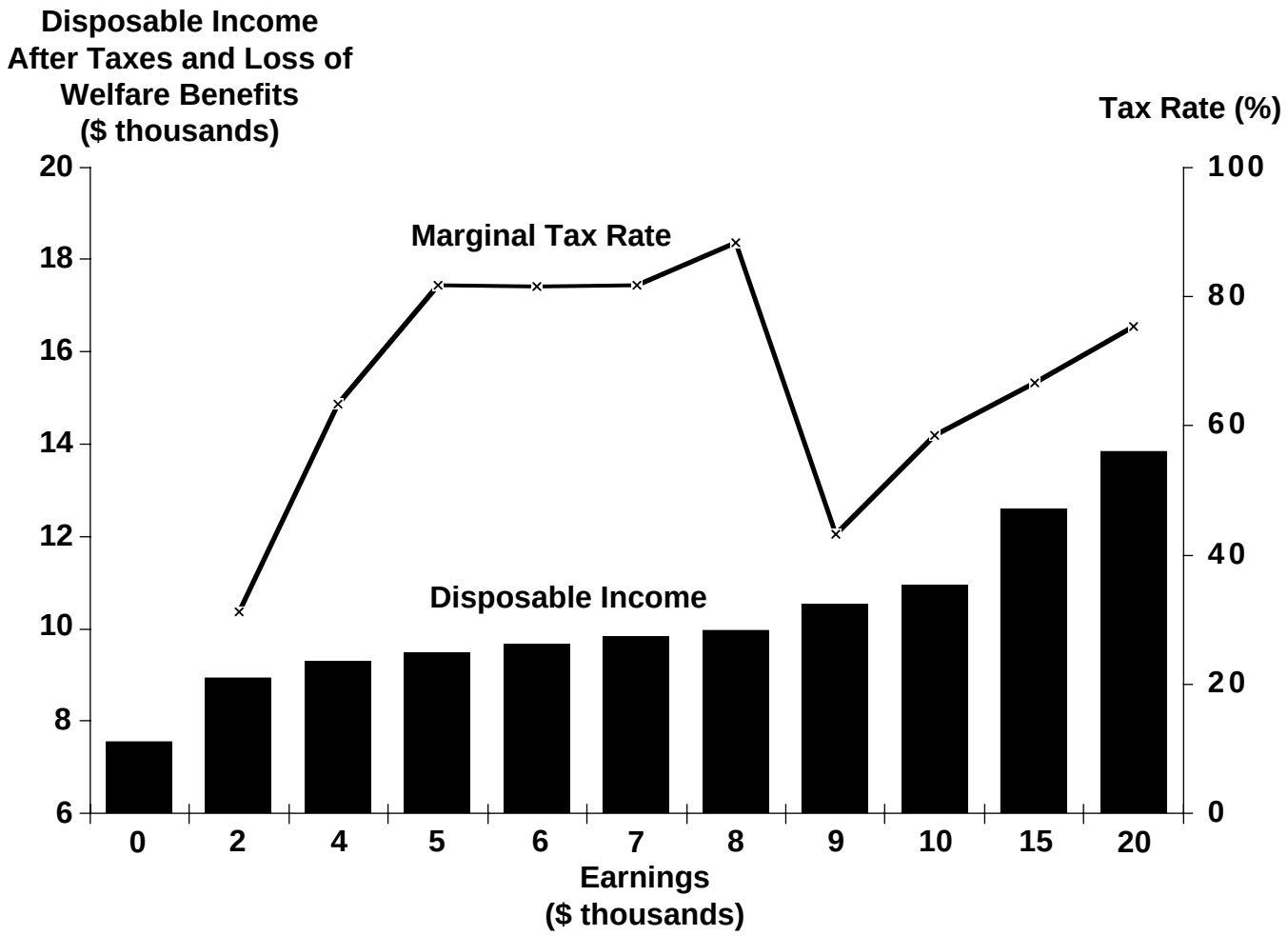
"The working poor may pay 60 cents in taxes for each additional dollar they earn."

In fact, the benefit to working poor families is far less than it appears. The EITC is phased out at a 20.22 percent rate when a family's earned income reaches $11,000, with the credit completely eliminated when its income reaches $26,000. Thus families in the phase-out range face an extra marginal tax rate of more than 20 percent.

Coming on top of direct taxes and the loss of other benefits, this means that families with incomes between $11,000 and $26,000 are being taxed at the rate of about 60 percent on each additional dollar earned, on the average. This total tax rate includes federal, state and local taxes plus the reduction in EITC.

FIGURE V-1

Marginal Tax Rates for a Single Mother with Two Children in Pennsylvania

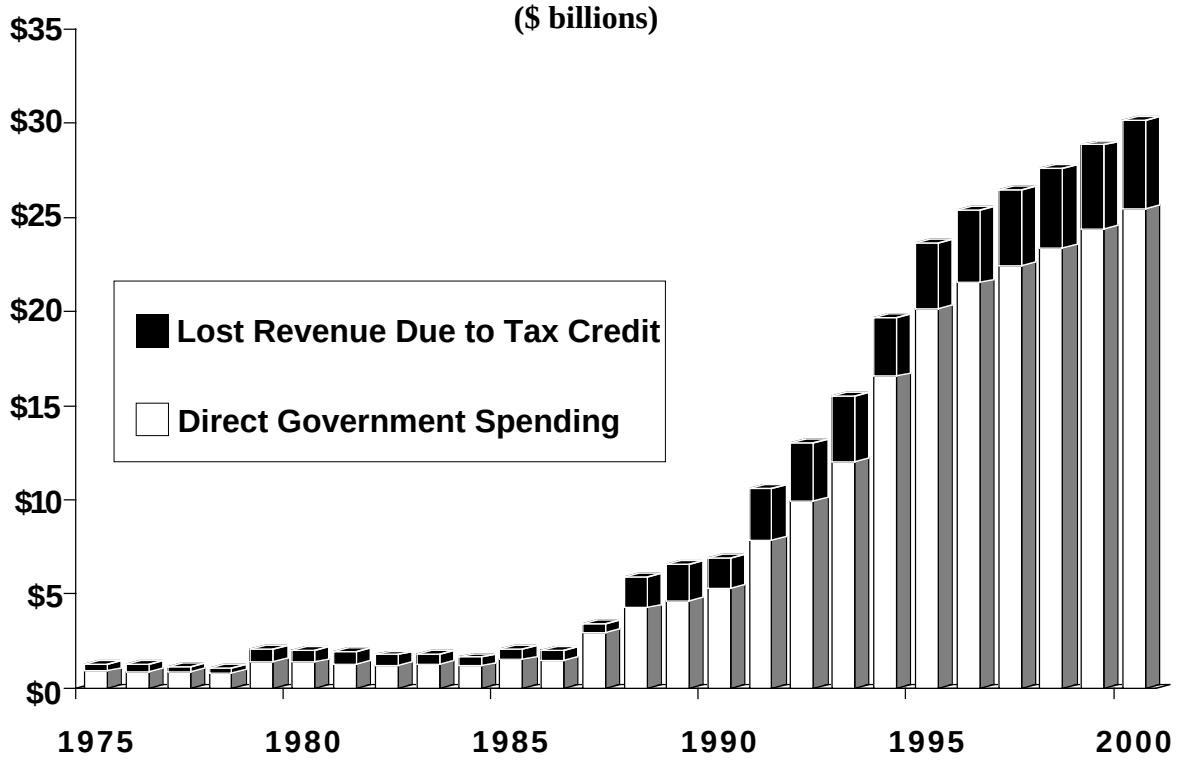


Source: Congressional Research Service.

FIGURE V-2

Cost of the Earned Income Tax Credit

($ billions)



Note: 1994-2000 data are projected.

Source: Joint Committee on Taxation.

Since about two-thirds of EITC recipients and 84 percent of the income earned by all EITC recipients are in the phase-out range, for most who receive it the credit is a disincentive to work. Due to the EITC, many families reduce rather than increase their work effort.

"Nearly half of the families who get the EITC would have more money without it."

The EITC does lift some families out of poverty, but many would be better off without it. Professor Edgar Browning of Texas A&M University, in an article in the March 1995 issue of the *National Tax Journal*, calculated the effects on family income of the EITC, taking account of the reduced work effort of those in the phase-out range. He discovered that *nearly half of all families receiving the EITC actually had less total money income than they would have had without the credit because they worked less.* Overall, Browning estimated that each $1 of EITC the federal government spends increases the net income of the working poor by just 46 cents.

Browning also found that a significant percentage of EITC benefits go to families well above the poverty level. Indeed, according to the House Ways and Means Committee, by 1996 almost one-third of EITC benefits will go to families with incomes over $20,000 per year.

Other studies also have found that the EITC's disincentive effects outweigh its benefits to the working poor. For example, Professors Stacy Dickert, Scott Houser and John Karl Scholz of the University of Wisconsin, writing in the 1995 edition of *Tax Policy and the Economy*, found that on balance the EITC reduces total hours worked.

And Marvin Kosters of the American Enterprise Institute points out that the EITC imposes a severe "marriage penalty" because it applies to a maximum of two children per qualified worker. If both husband and wife work and they have more than two children, they have a powerful financial incentive to get divorced. The reward can be as much as 25 percent of the couple's combined income, according to Kosters.

Solving the Problem. There are just three ways to remove the tax rate effects of means testing. The first is to remove the means test and pay benefits to everyone, regardless of income. The second is to abolish welfare altogether. Neither of these seems feasible at this time; the first is too costly and the second too harsh.

The third approach is the one now being pursued: require work of those who receive welfare. If welfare recipients are forced to work, then the loss of benefits no longer poses a disincentive.

Wage Stagnation and Nonwage Compensation

In June 1995 the Bureau of Labor Statistics released its annual report on employer costs for employee compensation. Based on a survey taken in March, the report stated that employer costs averaged $18.38 per hour for workers in private industry and state and local governments. Of this amount, $13.12 per hour went to wages and salaries and $5.26 to employee benefits and taxes.

"Recent declines in real wages have been offset by nonwage compensation."

Press reports ignored fringe benefits and made much of the fact that although wages had risen since 1994, after adjustment for inflation they had fallen by 30 cents per hour. A former Clinton Treasury Department economist, Professor Bradford DeLong of the University of California at Berkeley, told the *New York Times* that the decline in real wages was the greatest since the 1840s. In fact, the decline in real wages was almost totally offset by an increase in nonwage compensation.

Labor Secretary Robert Reich attempted to blame at Big Business. "The owners of capital are registering huge gains while ordinary working Americans are seeing their incomes fall," he said.

The media, instead of asking whether raising taxes, increasing spending and expanding government regulation were to blame for the decline in real wages, turned their attention to business. For example, columnist Morton Kondracke wrote, "In the manufacturing sector...productivity increased by 4.9

percent from 1993 to 1994, but wages and benefits dropped by 2 percent. The difference went into corporate profits."

The Role of Nonwage Compensation. The Department of Commerce divides total employee compensation into three major categories: (1) wages and salaries, (2) employer contributions for social insurance (i.e., Social Security) and (3) other labor income, mainly such fringe benefits as pensions, health and life insurance and workers' compensation.

Both nonwage portions of compensation have risen sharply over the last 20 years (see Figure V-3):

- In 1974 employer contributions for social insurance took just 7 percent of total compensation.
- By 1994 they had risen to 8.6 percent, the result of numerous increases in Social Security tax rates and the taxable wage base.

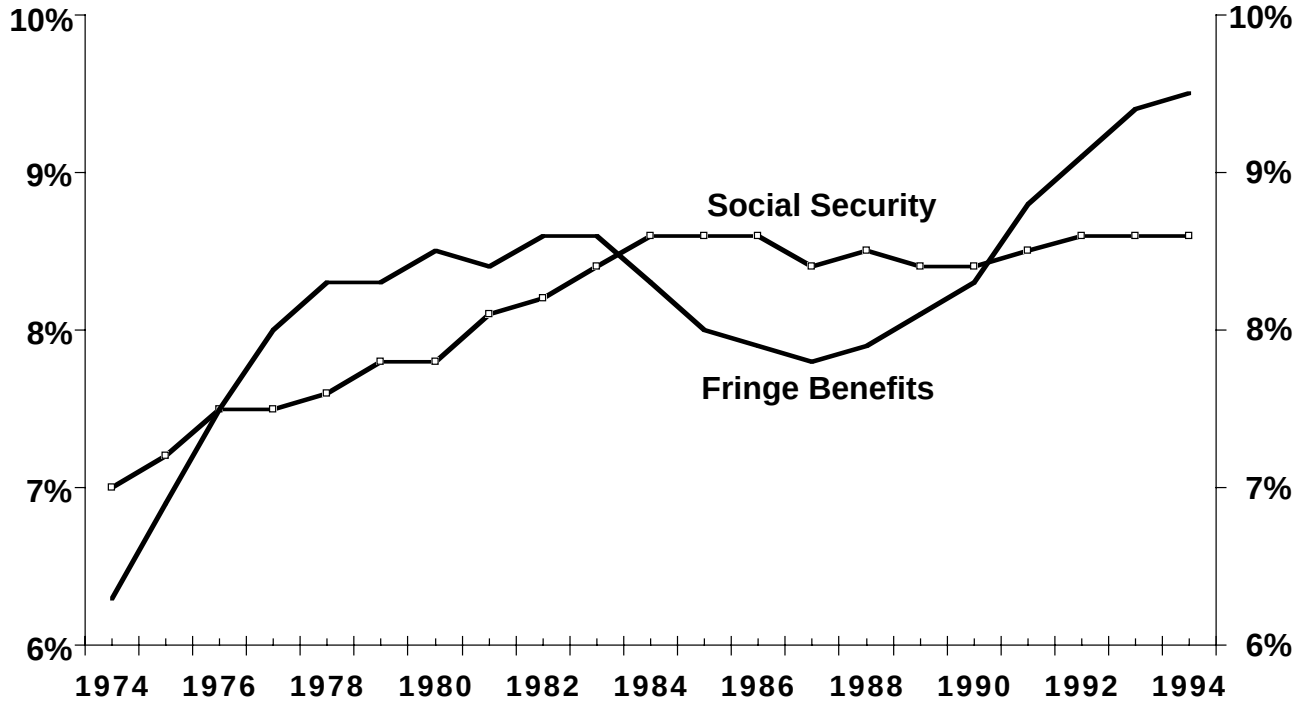
The percentage of compensation going to fringe benefits has risen even more.

"Employer contributions for Social Security and fringe benefits have risen sharply."

- In 1974 fringe benefits accounted for 6.3 percent of employee compensation.
- By 1994 they had risen to 9.5 percent of compensation.

FIGURE V-3

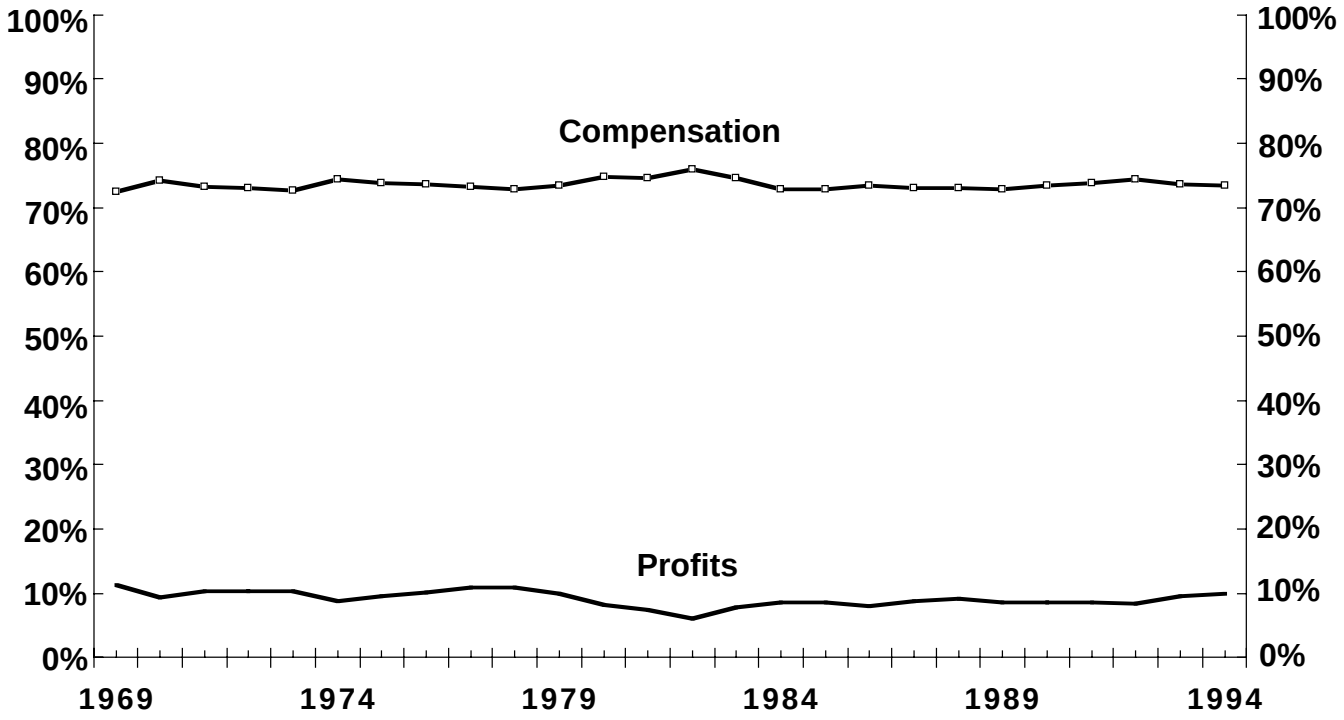
Social Security and Fringe Benefits as Shares of Employee Compensation



Source: Department of Commerce.

FIGURE V-4

Compensation of Employees and Corporate Profits as Shares of National Income



Source: Department of Commerce.

In short, workers have chosen to take more of their compensation in the form of benefits, and their choice is not surprising. Benefits are tax free, whereas wages are taxable.

That workers will substitute tax-free benefits for taxable wages when tax rates rise is a phenomenon well documented in the economic literature. For example:

"Workers may value an additional $1 of fringe benefits 40 percent more than $1 of wage income."

- A 1978 study by Henry Farber of the Massachusetts Institute of Technology found that union workers valued an additional $1 of fringe benefits 40 percent more than $1 of discretionary income.
- A more recent study by William Gentry and Eric Peress of Duke University found that a 1 percentage point tax increase raises the percentage of blue-collar workers offered employer-financed life insurance and pensions by between 1.21 percentage points and 1.33 percentage points.

Responding to Higher Tax Rates. The steepest rise in benefits came during the 1970s, when inflation was pushing workers into higher and higher tax brackets. In the early 1980s, after the Reagan administration got inflation

under control, indexed tax brackets to inflation and cut tax rates, workers shifted out of benefits and took more of their income in the form of wages.

Since 1990, tax rates have been rising again as a result of the Bush and Clinton tax increases. Workers have responded by increasing the share of their compensation from tax-free benefits. Thus President Clinton's 1993 tax increase was a major contributor to the relative decline in wages.

"Workers' share of national income has remained nearly constant over time."

Employee Compensation and Corporate Profit. Workers receive almost three-quarters of national income, while corporate profits amount to less than 10 percent (see Figure V-4). These numbers are very consistent over time. There is certainly no trend toward higher profits at the expense of employee compensation.

While it is true that the stock market has hit record highs in recent months, the principal beneficiaries are not fat-cat businessmen, but workers. More than 25 percent of all corporate equities are held by employee pension funds — up from just 9 percent as recently as 1970. And this figure is very conservative because it measures only pensions that are institutionally managed — mainly defined-benefit plans — thus excluding many defined-contribution plans that workers manage themselves.

In general, labor and capital do not compete with each other for a share of the pie. Their fortunes rise and fall together with the health of the economy. Ultimately, what is good for profits is good for wages and vice versa.

VI. Taxes on Capital

Penalties on Savings and Investment

Question: Why does the United States have the lowest savings rate of any major nation?

Answer: Not because we are guilty, pathological spenders or "me-generation" have-it-all-nowers. Americans spend more and save less because our tax laws penalize saving.

Income we spend now is taxed once, while income we save and invest is taxed four times.

To take an example, when we earn $100 at work we pay about 15 percent of it in federal income taxes. If we spend the remaining $85 the federal government does not tax it again; we are done with the IRS.

But suppose we save the $85 and put it in the bank. Now the government taxes the approximately $4.25 in interest the bank pays us when it returns our $85 to us at the end of the year.

"Taxing interest makes future consumption more costly — and current consumption more appealing."

But that interest is really compensation for something we have given up: the immediate use of our $85 and the immediate satisfaction we would have had in spending it. It is like an insurance payment we receive after a fire or a car accident: compensation for something we have lost. The interest does not add to our assets as much as it makes us whole after a loss. So taxing interest is a penalty making future consumption more costly than current consumption; the IRS is telling us it is better to spend now.

It gets worse. If instead of saving the $85 in the bank we invest it in a company — which allows the company to hire more people or make more products — the IRS taxes its earnings twice, once when the company earns a profit and a second time when the company pays part of that profit to us as investors. So the IRS is telling us it really doesn't like our investing in companies, and if we do it is going to double-tax us. No wonder Americans don't save and invest as much as people in other countries!

The U.S. tax system is simply biased against savings and investment.

There are two ways to correct the bias against savings. One is to allow people to deduct money they save from their current taxable income, while taxing the saving and its return when spent in the future. This is essentially how Individual Retirement Accounts and other pension plans operate. The other is to allow no deduction for saving, but permit any interest to accumulate tax free. This is basically how municipal bonds are treated today.

Either the IRA or the municipal bond model would create neutrality between spending and saving. It would eliminate the present tax bias against saving and in favor of current consumption.

As to the second bias, the bias against investment by double taxing it — once at the company level when the company earns profits, and again when the profits are paid to company investors in the form of dividends — that can be corrected too.

By treating corporate shareholders like sole proprietors or partners in the business, all the corporation's profits would pass through to them without a separate layer of taxation, regardless of whether dividends are paid or not. The shareholders would then pay tax on their respective individual share of corporate profits and losses.

But double-taxing investments is not the end of the story – the IRS adds a third layer by taxing the growth of our investment through the capital gains tax. Since "capital gains" merely reflect the present value of future profits, taxing a capital gain while taxing the profits that create the gain is also a double tax.

Finally, if one should have the misfortune of dying while holding the investment, the government will seize about half of the investment through estate taxes. In some ways this is the worst of all taxes because it is a direct tax on capital. It does not even pretend to be a tax on gains or earnings, since assets that have lost value are taxed the same as those that have risen.

"In the United States, capital is whacked with four levels of taxes."

So there are four different layers of taxation on capital in the United States. First, we double-tax saving by taxing interest and not allowing a deduction for saving. Second, we double-tax saving when it is invested in corporate equities. Then, when the prospect of higher future earnings causes our stocks to rise in value, we levy a capital gains tax on the original saving. And if the saving outlives us, we whack it again with the estate tax.

Is it any wonder the U.S. has the lowest saving rate of any major country?

Supply of Capital

In the past 200 years, the United States has evolved from a less-developed country to a country with the highest standard of living in the world. The reasons for this evolution were that (1) we maintained a relatively free economy and (2) we encouraged the accumulation of capital.

Workers today are not smarter than their ancestors, and there is no reason to think that they work harder. Yet today's workers earn many times more than people did when the average wage was a dollar a day. Today's

workers earn more because they produce more, and they are more productive largely because of the existence of capital.

Two hundred years ago the primary capital in America's dominant agricultural industry consisted of little more than a hoe, a plow and an axe. Today, people combine their labor with highly sophisticated electronic equipment in virtually every industry.

What Is Capital? The word "capital" means different things to different people. In the financial press, capital often means money or liquid assets. In the context of this report, capital means physical assets such as buildings, machines, equipment, etc. In terms of the economy's ability to produce goods and services, the constraint is not paper money, which we can print in unlimited quantity. The constraint is the number and quality of physical assets that labor can use in the production process.

"Retirees and retirement plans own more than two-thirds of America's capital."

Who Owns Capital? Apart from houses and durable goods, most people do not own capital directly. Instead, they own capital indirectly by owning financial assets such as stocks and bonds. A share of stock in a company entitles the stockholder to a share of the company's assets. A bondholder has a claim against the income from a company's assets. Most people are also indirect owners of capital through employer-provided pension plans.

Considering both direct and indirect ownership, the ownership of capital in the American economy is widely dispersed. It is also closely connected with retirement. As Figure VI-1 shows, about 40 percent of the nation's capital stock is owned by those 65 years of age and older, and another 29 percent is owned through pension plans and IRAs. Thus more than two-thirds of the nation's capital stock is owned by the elderly or held for the purpose of providing people with an income during their retirement years.

Despite the fact that ownership of capital is widely dispersed, the wealthy tend to own more capital than the nonwealthy. On average:

- People with an annual income of $1 million tend to receive about 75 percent of their income as capital income and only 25 percent in the form of wages.
- By contrast, families with an average income tend to receive only 25 percent of their income from capital and 75 percent from wages.

Precisely because wealthy people receive a very large share of their income from capital, most proposals to "tax the rich" are either necessarily or inadvertently proposals to tax capital.

How Is Capital Taxed? In the United States and in other countries, governments tax capital in one of three ways. Taxes are levied on (l) capital assets, (2) the output of capital assets and (3) the income of the owners of capital assets. Examples of taxes on capital assets are property taxes and

wealth taxes. Examples of taxes on the output of capital are sales taxes and value-added taxes. Examples of taxes on the income from capital are corporate income taxes and personal income taxes on dividends, interest, rent and profit.

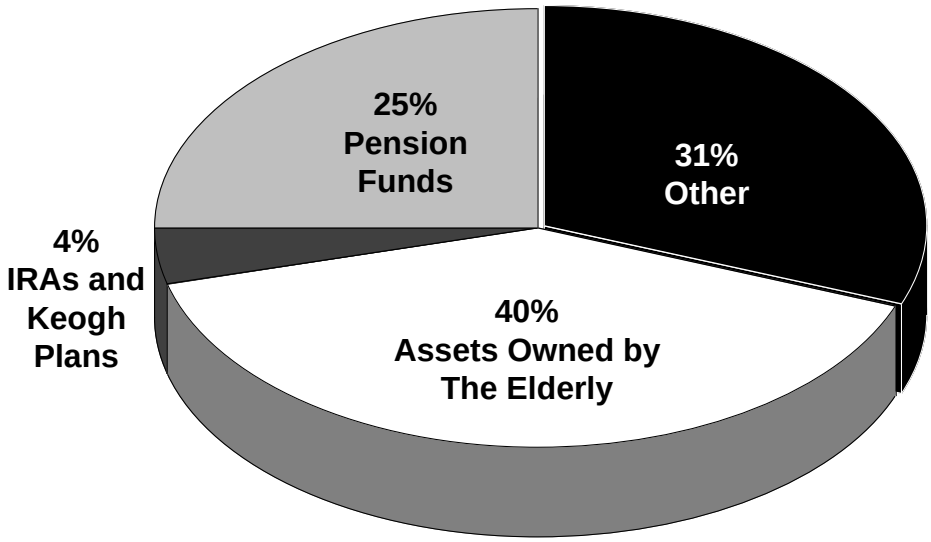
"Economic growth is the most effective antipoverty program."

Why Do Taxes on Capital Matter? The primary difference between rich and poor countries is the amount of capital per worker. The amount of capital determines not only a country's standard of living, but also its rate of economic growth. Economists have long known that economic growth is the most effective antipoverty program there is, and that the key to economic growth is capital formation. For example:

- Many less-developed countries have the potential to grow at 6 percent per year, provided they adopt policies that attract capital.
- At 6 percent per year, national income doubles every 12 years and quadruples every 24 years.
- If 24 years is considered a generation, a 6 percent growth rate will expand national income 12-fold after three generations — a feat which will do far more to alleviate poverty than all other programs combined.

FIGURE VI-1

Ownership of U.S. Capital Assets



Source: John C. Goodman, Aldona Robbins and Gary Robbins, "Elderly Taxpayers and the Capital Gains Tax Debate," National Center for Policy Analysis, NCPA Policy Report No. 153, July 1990.

How Taxes Affect the Supply of Capital

Aftertax Rate of Return Tends to Be Constant. The neoclassical economic theory of capital, adopted by most of the leading capital theory economists of the 20th century, is consistent with more than four decades of empirical evidence and the observations of economists extending back into the 19th century. Both theory and evidence support the conclusion that the aftertax rate of return on capital tends to be constant (see Figure VI-2):

- Over more than four decades, the real aftertax return on capital in the United States has averaged 3.3 percent.
- This rate of return rarely varies by a percentage point above or below its historic average.
- When a significant deviation occurs, say because of a change in taxes on capital, the aftertax rate of return is usually restored to the 3.3 percent average within five years, with 60 percent of the adjustment taking place within two years.
- As a result, the aftertax rate of return on capital is one of the most constant relationships found in all of economics.

"The aftertax rate of return on capital tends to be constant over time."

The reason this rate tends to be constant is that the world investment community is willing to supply virtually any amount of capital to the United States so long as investors can earn a 3.3 percent rate of return.

- When the rate of return rises above 3.3 percent, increased investment expands the capital stock until the rate of return falls back to its historical average.
- When the rate of return falls below 3.3 percent, reduced investment slows the growth in the capital stock until the rate of return rises to its historical average.

The relationship between investment behavior and the aftertax rate of return to investors has been largely ignored by economists in the Keynesian tradition, who tend to focus exclusively on interest rates. Yet the Keynesian focus is without empirical foundation.

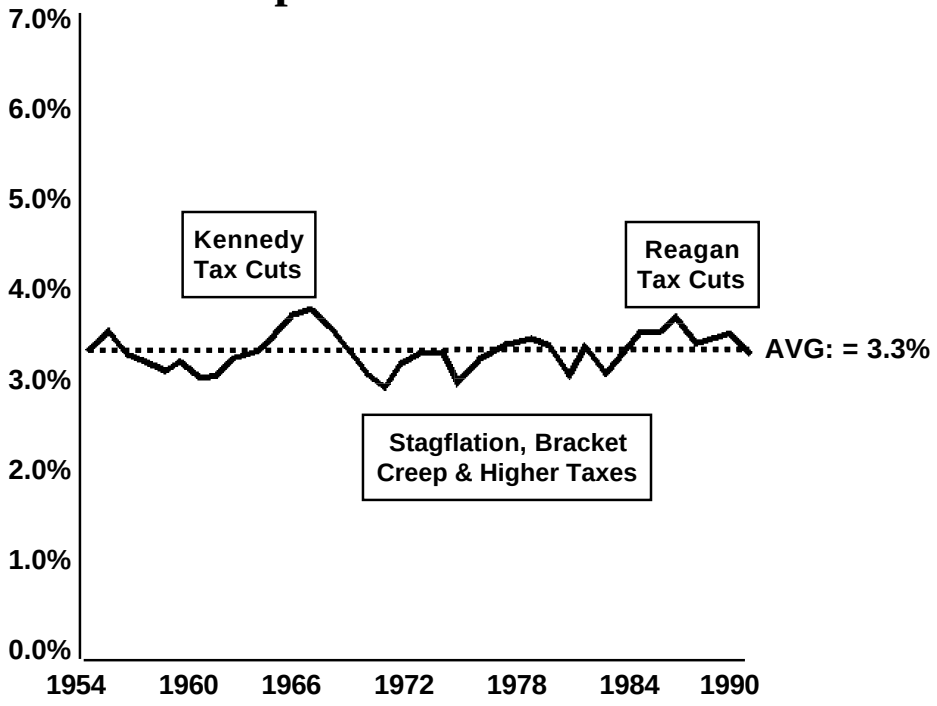
- Over more than four decades, 75 percent of the variation in investment spending can be explained by changes in the rate of return on capital alone.
- By contrast, there is virtually no relationship between investment spending and interest rates.

Tax Increases Reduce the Supply of Capital. The recognition that the rate of return on capital tends to be constant has profound policy implications. Specifically:

- Although taxes on capital affect the *before-tax* rate of return to owners of capital, they have no permanent effect on the *aftertax* rate of return.

FIGURE VI-2

The Real Aftertax Rate of Return on Capital in the United States



- Thus the primary effect of increased taxes on capital is to reduce the size of the capital stock and, therefore, the incomes of wage earners.

Lower Supply Reduces Labor Income. In the current policy debates over "tax fairness," proponents of higher taxes on capital income imply that wage earners will somehow gain, or at least be unaffected, by the higher tax rates. In fact, almost every proposal to tax capital is an indirect attempt to tax labor.

"It's simple: the more investors invest, the more wage earners earn."

- Since 98 percent of the variation in the wage rate over more than four decades is directly due to changes in the size of the capital stock, any proposal that would reduce the size of the capital stock will also reduce labor income.
- Moreover, for every dollar of extra aftertax income to investors, there are $12 of additional aftertax income for wage earners — a relationship that has been fairly constant over time.
- Thus more than 90 percent of any new taxes on capital will be paid by wage earners rather than recipients of capital income.
- The reverse is also true: more than 90 percent of the benefit of any reduction in taxes on capital will flow to wage earners rather than to investors.

Proponents of high taxes on capital also argue that a reduction in taxes on investment income will cause a larger federal deficit. In fact, almost any cut in capital taxes will produce a substantial profit for the tax collectors. In general:

- Every $1 billion reduction in annual taxes on capital income will ultimately lead to a $25 billion increase in the nation's output of goods and services.
- Government will receive about $12 billion in new tax revenues as a result of the higher output, and wage earners will receive an additional $12 billion in aftertax wages.

Because the United States overtaxes capital relative to labor, we have less capital than we otherwise could have — given the same government revenue. The lower level of capital results in less output and a lower national income.

Double Taxation of Profits

"The total federal tax on corporate profits can be as high as 61 percent."

One of the most important recommendations in the January 1996 report of the National Commission on Economic Growth and Tax Reform established by the Republican congressional leadership — the Kemp Commission — was that the corporate income tax should be abolished. The commission recommended that the corporate and individual income taxes be fully integrated, thus eliminating the corporate tax as a separate layer of taxation.

Currently, the federal government double-taxes corporate profits. First, corporations pay 35 percent on their gross profits. But when the net profits are paid out to the corporation's owners, the shareholders, they are taxed again at rates as high as 39.6 percent. Thus the total federal tax on corporate profits can be as high as 61 percent.

No other major country penalizes corporate profits this way. All offer some form of relief for double taxation. The reason is because double taxation is both unfair and inefficient.

It is unfair because all shareholders are taxed at the same rate regardless of their income. Both rich and poor shareholders implicitly pay the same 35 percent tax at the corporate level.

Moreover, shares held by IRAs and 401(k) plans pay the corporate tax as well, even though they are supposed to be tax-exempt.

The double tax is inefficient because it raises the cost of capital, resulting in reduced investment, less growth, fewer jobs and lower wages. It also encourages excessive borrowing because interest, in contrast to dividend payments, is tax deductible.

Consequently, there is virtually no intellectual support for the current system of double-taxing corporate profits. Yet ironically, past efforts to

eliminate double taxation have met with passive resistance from the corporate community.

A November 1995 article in the *Yale Law Journal* by professors Jennifer Arlen and Deborah Weiss explains this apparent paradox by showing that corporate managers actually benefit from the double-tax system. The reason is that it gives them a justification for retaining a large share of corporate profits rather than paying them out to shareholders.

In 1994 corporations retained $117 billion, or 36 percent of their total aftertax profits.

Arlen and Weiss speculate that managers like retained earnings because it is essentially free money they can use to build empires and expand their power.

Such investments tend to yield lower returns than those that must be justified to the stock and bond markets by selling shares or borrowing new money.

Thus it is not surprising that many of the worst corporate investments of recent years, such as AT&T's purchase of NCR that contributed to 40,000 layoffs, were financed out of retained earnings.

Shareholders should cheer the Kemp Commission's recommendation.

Estate Taxes

"The estate tax discourages work, saving and investment, without redistributing wealth."

The estate and gift tax brings little revenue in to the federal government. In fiscal year 1997 it is expected to raise just $17 billion, according to the Office of Management and Budget. That is only 1.1 percent of total federal revenues, estimated to reach $1.5 trillion. However, while the tax is insignificant in terms of federal revenue, it is quite significant economically. It wastes resources. It discourages work, saving and investment. And it does virtually nothing to redistribute wealth (as some who favor it would like). In short, the estate and gift tax is a failure. It should be abolished.

The federal estate tax was first enacted in 1916 on estates larger than $50,000 (equivalent to $720,000 today). The top rate was 10 percent. However, the revenue yield from the tax was small because people who would have been subject to it simply gave away their assets tax-free during their lifetimes. This led to the establishment in 1924 of a gift tax to augment the estate tax. Since 1976 the estate and gift taxes have been unified into one tax system. Today the tax applies to estates above $600,000 ($1.2 million for couples), beginning at a rate of 18 percent and rising to 55 percent. In 1991 just 1.25 percent of adult deaths in the United States resulted in taxable estates.

The Richest Don't Pay. A common misconception is that the estate tax is paid mainly by the rich — including those on the Forbes 400 list. However, by using estate-planning techniques, the very rich actually evade most of the tax.

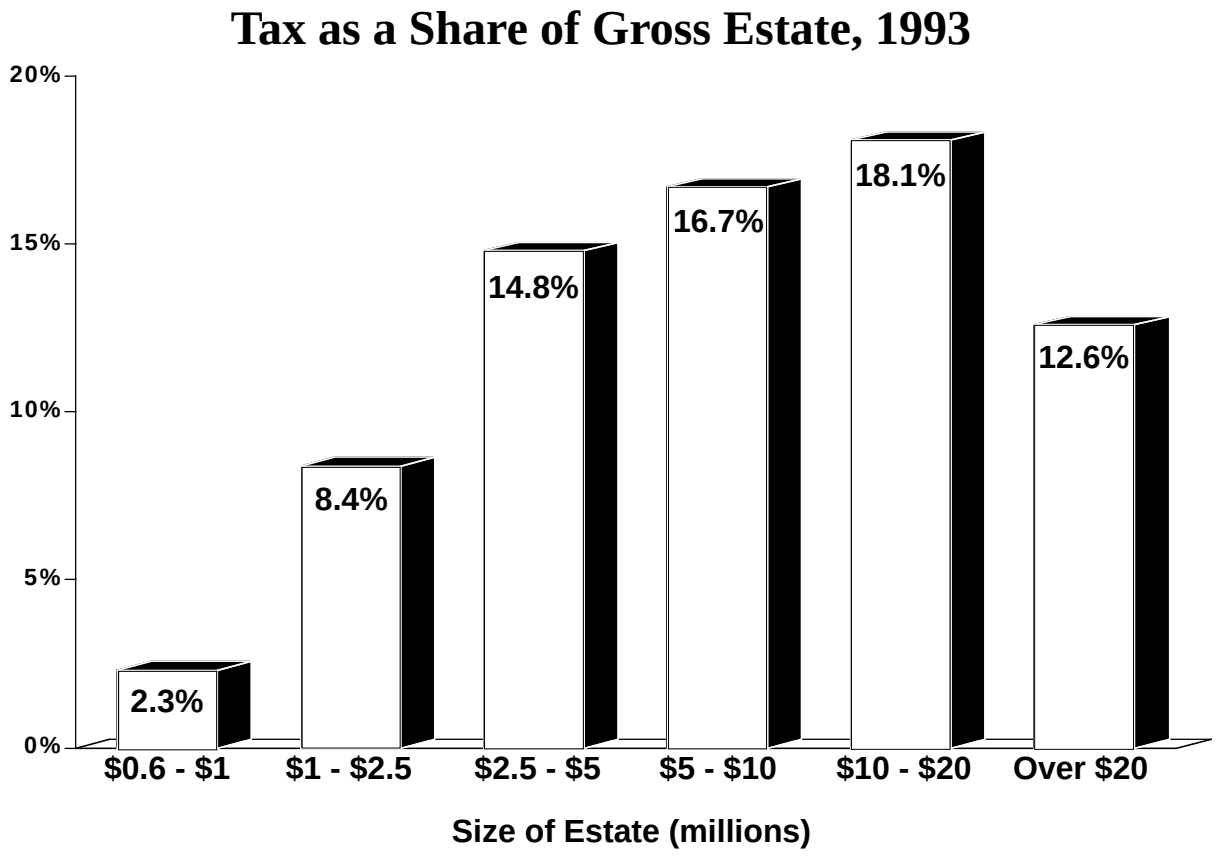
- In 1993, 52.4 percent of all estate tax revenue came from estates under $5 million.
- In the same year, estate taxes as a share of gross estates fell for those with estates above $20 million. (See Figure VI-3.)

The reason for this disparity is that careful estate planning can virtually eliminate the tax. At the simplest level, individuals can give away up to $10,000 per year per person free of gift tax. Also, there is a large deduction for gifts made to spouses, whose estates may be taxed separately. More complex methods for reducing the burden of the estate tax include life insurance trusts, qualified personal residence trusts, charitable remainder trusts, charitable lead trusts and generation-skipping trusts.

"Farmers and small business owners pay a disproportionate share of estate taxes."

For the Rich the Tax Is Voluntary. So effective are these methods of avoiding estate taxes that George Cooper, a Columbia University law professor, says that the estate tax is essentially voluntary. As he writes, "The fact that any substantial amount of tax is now being collected can be attributed only

FIGURE VI-3



Source: Internal Revenue Service.

to taxpayer indifference to avoidance opportunities or a lack of aggressiveness on the part of estate planners in exploiting the loopholes that exist." Economists Henry Aaron and Alicia Munnell put it even more bluntly. In their view, estate taxes are not taxes at all but "penalties imposed on those who neglect to plan ahead or who retain unskilled estate planners."

However, as the figure makes clear, the ability to exploit existing tax-avoidance techniques is not uniform. Since many of the planning techniques are costly and require long lead times to implement, those with the largest estates have the greatest ability to engage in estate planning. Families with histories of wealth are more likely to be familiar with them. Thus a disproportionate burden of the estate tax falls on those with recently acquired, modest wealth — including farmers and small business owners. In many cases their assets consist almost entirely of their businesses or farms. Though their incomes are not very high, at death they are declared to have been "rich."

"The estate tax may raise no net revenue for the federal government."

Does the Tax Raise Any Money? The impact of estate planning goes beyond the estate tax and impacts the income tax as well. For example, under a charitable remainder trust one donates assets to a tax-exempt institution but retains the income from the assets until death. Not only are the assets fully shielded from the estate tax, but the charitable donation also reduces one's income taxes. Because of such interactions between the estate tax and the income tax, B. Douglas Bernheim, an economics professor at Stanford University, believes that lost income tax revenue may offset all of the revenue from the estate tax. If true, this means that *the estate tax raises no net revenue for the federal government.*

Slowing Economic Growth. While skeptical of the effect Bernheim identifies, Professor Edward McCaffery of the University of Southern California's law school believes that the impact of the estate tax on economic growth may be significant, reducing the incentive to work, save and invest. For example, if the primary reason why higher-income people work to earn more money is to leave a large estate to their children, the effective marginal tax rate is the income tax rate plus the estate tax rate. This rate can go as high as 73 percent at the federal level alone (39.6 percent top income tax rate, plus a 55 percent estate tax rate on the remainder), with state income taxes pushing it higher still. According to McCaffery, these negative effects on saving and work effort are not limited to the very rich. Moreover, to the extent the estate tax encourages gifts to children during the taxpayer's lifetime, it may reduce the children's work and saving as well.

Does the Tax Make the Rich Richer? According to a study by economists Laurence Kotlikoff and Lawrence Summers, intergenerational transfers constitute a significant share of the nation's capital stock. This means that the estate tax is a direct tax on capital. It follows that the nation's capital stock is automatically reduced by at least the amount of the tax. It is even larger if it affects the saving rate as well.

Ironically, the impact of the estate tax on saving and capital formation negates much of the redistributive effect of the tax. According to an article by

Joseph Stiglitz, former chairman of the Council of Economic Advisers under President Clinton, to the extent that the estate tax lowers the capital stock it raises the return to the remaining capital. Since the rich already own most of the existing capital, *the estate tax may actually make the rich richer.*

Other Burdens for the Economy. Finally, the estate tax imposes large deadweight costs on the economy. First is the cost of employing large numbers of Internal Revenue Service agents to collect estate and gift taxes. Second is the cost of employing legions of tax lawyers to avoid the tax. Aaron and Munnell report that some 16,000 members of the American Bar Association cite trust, probate and estate law as their specialty. They conclude that compliance costs alone may eat up a sizable fraction of all estate tax revenues.

In recent years both Canada and Australia have abolished the estate tax. The United States should do the same.

Case for Cutting Capital Gains Taxes

The 1986 Tax Reform Act increased the maximum tax rate on capital gains income from 20 percent to 28 percent. This 40 percent tax hike has reduced government revenues, discouraged entrepreneurship and caused many investors to hold on to assets they would prefer to sell.

As a result, support for change is growing. On September 27, 1994, every Republican candidate for the House of Representatives signed the Contract With America, which proposed indexing capital gains for inflation and effectively cutting the capital gains tax rate in half. Similar reforms were supported by many Democrats and such business organizations as the U.S. Chamber of Commerce. But so far no action has been taken. Let's see why it is needed — more than ever.

The Case for Indexing. Because tax brackets and the personal exemption are indexed to inflation, people who receive wage income cannot be pushed into a higher tax bracket by the effects of inflation alone. No similar protection exists for those who receive investment income.

"Indexing ensures that only real capital gains are taxed."

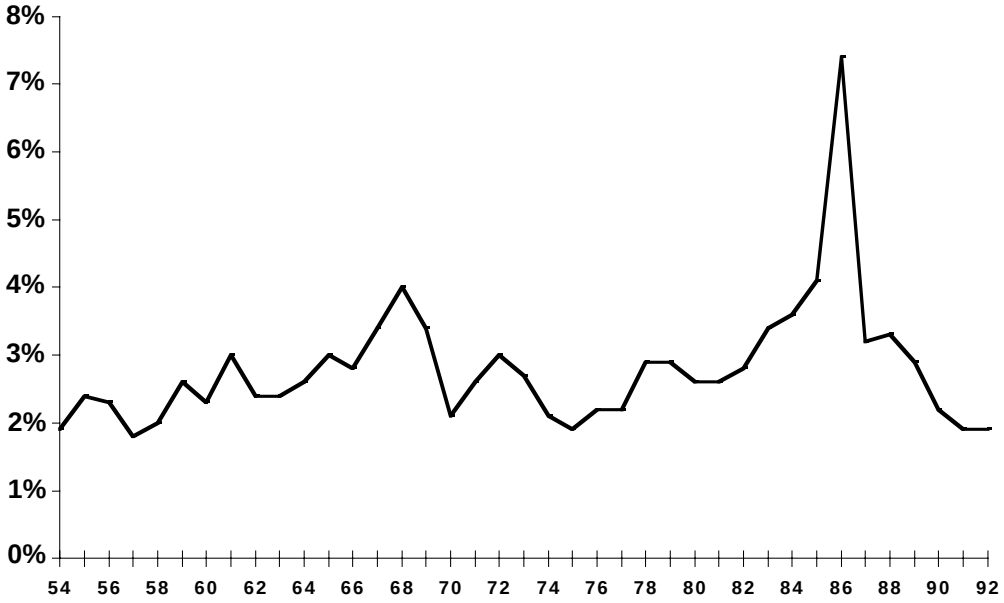
Because investors must pay taxes on gains that merely reflect the effects of inflation, the effective tax rate on their real gains can be extraordinarily high. For example, someone who invested in common stock in 1970, did as well as the Dow Jones Industrial Average and sold the stock in 1980 would have had a capital gain of 18.4 percent. During this same period the price level more than doubled, so the nominal gain actually represented a real loss of 44 percent. Nevertheless, the investor would have been assessed a capital gains tax. The purpose of indexing is to ensure that only real gains are taxed.

The Case for Lower Tax Rates. The vast majority of assets have value only because they are expected to produce future income. For example, bonds will produce interest income and stocks will produce dividends and

"Cuts in capital gains taxes in 1978 and 1981 led to increased sales of asets."

FIGURE VI-4

Capital Gains Realizations as a Percent of GDP



Source: Congressional Budget Office and Internal Revenue Service.

retained earnings. Since this income will be taxed as it is realized, there is no need to tax the owners of these assets at the time the assets are bought and sold. It impedes the efficient transfer of assets from those who value them less to those who value them more, and it makes investments in all income-producing assets less attractive.

Economic Effect: Unlocking Investments. The current taxation of inflationary gains, together with high statutory capital gains tax rates, creates a powerful "lock-in" effect. Since selling is taxed and possessing is not, high capital gains taxes encourage investors to hold rather than sell — thereby avoiding the tax indefinitely. Assets that are held until death avoid capital gains taxes altogether.

When investors lock in their assets this way, government loses revenue it would have gotten if tax rates were lower, and the capital market loses efficiency because the flow of assets to those who value them the most is impeded.

Economic Effect: More Revenue for Government. Capital gains are realized at the time assets are sold. It is clear from the history of asset sales that investors are highly sensitive to the tax on capital gains. Investors rushed to sell assets in advance of increases in the capital gains tax in 1969 and 1987 (see Figure VI-4). This led to a bulge in sales in 1968 and again in 1986. After the tax increase, however, asset sales fell. Conversely, cuts in the capital gains tax in 1978 and 1981 led to increased sales, as the lock-in effect abated.

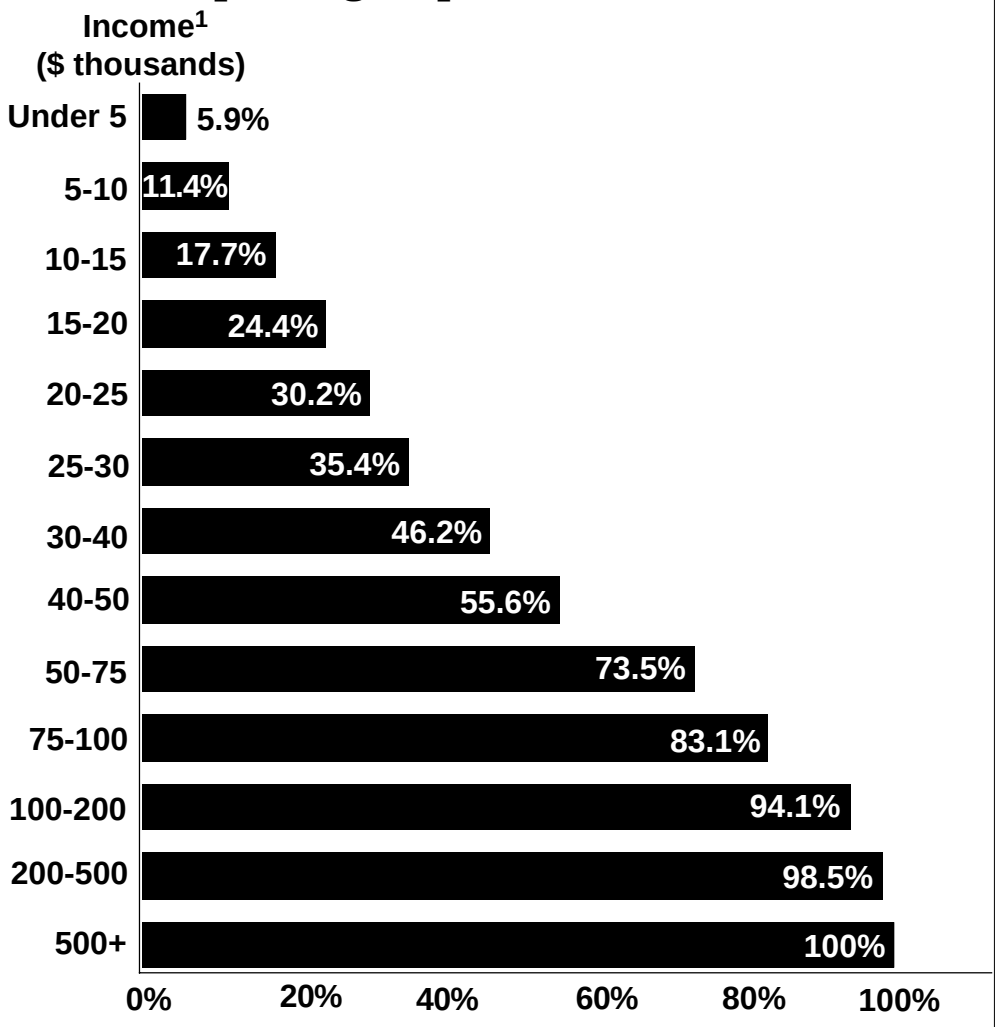
This history has been repeatedly ignored in Washington, D.C. In 1986 the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) misled many members of Congress by predicting that the increase in the maximum capital gains tax rate from 20 percent to 28 percent would not deter asset sales and would increase government revenues. In fact:

- Capital gains realizations in 1992 were $116.5 billion, far lower than the $165.5 billion in 1985.
- At 40 percent higher tax rates, capital gains tax revenue of $26.8 billion in 1992 was about 13 percent higher than the $23.7 billion collected in 1985, but after adjusting for inflation, the collections represented a 13 percent decrease.

"The majority of capital gains taxpayers are middle class."

FIGURE VI-5

Cumulative Percentage of Taxpayers Reporting Capital Gains in 1992



[1] Adjusted Gross Income.

Source: Internal Revenue Service.

Economic Effect: More Investment. Capital gains taxes affect investment decisions. In particular, they reduce the amount of capital available for investments with higher risk potential, such as new start-ups and companies in emerging sectors. As a result, the capital gains tax tends to be a direct tax on the entrepreneurship that all economists recognize as essential to growth.

Economic Effect: Benefits for All Income Groups. Despite the strong evidence that lower capital gains tax rates buoy the economy, many in Congress continue to resist cutting the rate for fear they will be accused of cutting taxes only for the wealthy. Yet the bulk of taxpayers realizing capital gains are those with middle incomes (see Figure VI-5).

- Well over half of all taxpayers with capital gains in 1992 had adjusted gross incomes of less than $50,000.
- More than 73 percent had incomes of less than $75,000.

"A 50 percent capital gains exclusion would increase GDP almost $1 trillion."

Economic Effect: Economic Growth. All Americans would benefit from the stronger economic growth that would result from lower taxes on capital gains. A 1994 study by the Institute for Policy Innovation predicted that:

- A 50 percent capital gains exclusion (effectively cutting the tax rate in half) plus prospective inflation indexing would lower the cost of capital by 5 percent, thereby inducing investors to increase the capital stock by $2.2 trillion by the year 2000.
- This larger stock of capital would create 721,000 new jobs and increase total GDP cumulatively by almost $1 trillion by the year 2000.

Financing the Tax Cut. Expansion of economic activity would increase the overall tax base of the economy by more than enough to compensate for any loss in federal revenue from the tax changes described above. Indeed, the indexing feature alone is probably enough to ensure that the proposal increases revenue. Since only new investments would be indexed, most taxpayers would want to realize their existing gains and invest in new inflation-indexed assets.

Benefits to the Poor

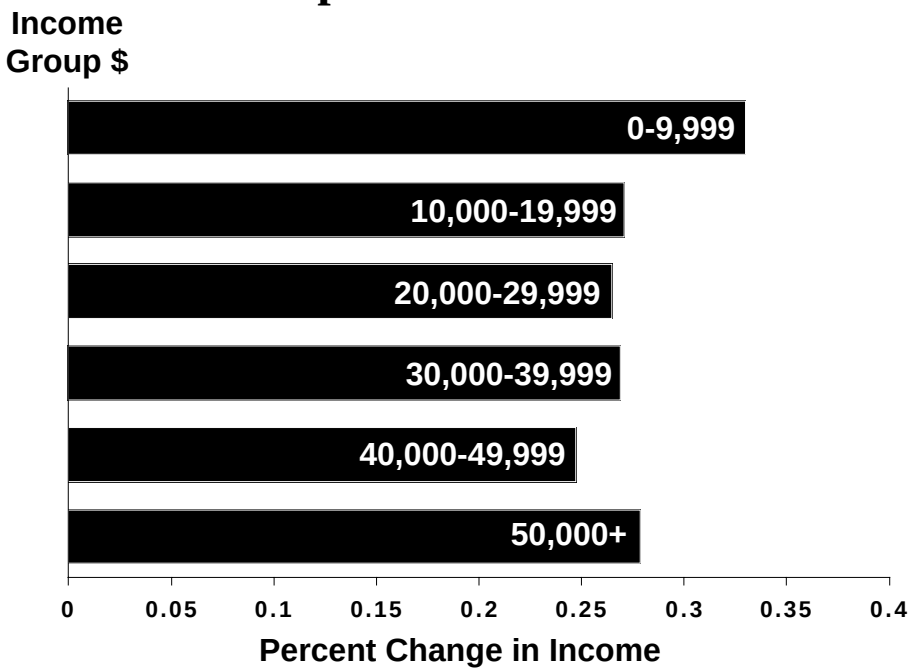
Much of the debate in Congress on whether to reduce the tax on capital gains has focused on who would benefit from such a reduction. Opponents claim that those with high incomes would gain disproportionately.

An economic analysis shows that a lower capital gains tax rate would increase savings and act as an engine of economic growth. After all effects are considered, some income groups gain more or less relative to other income groups, but all income groups would be net gainers from the type of capital gains tax cut proposed. More significantly, as a percentage of income, families in the lowest-income group would gain the most.

"The poor would get the highest percentage gain from a capital gains tax cut."

FIGURE VI-6

Income Effects of Reducing the Capital Gains Tax Rate



Capital gains were taxed at lower rates than other forms of income from the 1920s until the passage of the Tax Reform Act of 1986. During his presidency, George Bush proposed lowering the maximum tax on capital gains from 28 percent to 15.4 percent for assets held more than three years, 19.6 percent for assets held more than two years and 23.8 percent for assets held more than one year. This proposal was initially opposed by some congressional Democrats who claimed that it benefited upper-income taxpayers at the expense of those with lower incomes. Later they proposed a trade-off linking a capital gains tax reduction to a tax increase on higher incomes. However, no capital gains tax relief was adopted as part of the 1990 tax bill. President Clinton expressed support for some sort of capital gains tax relief, but none was included in the 1993 tax bill, either.

Supporters of a reduction in the capital gains tax rate contend that it would increase the value of real estate and other assets (benefiting all holders of assets), stimulate savings (lowering the cost of capital and stimulating investment) and encourage entrepreneurship (leading to economic growth).

Most economists believe that such a tax cut would mitigate the lock-in effect of investors holding onto assets that have increased in value, rather than selling them, paying the capital gains tax and purchasing new assets. This effect may cause a misallocation of risk and may reduce savings.

Additionally, a number of studies have found that a capital gains tax cut would actually increase federal revenues. For example, a study published by the National Center for Policy Analysis estimated that adoption of the Bush

proposal would have produced $185 billion in additional federal tax revenue over the following decade.

The Economic Model. Both the direct and indirect effects of a reduction in the capital gains tax rate were analyzed using what economists call a Computable General Equilibrium (CGE) model. The representation of the U.S. economy used for this study incorporates data from 14 primary production sectors, 14 consumption sectors, a foreign sector and government. It divides households into six income groups.

Tax rates in the model were changed to study the effects throughout the economy of the capital gains cut proposed by President Bush. Although more recent proposals differ in detail from the Bush plan, their effects would be similar.

"Incomes would also increase from a capital gains tax cut because the economy would grow faster."

Who Benefits? Upper-income groups would receive substantial benefits from a capital gains tax cut, but so would other income classes. (See Figure VI-6.) Not only would all income groups realize capital gains at a greater rate, their incomes also would increase due to the growth of the economy as a whole. Taking both direct and indirect benefits into account, the model indicates:

- The greatest *total* gains in income go to the highest-income group (earning $50,000 or more), which is not surprising since higher-income families tend to own the most capital.
- However, the highest *percentage* gains in income go to the *lowest*-income families ($0-$9,999).

The relatively high percentage gain in income (0.33 percent) to the lowest income group is due to several factors. For instance, many farmers who fall into this group are land rich and income poor. The reduction in capital gains taxes allows them to benefit from using their land for forestry as well by selling it. (In forestry, *all* income is taxed as a capital gain.) The expansion of the forestry sector is associated with an expansion of the logging and wood product sectors, which benefits workers in these sectors, who tend to be in the lowest-income group. Expansion in many sectors necessitates increased production of machinery in the manufacturing sector. Many service sectors also expand, with resulting benefits to workers.

The overall results of the reduction in capital gains tax rates are both positive and somewhat surpirsing.

- The lowest-income group ($0-$9,999) has the greatest percentage gain, and the percentage gain in income declines with increasing income among the three lowest-income groups ($0-$9,999, $10,000-$19,999 and $20,000-$29,999).
- The percentage change in income is greater for the $30,000-$39,999 group than for the $20,000-$29,000 group, but smaller than the percentage gain of the two lowest-income groups.

- The smallest percentage change in income is for the second highest-income group ($40,000-$49,999).
- And the highest-income group ($50,000 plus) enjoys a percentage increase in income second only to the lowest-income group.

Production Expands. Among the 14 production sectors in the model, the reduction in capital gains taxes would spur the growth of logging the most (5.8 percent). This is not surprising since, as previously noted, in forestry all income is subject to the capital gains tax rate. Producers in this sector would be likely to increase output considerably despite the fact that the tax-inclusive price of their products would fall by 8.4 percent.

Moreover, expansion of the machinery and finance sectors would assure increased future economic growth because capital in these sectors is taxed at a relatively high rate compared to capital in other sectors, and these two sectors represent the bulk of net investment. This makes them very important for economic growth.

Savings Increase. The computer simulation of a capital gains tax rate reduction shows that output would increase in every sector of the economy and that savings would increase substantially (0.26 percent). Savings increases because it can be used for investment, and households would enjoy greater aftertax returns due to the decrease in the capital gains tax rate.

This increase in savings is associated with an increase in production-sector financial services and consumer financial services. The increases in savings and consumer financial services, like the expansion in the producer financial services and manufacturing sectors, bode well for future economic growth.

"Demand for housing would be higher and interest rates would fall."

After savings and financial services, the largest increase in output occurs in the housing sector (0.24 percent). Gains in personal income associated with reduced capital gains taxes lead to higher demand for housing, reinforced by savings increases and a fall in interest rates.

Effect on Government Revenues. Another objection that is raised to the capital gains tax reduction is that it would reduce government revenues. In this model, government revenues do fall, but only by 1.40 percent. The loss is small because the initial revenue reduction associated with the tax cut is offset by increased revenue associated with the general increase in economic activity as secondary effects of the tax reduction expand the economy overall.

Indexing Capital Gains

Late in the 1996 campaign, Republican vice presidential candidate Jack Kemp raised a new issue in the tax debate. He said that, if elected, Bob Dole would issue an executive order indexing capital gains for inflation. The idea was quickly endorsed by Wall Street financier Ted Forstmann, who said it was "the right thing to do both morally and ethically."

The tax code currently does not differentiate between an asset's real increase in value and the increase due solely to inflation. On assets that have been held for a long time, a considerable part of their value may simply reflect inflation.

Taxes on the inflationary component can easily exceed any real increase in an asset's value, meaning the tax rate on real gains can be 100 percent or more. Indexing would fix this problem by increasing the basis for taxation by the inflation rate, with taxes applying only to gains in excess of inflation. The effect of indexing would be to greatly reduce the tax rate on capital gains.

Problems with Indexing. Unfortunately, there are significant legal, administrative and technical barriers to capital gains indexing. The first problem is legal.

"Indexing capital gains would be quite hard."

In 1992, Charles Cooper, a former assistant attorney general during the Reagan administration, wrote a paper arguing that the Treasury Department had the power to index capital gains by regulation. However, after this opinion was reviewed by George Bush's Justice Department, Attorney General William Barr ruled that such authority did not in fact exist.

The administrative barriers are also formidable. Figuring out exactly what inflation adjustment should apply to shares of stock that may have been acquired at different dates over a long period of time would be a nightmare of complexity. In the case of tangible assets, such as buildings, any improvements would have to be indexed separately. And matching indexed gains against losses would be extremely difficult.

Another administrative problem is that unless debt is also indexed, capital gains indexing could simply become a tax dodge. The reason is that inflation not only increases the value of assets, it also raises interest rates. But interest paid on money borrowed for investment is tax deductible. Thus people who borrow to purchase capital assets are already compensated for inflation by deducting interest that includes an inflation component. If gains are indexed, borrowers should only be allowed to deduct interest less the rate of inflation. This would be extremely complicated.

Finally, there are technical problems about what inflation rate to use when indexing capital gains. The consumer price index might not be appropriate for this purpose because it includes a limited number of goods and because it may overstate the true rate of inflation. For example, the Bureau of Labor Statistics has great difficulty adjusting prices for increases in quality and incorporating new products into the index while maintaining continuity.

Historically, the problem of inflation has been a major justification for having a lower tax rate on capital gains than on other forms of income. Conse-

quently, the institution of indexing might make it impossible to ever cut the tax rate on capital gains.

The best approach would be to *abolish* the capital gains tax. Capital assets have value only because of the flow of income they generate. But since we also tax dividends, interest and rent, the capital gains tax is really a double tax.

Depreciation and Investment

Our income tax system discriminates against long-term investments. Businesses are allowed to deduct the cost of an investment in plant and equipment on their income tax returns. But instead of being able to deduct the full cost in the year an investment is made, firms are forced to spread the expense over a number of years. These rules governing depreciation distort investment decisions in two ways:

- The tax law treats a dollar of depreciation in the future as if it were just as valuable as a dollar of depreciation today — ignoring the time value of money.
- The tax law also ignores the effects of inflation, treating an inflated dollar as though it were just as valuable as a real dollar.

"Neutral cost recovery removes removes tax considerations from investment decisions."

Under these rules, investments in short-lived assets are more attractive than investments in long-lived assets. In fact, the longer the required depreciation period, the less attractive the asset is — especially during periods of inflation.

The remedy for this problem is neutral cost recovery. Under this system, investors would be allowed to adjust future depreciation expenses for inflation and interest. These adjustments would remove the tax distortions and encourage investment decisions based on economic considerations, not tax considerations.

Why the Time Value of Money Is Important. Historically, IRS rules reflect the belief that deductions for depreciation should be calculated on a straight-line basis over the useful life of a capital asset. Thus if a piece of equipment has a useful life of 15 years, a firm would be able to deduct one-fifteenth of the purchase price each year for 15 years.

For example, if the asset were purchased for $150,000, a firm could deduct $10,000 from its gross income per year. However, at a 5 percent discount rate, this $10,000 deduction would be worth only $5,051 in year 15. In total, the present value of these deductions would be $108,985, rather than $150,000 — or only two-thirds of the actual cost.

Modern rules on depreciation are more liberal than straight line. But they have the same basic problem.

Why Inflation Is Important. The problem is compounded by inflation. For example, at a 5 percent annual inflation rate, the rate of interest in

the previous example becomes 10 percent. At this higher rate of interest the present value of allowed depreciation expenses would be $2,633.

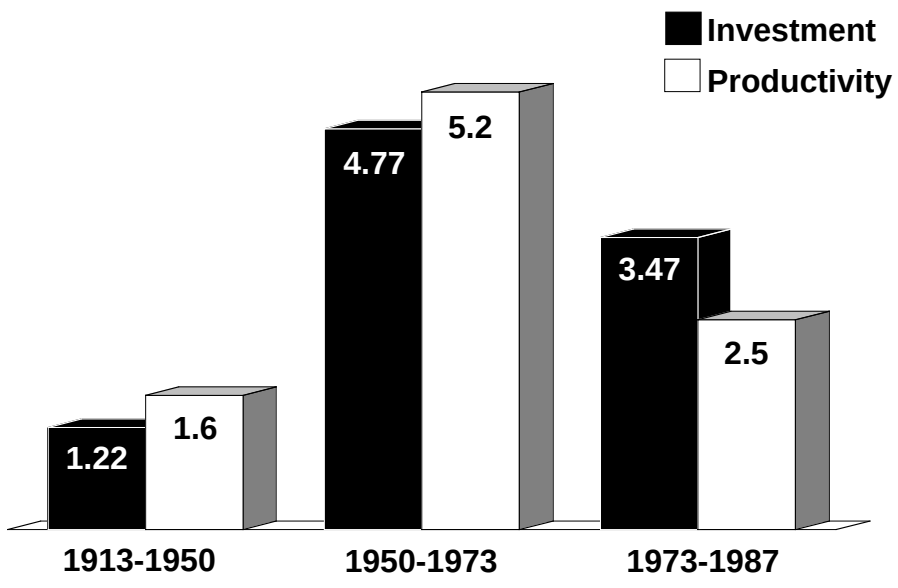
Why Depreciation Rules Matter. Depreciation allowances are an important element in the cost of capital. If firms are allowed to write off an investment more quickly, they are much more likely to invest more, thereby increasing the rate of economic growth, living standards and the number of jobs. Over the long run, investment and productivity are strongly correlated (see Figure VI-7).

The Kennedy Tax Cut. A study by tax economist Norman Ture confirmed that accelerated depreciation during the 1950s made corporate investment significantly higher than it otherwise would have been. This positive experience led the Kennedy administration to further liberalize depreciation, allowing firms to write off their investments 32 percent faster on average. Kennedy also instituted a 7 percent credit against tax liabilities for new investments in machinery and equipment. As Figure VI-8 illustrates,

"Over time, investment rates and productivity rise and fall together."

FIGURE VI-7

Investment and Productivity in Five Nations

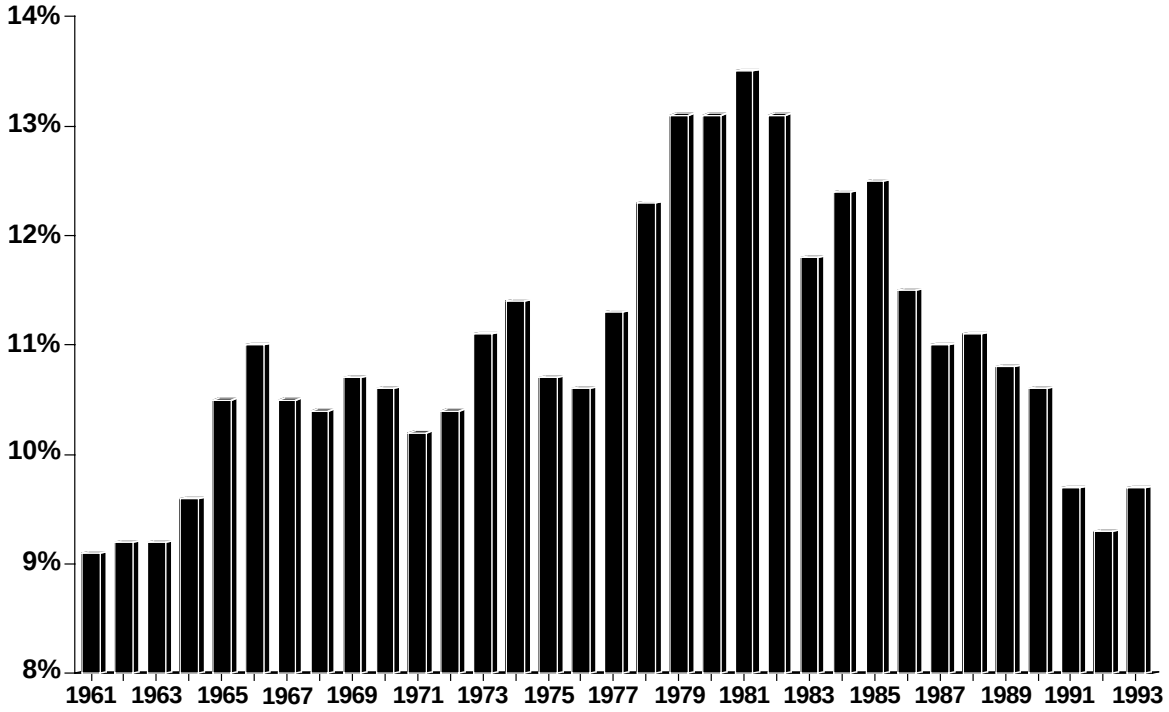


Source: Angus Maddison, *Dynamic Forces in Capitalist Development* (London: Oxford University Press, 1991), pp. 142, 150.

Note: Data are the arithmetic average annual growth rates for the United States, France, Germany, the Netherlands and the United Kingdom. Investment figures are based on gross nonresidential capital stock per employed person. Productivity figures are the percentage increase in the gross value added per person employed in industry.

FIGURE VI-8

Gross Private Domestic Nonresidential Fixed Investment as a Share of GDP



Source: Department of Commerce.

"Investment shot up after Kennedy liberalized depreciation rules."

gross private nonresidential fixed investment as a share of GDP shot up shortly after the new depreciation rules became effective in 1962.

Liberalization in the First Reagan Tax Cut. The Kennedy administration's depreciation rules remained largely intact until 1981, when the Reagan administration pushed for still faster depreciation rates. The reform placed all depreciable assets into four broad groups: structures could be depreciated over 15 years; equipment, machinery and research and development expenses could be written off in ten, five or three years — depending on the type of asset.

Taking the Gains Back in Other Reagan Tax Changes. Unfortunately, Congress took back much of the 1981 acceleration the following year. Depreciation periods were further lengthened in the Tax Reform Act of 1986, which also repealed the investment tax credit. The result of these changes has been to lengthen the write-off period for depreciation of assets, increasing the cost of investment and reducing capital investment.

Achieving Neutrality. Although motivated by a desire to make tax depreciation neutral with regard to investment, tax reform in 1986 made the situation worse. Even under accelerated depreciation methods currently in effect, depreciation allowances taken in future years are worth less than those

taken sooner because of inflation and the time value of money. Economists have long held that true tax neutrality requires that firms be able to deduct the full present value of their investments.

"True tax neutrality requires that firms be able to deduct the full present value of investments."

Effects on Federal Revenues. One way to solve this problem is to allow firms to deduct the full cost of an investment in the year the investment is made. However, a major barrier to adoption of this reform is that it would lead to a huge short-term revenue loss for the government, as businesses reduced their tax payments. Although in the long run a larger capital stock would lead to permanently higher revenue for the government, current budget rules do not allow Congress to take such future increases into account.

Neutral Cost Recovery. In order to get around this barrier, an alternative method of depreciation has been devised. Firms would continue to write off their investments over a period of years, but future depreciation allowances would be increased by the rate of inflation and the real interest rate. Firms ultimately would be able to deduct the full real present value of their investments.

In 1994 such a proposal was included in the House Republicans' Contract With America. From the point of view of investors, the tax change would be equivalent to a $90 billion-a-year tax cut on new investment. The revenue loss would be offset by faster economic growth resulting from a larger capital stock. On net, neutral cost recovery would actually increase federal revenue in the first five years.

VII. Are Seniors Taxed Unfairly?

Wealthy industrialists and Wall Street investors pay only 40 cents in federal taxes on the next dollar they earn. But middle-income elderly people drawing Social Security benefits pay far higher taxes.

Thousands of them are people who invested in Individual Retirement Accounts or other tax-deferred retirement plans. Expecting lower tax rates in retirement, they have discovered that instead they face higher marginal tax rates than younger people — or even wealthy older people. The major culprits are the earnings penalty, the so-called Social Security benefits tax and the capital gains tax.

The 104th Congress passed reforms in all these areas, only to have President Clinton veto all except an increase in the earnings penalty threshold. The 105th Congress has not yet enacted any reforms.

The Earnings Limit Penalizes Work

"A couple can pay more than a dollar in taxes for each additional dollar they earn."

The 42 million-plus Americans age 60 and over represent a vast store of human capital, rich in talent and ability. Yet this valuable resource is increasingly wasted.

- In 1930, before Social Security, 54 percent of men age 65 and over were in the labor force.
- Today the labor force participation rate of men age 65 and over is about 16 percent.

One reason for that change is government policy. If elderly workers under the age of 70 want to improve their standard of living or continue using their work experience and skills, the government takes the bulk of their additional wages through special taxes.

For example, if a married 64-year-old couple with as little as $23,000 in total annual income earns another dollar in wages, as much as 83 cents of it can go to taxes. At higher income levels, the couple can pay even more than a dollar in taxes for each additional dollar they earn —*so their net income decreases if they work for pay.*

As part of the Republican Contract With America, Congress passed and the president signed legislation that will allow Social Security recipients ages 65 through 69 to earn up to $30,000 a year by 2001 without penalty. (See Table VII-1.) This is a step in the right direction, but both the elderly and the economy would benefit more if the earnings penalty were abolished completely and immediately.

Because the earnings penalty punishes productive work, our national income is smaller than it otherwise would be. The earnings penalty also is unfair, punishing those who have to rely on wage income. Only those earning wages or salaries face a limit. This penalty does not apply to those who receive their income from investment.

Tax Effects of the Earnings Penalty. Social Security beneficiaries face one of two earnings penalties, depending on their age, in 1997:

- For those ages 62 through 64, the Social Security Administration reduces benefits by $1 for every $2 of wage and salary income above $8,640 per year.
- Those ages 65 through 69 lose $1 in Social Security benefits for every $3 of earnings in excess of $13,500 per year.

"In reducing benefits, the earnings penalty becomes a tax."

Although these penalties are in the form of the withholding of benefits, they are in effect a tax. Specifically:

- A Social Security beneficiary whose benefits are reduced $1 for each $2 of earnings faces the equivalent of a 50 percent marginal tax rate on wage income. (This tax rate continues until wages above the earnings limit reach twice the amount of benefits — at which time all benefits have been lost.)
- Beneficiaries who lose $1 for every $3 of wages face a 33 1/3 percent marginal tax rate. (This tax rate continues until earnings in excess of the limit reach three times the amount of benefits.)

This tax penalty is in addition to federal and state income and payroll taxes. As Figure VII-1 and Table VII-2 show, when all these taxes are combined, even for those not subject to the additional tax on Social Security

TABLE VII-1

Annual Earnings Limit for Seniors[1]

Year	Ages 65 to 69[2]	Ages 62 to 64[3]
1995	$11,280	$8,160
1996	$12,500	$8,280
1997	$13,500	$8,640
1998	$14,500	
1999	$17,000	
2000	$25,000	
2001	$30,000	

[1] The penalty does not apply to seniors age 70 and older.

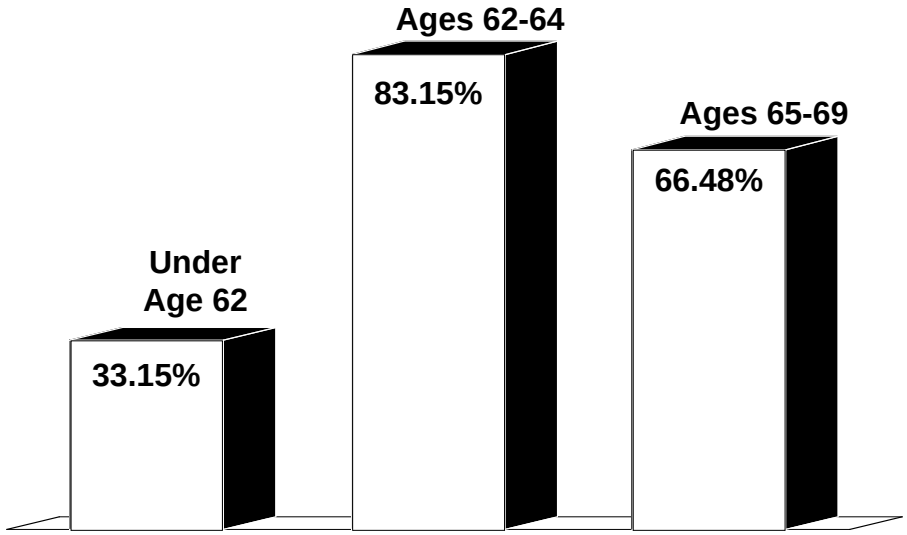
[2] Increases scheduled by law.

[3] Adjusted annually for wage increases.

Source: Social Security Administration.

FIGURE VII-1

Marginal Tax Rates for Workers
(15% federal income tax bracket)



benefits (discussed below), marginal tax rates are very high at moderate income levels:

"A 64-year-old single retiree with an income of $18,000 can face an 83 percent marginal tax rate."

- A 64-year-old single retiree with an income of only $18,000 is in the 15 percent federal income tax bracket but may face an 83 percent marginal tax rate.
- A 65-year-old single retiree with an income of $23,000 is also in the 15 percent federal tax bracket and may face a 66 percent marginal tax rate.

As high as the marginal tax rates are for these workers, they are even higher when a working beneficiary is also subject to the so-called Social Security benefits tax, which can apply to as much as 85 percent of benefits. A recipient subject to both the earnings penalty and the benefits tax can pay more than a dollar in tax on an additional dollar of income (as discussed below).

That doesn't even take into account that at least 15 states tax Social Security benefits. And workers who are self-employed face additional FICA taxes. It appears to be at least theoretically possible for a self-employed 63-year-old worker living in Montana to face a marginal tax rate of 130 percent. Perhaps the most insidious effect of these policies is to severely penalize moderate-income elderly who must continue to work after age 65.

Effects on Elderly Workers. These high marginal tax rates affect the behavior of elderly workers. About 1.9 million retired workers ages 65 to 69 who are eligible for Social Security benefits have earnings. An extraordinarily large number of them earn up to (or near) the earnings limit and then quit working. Specifically:

- About 400,000 elderly workers earn annual wages within 10 percent of the earnings limit.
- These workers apparently earn all they can without being subject to the retirement earnings penalty.

"Moderate-income elderly who must work after age 65 are severely penalized."

No doubt many others pass up full-time or part-time work because of the earnings penalty. And no doubt still others work in the underground economy, receiving unreported cash or some other form of payment.

Why Have an Earnings Limit? The retirement earnings limit has been part of Social Security since its inception. The original reason given for

TABLE VII-2

Examples of Marginal Tax Rates With the Earnings Penalty

(Beneficiaries in 15% federal income tax bracket)

Single Retiree	Age 64	Age 65
Savings income	$1,000	$1,000
Wage income	9,000	14,000
Social Security income	8,000	8,000
Total income	$18,000	$23,000
Marginal Tax Rate:		
S.S. benefit reduction	50.00%	33.33%
Federal income tax*	15.00	15.00
Payroll tax**	14.15	14.15
State income tax	4.00	4.00
Total marginal rate	83.15%	66.48%

Married Couple	Age 64	Age 65
Savings income	$2,000	$2,000
Wage income	9,000	14,000
Social Security income	12,000	12,000
Total income	$23,000	$28,000
Marginal Tax Rate:		
S.S. earnings penalty	50.00%	33.33%
Federal income tax*	15.00	15.00
Payroll tax**	14.15	14.15
State income tax	4.00	4.00
Total marginal rate	83.15%	66.48%

* Both individuals and couples with incomes placing them in the 28 percent income tax bracket would also be subject to the Social Security benefits tax. See Table VII-3 for examples.

** The examples incorporate the self-employed payroll tax rate after allowance for the share that is deductible from federal income tax. For those not self-employed, the combined employee/employer rate is the true measure of the tax burden on the gross wage.

it was that Social Security should replace lost earnings. Benefits, it was believed, should not go to people who continued to work. This policy was consistent with the Depression-era view that Social Security should encourage older workers to leave the workforce, making more jobs available for the young.

Times have changed. The United States now faces a shortage of workers, not a glut. The continuing labor force participation of older Americans, who possess valuable skills acquired over 30 or 40 years, is increasingly important to the health of the U. S. economy.

Benefits Tax on Retirement Income

Social Security benefits were entirely free of taxes until 1983, when Congress voted to tax 50 percent of benefits above a certain income level. President Clinton raised this to 85 percent in 1993. The 104th Congress voted to repeal the Clinton tax increase on Social Security recipients but could not override the presidential veto.

The Social Security Administration estimates that approximately 3 million families paid higher income taxes in 1994 as a result of the expanded Social Security benefits tax.

Despite its name, the Social Security benefits tax is really a tax on other income — interest, dividends, pensions, wages and even otherwise tax-exempt income — that beneficiaries may receive. No tax is paid unless a taxpayer's modified adjusted gross income (MAGI) reaches a certain level. Beyond that point, the tax rises as income rises.

"The Social Security benefits tax is really a tax on other income."

Calculating the Benefits Tax. The MAGI is the total of all non-Social Security income, including any tax-exempt interest (such as from municipal bonds), plus 50 percent of any Social Security benefits received. If the total is greater than $25,000 for single persons or $32,000 for couples, one-half of the excess is included in taxable income. Since 50 cents of benefits is taxed for each additional dollar of income, when elderly taxpayers earn $1 they pay taxes on $1.50.

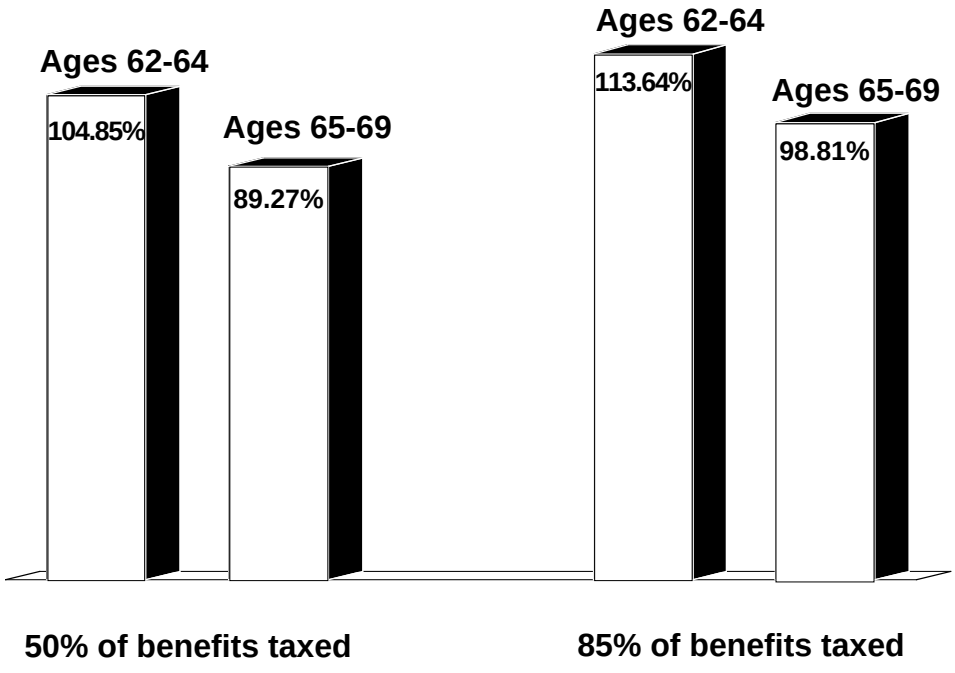
- Elderly taxpayers in the 15 percent income tax bracket pay an effective rate of 22.5 percent (15% x 1.5).
- Elderly taxpayers in the 28 percent income tax bracket pay an effective rate of 42 percent (28% x 1.5).

Since the Clinton administration's 1993 tax increase, 50 percent of benefits are taxed only up to the point at which the MAGI reaches $34,000 for singles and $44,000 for couples. Beyond that point, 85 percent of benefits become taxable up to the point at which 85 percent of total benefits are included in taxable income. Since 85 cents of benefits is taxed for each addi-

"Some elderly taxpayers face marginal tax rates of more than 100 percent."

FIGURE VII-2

Marginal Rates for Workers Subject to Tax on Social Security Benefits
(28% federal income tax bracket)



tional dollar of income at that level, when elderly taxpayers earn $1 they pay taxes on $1.85.

- Elderly taxpayers in the 15 percent income tax bracket pay an effective rate of 27.8 percent (15% x 1.85).
- Elderly taxpayers in the 28 percent income tax bracket pay an effective rate of 51.8 percent (28% x 1.85).

Benefits Tax Plus Earnings Penalty. When all taxes are considered (see Figure VII-2):

- Beneficiaries subject to both the earnings penalty and taxation of up to 50 percent of benefits can face marginal tax rates of 89 percent (those ages 65 through 69) to 105 percent (those ages 62 through 64) on additional wages.
- Beneficiaries subject to both the earnings penalty and taxation of up to 85 percent of benefits can face tax rates on additional wages of 99 percent from ages 65 through 69 and 114 percent from ages 62 through 64.

Table VII-3 shows how tax rates on additional earnings rise as Social Security benefits become subject to taxation. This table is based on a 28 percent marginal tax rate, the one to which beneficiaries with these earnings are likely to be subject.

"The middle-income elderly face high marginal tax rates on income from savings."

Taxing Middle Class Savings. About 60 percent of the income of elderly taxpayers comes from investments (including pensions). For most younger people, the tax rate on investment income is 15 percent or 28 percent. For the elderly, the Social Security benefits tax raises the rate on income from savings by as much as 85 percent (see Figure VII-3).

- Capital gains income is subject to the 52 percent top rate for Social Security recipients vs. 28 percent for others.
- Tax-exempt income of the elderly can be taxed at a rate of 24 percent vs. a zero rate for younger taxpayers.
- Social Security cost-of-living adjustment (COLA) increases are taxed at a rate as high as 12 percent.

TABLE VII-3

Tax Rates With the Earnings Penalty as Social Security Benefits Become Subject to Taxation

(Beneficiaries in 28% federal income tax bracket)

	Married Couple 50% phase-in range	Married Couple 85% phase-in range
Pension income	**$12,000**	**$18,000**
Savings income	**5,000**	**10,000**
Wage income	**14,000**	**14,000**
Social Security income	**12,000**	**14,000**
Total income	**$43,000**	**$56,000**

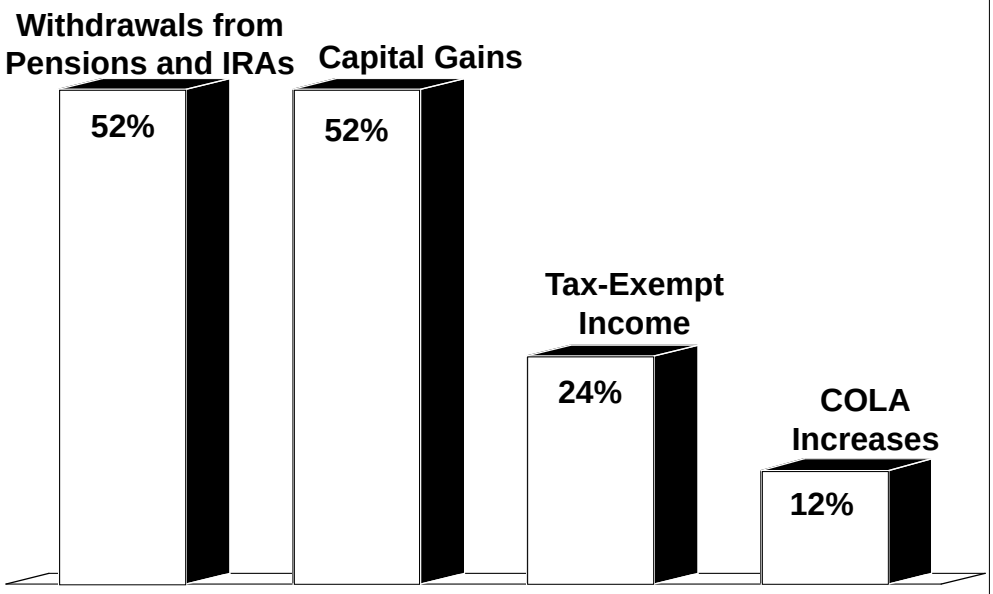
	Age 64	Age 65	Age 64	Age 65
Marginal Tax Rate:				
S.S. benefit reduction	**50.00%**	**33.33%**	**50.00%**	**33.33%**
Federal income tax*	**38.50**	**39.67**	**45.85**	**47.84**
Payroll tax**	**12.35**	**12.27**	**11.79**	**11.64**
State income tax	**4.00**	**4.00**	**6.00**	**6.00**
Total marginal rate	**104.85%**	**89.27%**	**113.64%**	**98.81%**

* Effective rate in the 28 percent bracket caused by a complex interaction resulting when the earnings penalty reduces the amount of income considered in calculating the benefits tax. The rate due to the earnings penalty is not strictly additive to the income tax effects of benefits taxation.

** The examples incorporate the self-employed payroll tax rate after allowance for the share that is deductible from federal income tax.

FIGURE VII-3

Marginal Tax Rates for the Middle-Income Elderly



[1] Taxpayer is assumed to be in the 28 percent income tax bracket, receiving Social Security benefits and below the cap on the Social Security benefits tax.

People with no income other than Social Security or only modest additional income are unaffected by the benefits tax. For those with higher incomes, once 85 percent of total benefits is taxed, additional income is taxed at ordinary tax rates. It is individuals with up to about $30,000 of other income or couples with up to about $42,000 who face the sharply higher marginal tax rates. Thus the middle-income elderly are singled out for the heaviest burden.

"The benefits tax makes IRAs, 401(k)s, Keoghs and SEP plans much less valuable."

Benefits Tax Also Taxes the Young. Because of the Social Security benefits tax, the savings and retirement plans of the vast majority of young people are much less valuable. Congress created a special tax status for employer-provided pensions, IRAs, 401(k)s, Keoghs and SEP (Simplified Employee Pension) plans to encourage retirement savings. The law allows people to avoid taxes now and defer them until their retirement years on the theory that most income will be taxed at lower rates after they retire. As explained above, that is no longer true for many young workers.

Thus taxing 85 percent of Social Security benefits not only taxes the elderly; it also decreases the aftertax value of most American workers' pension plans.

Hidden Effects. Because of the way income tax returns are organized, many elderly taxpayers do not realize that the Social Security benefits

tax actually taxes other income. (See Table VII-4.) And because many states accept the federal definition of taxable income, it increases some state and local income tax rates by 50 percent.

"The elderly comprise 12 percent of the population, but hold 40 percent of capital assets."

Higher Taxes on Capital Gains. Although the elderly constitute only 12 percent of the population, they hold about 40 percent of all capital assets in the United States. For the reasons discussed, they face marginal tax rates much higher than younger people with similar incomes. Thus the tax on capital gains hits them harder than any other age group. Many of their assets — including houses, small businesses and farms — have been acquired during a lifetime of work. When they sell assets to realize some of the fruits of their labor, they may find themselves suddenly paying a high tax on a gain, much of which actually represents inflation.

TABLE VII-4

Calculating Taxable Social Security Benefits for a Couple

Combine:	**WAGES**
	+
	INVESTMENT INCOME
	+
	TAX-EXEMPT INCOME
	=
	NON-SOCIAL SECURITY INCOME
Add:	**1/2 SOCIAL SECURITY BENEFITS**
	-
Subtract:[1]	**$32,000**
	x
A. Multiply difference up to $12,000 by:	**0.50**
B. Multiply additional difference by :	**0.85[2]**
Add A and B to get Taxable Benefits :	**TOTAL[3]**

[1] No tax is payable unless the total exceeds $32,000.

[2] Until 85 percent of total Social Security benefits are included in taxable income.

[3] Treated as taxable income subject to ordinary income tax rates.

A reduction in the capital gains tax not only would ease the burden many of the elderly face, but also would free up capital held by the nonelderly by making it more attractive for them to realize their gains.

Reducing Taxes on the Elderly Could Reduce the Deficit

Current budgeting rules require that added federal spending be matched by cuts in other spending or by increases in revenue. The Congressional Budget Office (CBO) estimated that raising the Social Security earnings limit to $30,000 for workers ages 65 through 69 would cost the government $6.6 billion in additional benefits paid to those workers over the following five years — thus increasing the five-year budget deficit by $6.6 billion.

This static estimate assumes that even though the incentive to earn more will be sharply higher, no more elderly people will work, earn and pay taxes on their added income. Hence there will be no revenue gains to offset the cost of raising the earnings limit. In this view, the same number of elderly people would work the same amount, whether every dollar they earned left them 50 cents richer or 5 cents poorer.

"In the static view, the same number of elderly people would work the same amount, regardless of their tax bite."

In reality, increasing or eliminating the earnings limit could easily result in additional tax revenue equal to or greater than the apparent static cost.

The CBO also omitted other boosts to the federal budget from increasing or eliminating the Social Security earnings limit, including:

- If greater labor market participation by the elderly caused more of them to be covered by an employer's medical insurance, there would be less spending by Medicare. (Group health plans of employers with 20 or more employees are the primary payers, and Medicare is the secondary payer for workers age 65 or older.)
- Medicaid and Supplemental Security Income outlays would be less as the elderly ages 65 through 69 saved part of their additional earnings to support themselves later.

An econometric analysis by NCPA economists found that increasing or eliminating the earnings limit would result in the federal government receiving more in new work-related tax revenues than it would lose in increased Social Security benefit payments.

Effects of Increasing the Earnings Limit. Before the earnings limit was raised, the Social Security benefits of some 750,000 elderly workers were partially withheld because their wage income exceeded the earnings limit. If each of these workers earned an additional $1,000 without penalty, benefit payments would rise by about $37 million. However:

- The workforce would increase by the equivalent of 60,000 to 70,000 full-time jobs.
- The federal government would receive an additional $563 million in taxes on increased earnings and another $134 million in taxes because of an increase in capital income.
- On balance, the total increase in new revenue ($697 million) would exceed the total increase in new Social Security spending ($37 million) by $660 million.

"Eliminating the earnings limit could increase tax revenues and decrease federal outlays."

Raising the earnings limit by $1,000, then, would result in a *net increase* in federal revenues and a *reduction* in the federal deficit.

Effects of Abolishing the Earnings Limit. Eliminating the earnings limit altogether for retired workers between the ages of 65 and 69 would increase labor and capital income, thereby increasing federal tax revenues. It also would increase the amount of Social Security benefits paid, thereby increasing federal spending.

- The number of elderly workers with some wage income would rise from 1.9 million to 2.6 million — an increase of 38 percent.
- The additional work effort would increase the wage income of all elderly workers by $10.3 billion.
- The federal government would be obligated to pay an additional $4.8 billion in Social Security benefits, but would collect $4.94 billion in additional taxes, for a net increase in federal revenue of $140 million.

Changing the Earnings Limit Would Not Affect the Social Security "Trust Fund." An arbitrary and unnecessary restriction on changing the earnings limit arose from the Omnibus Budget Reconciliation Act of 1990 (OBRA90), which forbade any action to worsen the five-year and 75-year "actuarial balance" of the Social Security system. If the payment of Social Security benefits increased after raising the earnings limit, as forecast by static analysis, it could technically have an unfavorable effect on the Social Security trust fund.

In fact, this restriction has no economic meaning and no impact on the health of the Social Security program. The reason is that the Social Security trust fund does not really fund benefits in the future. It contains Treasury securities — IOUs the federal government has written to itself. These IOUs are liabilities, not assets, of the government. Thus the trust fund is nothing more than budget authority for the Social Security Administration — permitting it to continue spending without requiring further permission from the Congress. When the time comes to pay future benefits, the Treasury will have to get the money by taking it out of current tax revenues or borrowing in that year's credit market.

Effects of Repealing the Benefits Tax Increase. Rolling back the portion of benefits included in the benefits tax calculation from 85 percent to 50 percent would also help reduce the deficit. By the year 2000, the higher Social Security benefits tax will cause an $84.4 billion annual reduction in gross national product, and federal revenue will be $10 billion lower than it otherwise would be.

Tax Fairness. Even if one accepts the argument that Social Security beneficiaries paid for only a small portion of their benefits through payroll taxes, why shouldn't they be taxed at the same marginal tax rate as all other taxpayers? One way to do this would be to have a portion of Social Security benefits included in the ordinary income of all elderly beneficiaries — taxable at ordinary income tax rates. Exemptions could be raised to prevent undue hardship for the low-income elderly without increasing marginal tax rates.

Changing the Method of Taxing Benefits. Ideally, Congress should stop taxing Social Security benefits based on the amount of other income. Lower-income taxpayers could be sheltered from benefits taxation quite simply, and without this tax penalty on other retirement income. Some amount of benefits — say $6,000 for a single retiree, $8,000 for a couple using a 50 percent spousal benefit and up to $12,000 for a couple with independent benefits — could be made tax-exempt. Up to one-half of benefits above the exempt amounts could be added to ordinary taxable income. These exempt amounts and/or the percent of benefits subject to tax could be adjusted to produce at least as much revenue as the current method of taxing benefits.

This switch in the method of taxation would reduce marginal tax rates on other retirement income without reducing revenue to government. This, in turn, would sharply enhance saving incentives and economic growth, which would actually increase federal revenue. However, adding more benefits to taxable income would push some taxpayers into higher tax brackets, and to that extent it would be counterproductive. Therefore the new taxation formula should be adjusted to insure it is no more than revenue-neutral, and other means should be found to "pay for" the elimination of the earnings limit.

"Congress could reduce marginal tax rates on other retirement income without reducing revenues."

The 1994 Republican Contract With America proposed to repeal the 1993 tax increase on Social Security recipients as well as the earnings test. The repeals cannot come too quickly.

VIII. Clinton Budget

Clinton's 1998 Budget Proposal

President Clinton stated seven times in his 1997 State of the Union message that his proposed 1998 budget was balanced. So is it?

Robert Reischauer was director of the Congressional Budget Office (CBO) under the Democrats and is now ensconced at the Brookings Institution in Washington. On February 6, just prior to release of President Clinton's 1998 budget proposal, Reischauer laid down five markers that would indicate whether the budget was "for real." The markers were:

- Are the numbers honest? If the administration's baseline budget forecast is not close to the CBO's, there is reason to doubt the budget's underlying assumptions.
- Does it use gimmicks? If all significant budget cuts are put off until the distant future, the cuts simply are not credible.
- How are tax cuts paid for? If the budget proposes to pay for its tax cuts with tax increases, there's a problem because such increases are unlikely to be realized.
- Are one-time savings used? If the budget relies heavily on nonre-curring savings, it undermines the credibility of any balanced budget estimate.
- Does it make unrealistic promises? If the budget promises large cuts in nondefense discretionary spending, it is unrealistic because such cuts are unlikely to be enacted.

These are markers of a prominent Democrat, not a Republican. So applying Reischauer's markers to the actual budget put forward by President Clinton is not unfair or partisan.

So is the President's proposed budget balanced?

No. By Reischauer's test the numbers are not honest. The administration forecasts faster growth, lower unemployment and lower interest rates than the CBO. And the nonpartisan Committee for a Responsible Federal Budget points out that the administration makes the completely unrealistic assumption that the growth of Medicare spending will fall from over 4 percent to less than 2 percent per year. As a result, the administration's current services deficit for 2002 is $60 billion less than CBO's. (Current services assumes no changes in policy.)

"The Clinton budget is loaded with gimmicks."

Second, the budget is loaded with gimmicks. The budget proposes a temporary health insurance program for workers between jobs that will cost $10 billion between 1998 and 2001 but nothing in 2002. And it proposes

numerous tax cuts that also magically expire in 2001. Finally, three-fourths of Clinton's proposed spending cuts come after the year 2000 — after he has left office. This led the *Washington Post* to label the budget "an illusion."

"Clinton's proposed tax cut can be canceled — to balance the budget in 2002."

Third, on taxes Clinton gives with one hand but takes almost everything back with the other. His budget proposes $103.3 billion in tax cuts between 1997 and 2002 but offsets them with $82.5 billion in tax increases. This leaves a net tax cut for the American people of just $20.8 billion over five years, or just 0.1 percent of estimated federal revenues. And even this puny tax cut may not last because the budget proposes to automatically cancel the tax cuts if necessary to achieve budget balance in 2002.

Fourth, the budget assumes numerous one-shot revenues from government asset sales, including $36 billion from auctioning radio spectrum between 1998 and 2002. Interestingly, three-fifths of this revenue is expected to come in 2002.

Lastly, the budget projects $58 billion of cuts in nondefense discretionary programs between 1997 and 2002, with $45.8 billion of these cuts coming in 2001 and 2002. This would put the total for such spending at $293 billion in 2002, a mere 4 percent increase from current levels of spending in nominal terms and a decrease in real terms, which is probably not achievable politically.

Increased Taxes in the 1997 Budget Proposal

Much of the deficit reduction in President Clinton's proposed 1997 budget came from higher taxes. The plan estimated $60 billion in additional revenue from eliminating "corporate welfare." Among this so-called welfare is Section 911 of the tax code, which the President proposed to repeal.

This is a severely wrong-headed idea.

Section 911 is not welfare in any sense of the term and the ultimate result of its repeal would be to hurt all Americans.

Section 911 relates to the taxation of income Americans earn by working in foreign countries. Unlike every other nation on earth, the United States taxes its citizens even when they live and work in other countries.

Thus an Englishman living and working in America pays U.S. taxes, but does not pay English taxes. By contrast, an American working in England must pay taxes to England and the United States.

Although Americans receive a credit against their U.S. taxes for taxes paid to foreign governments, this double taxation still imposes a severe hardship on Americans working abroad. For this reason, Section 911 allows Americans to earn up to $70,000 in another country without paying U.S. taxes on that income.

This is what the Clinton administration proposed eliminating. Henceforth, Americans would have to pay U.S. taxes on all their foreign-earned income.

This would be unfair, but perhaps more importantly it would reduce U.S. exports and thereby reduce economic growth. Thus the ultimate impact would be felt by many Americans who never even visit, let alone work, in a foreign country.

"Only the U.S. taxes citizens living, working and paying taxes abroad."

The reason is that about 18 percent of all U.S. exports go from U.S. companies to their foreign affiliates. Exports mean jobs for Americans and higher wages as well because firms engaged in exports tend to pay higher wages than those that do not. (In 1993 U.S. companies exported $138 billion in goods and services to their foreign affiliates.)

Naturally, American firms prefer to staff their foreign operations with Americans.

However, it is far more expensive to staff foreign operations with American citizens than foreigners, largely due to double taxation. U.S. firms must pay Americans more to compensate for the higher taxes.

When this becomes prohibitively expensive, firms hire foreign nationals who may not be as qualified and probably have less familiarity with American companies.

The result is reduced exports and fewer jobs here in America. According to a recent study by Price Waterhouse, repeal of Section 911 would reduce U.S. merchandise exports by at least $9 billion per year and eliminate 143,000 U.S. jobs.

IX. Across-the-Board Tax Cuts

The Dole Plan

Historically, tax levels even close to the current burden have triggered major tax cuts. Last year, Republican presidential candidate Bob Dole proposed an across-the-board reduction of 15 percent in the individual income tax, as well as a cut in the capital gains tax from 28 percent to 14 percent. The purpose, Dole said, was to "repeal the Clinton tax hike on the middle class" and to "return total taxes to where they were when Ronald Reagan left office."

Although President Clinton continued to proclaim that the nation's economy is in the best condition in the last 30 years, overall economic growth has in fact been weak compared to previous expansions. Further, incomes today, whether measured by weekly earnings or by median family income, are lower than they were in the 1980s.

Stimulating the Economy. The main goal of the Dole economic plan was to increase the anemic rate of growth of the U.S. economy. From the fourth quarter of 1992 through the second quarter of 1996, real GDP increased by an average of just 2.4 percent per year. Even the growth rate for 1996, now estimated to reach between 2.6 percent and 3 percent, is well below the economy's historic growth rate of 3.1 percent.

What effect would an across-the-board rate reduction and cut in the capital gains tax rate have on economic growth? Based on the published revenue estimates, the Tax Foundation has estimated that the impact of the plan would be an increase in GDP of 0.1 percent the first year, rising to 0.8 percent in the third year as the tax cut is phased in and then falling to 0.3 percent in the sixth year.

Some critics have attacked as implausible the idea that growth can be raised at all. For example, an article in the August 12, 1996, *New Yorker* maintained that the economy cannot grow more than 2.5 percent per year without reigniting inflation. It said that faster growth would lower unemployment, and with the economy already at full employment the added demand for labor would only increase wages and prices.

"We are nowhere near full employment."

Increasing Employment. This analysis is faulty on several counts. First, we are nowhere near full employment even though the unemployment rate dipped briefly to 5.1 percent in 1996. In recent years, some economists have insisted that the "natural" rate of unemployment is 6 percent and that a drop below that rate will trigger inflation. Historically, however, 4 percent unemployment was considered "full employment," and in the 1950s this rate was achieved without inflation.

Second, the unemployment rate does not fully take into account part-time workers who would prefer to work full-time, and it does not count those

who have given up hope of finding a job. In July 1996, according to the Bureau of Labor Statistics, there were 9.6 million people in the two categories.

- 4.4 million held part-time jobs due to lack of full-time work.
- 5.2 million had dropped out of the labor force altogether.

"Average weekly hours for all private-sector employees have fallen sharply."

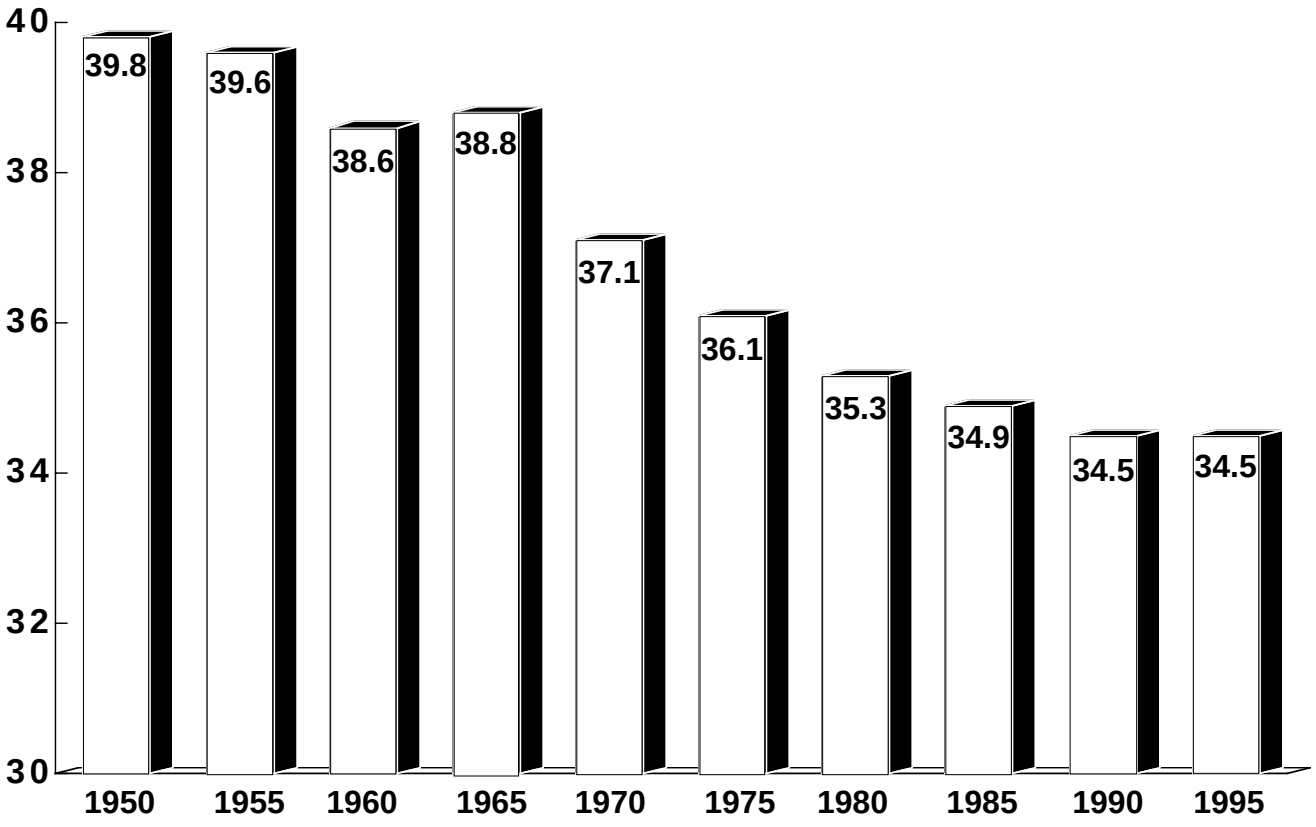
Further, there is vast room for expansion of the labor supply through increased hours. As Figure IX-1 illustrates, average weekly hours for all private-sector workers have fallen sharply over the last 30 years. This is partly due to the rise of part-time employment, but also due to fewer work hours for those nominally employed full-time. In July 1996, for example, 9.7 million full-time employees worked fewer than 35 hours per week.

In short, there is good reason to believe that the labor supply could easily expand enough to raise the growth rate well above current levels.

Increasing Incomes. The Clinton administration maintains that a 2.2 percent growth rate is the best we can do at present. Further, it says that with unemployment now in the low 5 percent range, any increase in growth would

FIGURE IX-1

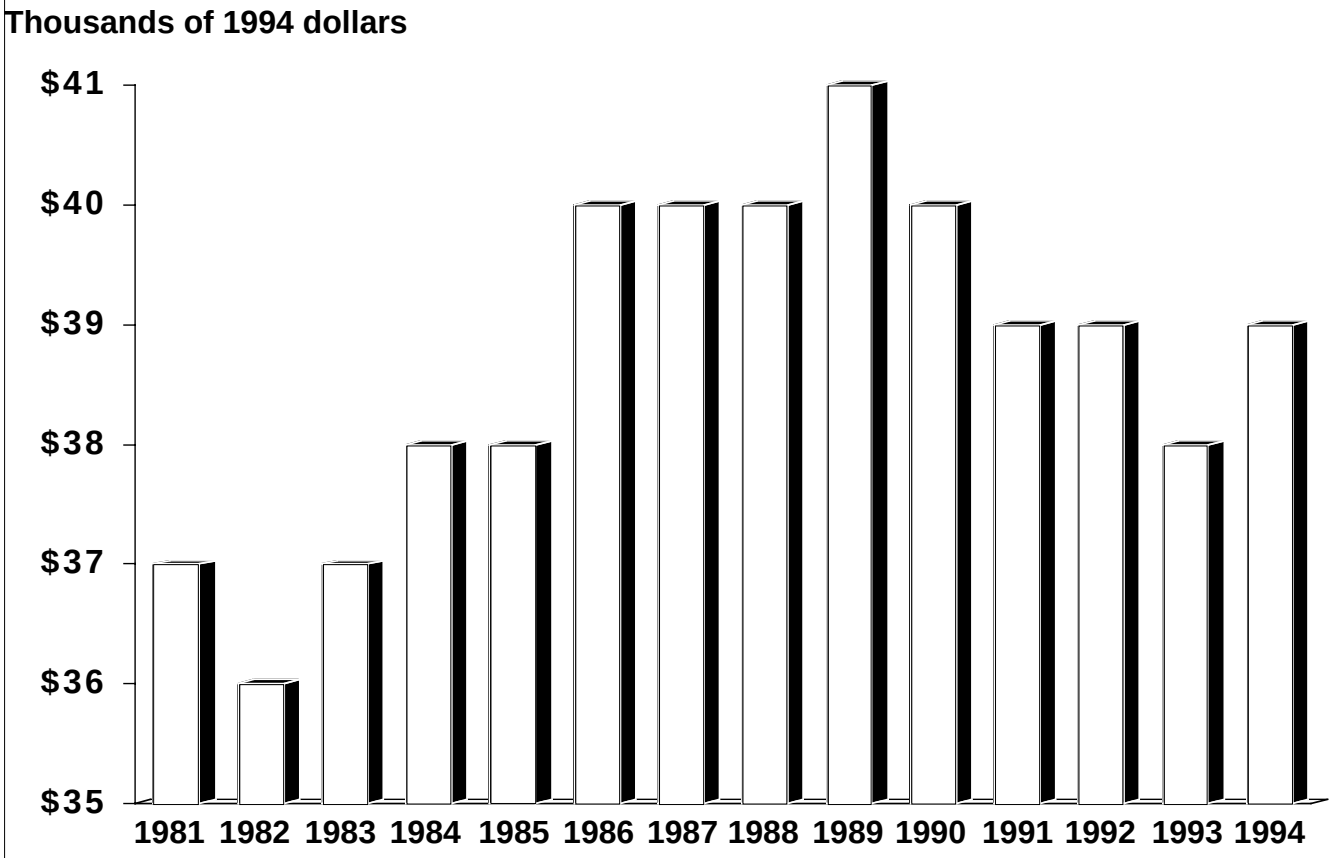
Average Weekly Hours Worked, All Private-Sector Workers



Source: Bureau of Labor Statistics.

FIGURE IX-2

Real Median Family Income



Source: Census Bureau.

"Real median family income fell from $40,890 in 1989 to $38,782 in 1994."

push up wages and thus trigger inflation and an increase in interest rates by the Federal Reserve.

It is true that faster growth would raise wages. But in 1995, according to the Bureau of Labor Statistics:

- Real average weekly wages were just 75 cents higher than in 1992.
- Real average earnings were $255.29 per week, or 5.5 percent lower than during the Reagan administration, when they averaged more than $270 per week.

Declining real wages, in turn, have led to a decline in living standards. According to the Census Bureau, real median family income fell from $40,890 in 1989 to $38,782 in 1994. (See Figure IX-2.) By contrast, during the Reagan administration, real median family income rose every year after the end of the recession.

The Senate Budget Committee reports, as shown in Figure IX-3, that the median family now pays 25 percent of its income in federal taxes, compared to 12 to 13 percent in the early 1960s. With this increased tax burden,

many families are having trouble making ends meet, saving for college and retirement and living as well as their parents did.

In short, workers need a pay raise, and increasing the demand for labor is one way to provide it. Of course, keeping inflation under control is also an essential goal. But nothing in economic theory or economic experience demonstrates that rising real incomes are inconsistent with price stability. Moreover, Federal Reserve Chairman Alan Greenspan and other Fed officials have repeatedly stated that monetary policy would not stand in the way of balanced higher growth.

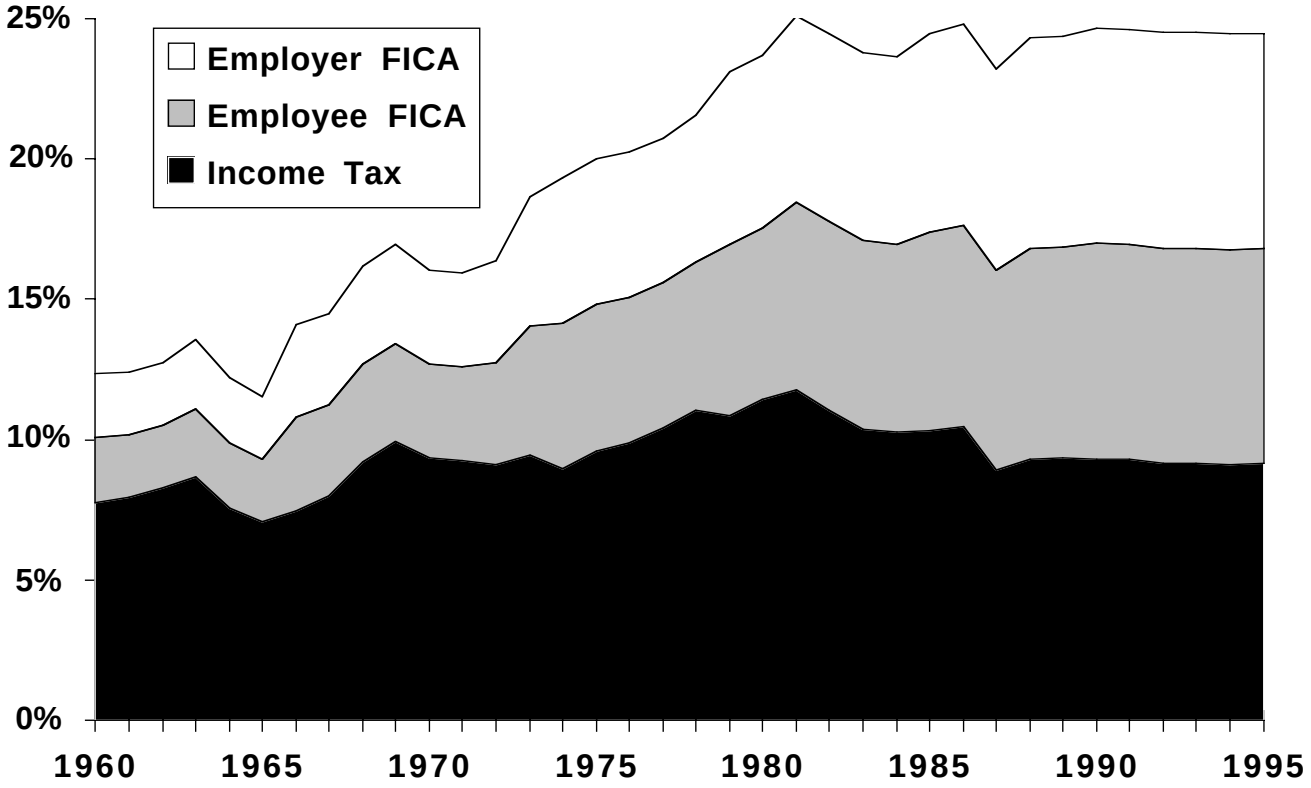
Relieving the "Consumer Crunch." The American Bankers Association reported that 3.66 percent of all credit card holders were behind in their payments in the second quarter of 1996. This is the highest figure in 22 years and well above the level during the 1990-91 recession. At the same time, consumer debt has hit an all-time high — over $1 trillion — a 44 percent increase during the Clinton administration. With debt at such a high level, even a small rise in short-term interest rates could depress consumer spending very quickly.

"Federal taxes on the median family have doubled since the early 1960s."

While household assets also have risen due to the run-up in the stock market, much of the gain is locked into retirement accounts such as 401(k)

FIGURE IX-3

Average Federal Tax Rate on the Median Family



Source: Senate Budget Committee.

plans and is difficult to tap in a crunch. Generally, federal law requires financial institutions to withhold 20 percent of assets withdrawn from a retirement account.

Yet for many consumers the crunch is already here.

- According to the American Bankruptcy Institute, personal bankruptcies hit an all-time high in 1995 at 874,642 filings.
- Personal bankruptcies reached another high in 1996, with filings by 1,125,006 individuals — at a rate of more than 100,000 a month in the last two quarters of the year.
- This was an increase of 28.6 percent over 1995, and more than double the number in 1986.

While a 15 percent tax rate reduction may not be enough to solve the problems of declining real incomes, stagnant wages and soaring debt burdens, it would put more money into people's pockets. Therefore it would unambiguously raise disposable incomes and give people more resources with which to service their debts and avoid bankruptcy.

Lessons from the Reagan Years. Opponents of a tax cut contend that it would be repeating the mistakes of the Reagan administration in the 1980s, when cutting taxes led to economic disaster. However, when asked for evidence that the American people suffered from Reagan's tax cut, critics have none to offer except the increase in the federal budget deficit.

"Spending, not Reagan's tax cuts, boosted deficits in the 1980s."

In fact, the Reagan tax rate cut had nothing whatsoever to do with increasing the deficit in the 1980s. On average, federal receipts as a share of GDP were higher in the 1980s than in the 1970s — 19.0 percent of GDP versus 18.5 percent. What caused the deficit is that spending exploded. Although Reagan was often attacked for "slashing" the budget, outlays as a share of GDP actually rose from 20.6 percent of GDP in the 1970s to 23.1 percent in the 1980s.

On every other score, the 1980s were a smashing economic success. The country entered the decade with the annual inflation rate at 12.5 percent and the prime interest rate at 21 percent. Real income of the median family had fallen by $3,000 between 1973 and 1981. The sharp but brief 1981-82 recession effectively broke the back of inflation, setting the stage for the longest peacetime economic expansion in our nation's history — 92 months of continuous real growth.

- From 1982 to 1989, real growth averaged 3.9 percent per year.
- Real median family income increased by $4,564, or 12 percent, between 1982 and 1989.
- By contrast, real family income has fallen by $2,108, or 5.2 percent, in the 1990s.

Dealing with the Deficit

Opponents of an across-the-board tax rate cut argue that it would either require massive spending cuts or lead to higher deficits. Liberals contend that the necessary spending cuts would be so large they would devastate essential programs. While conservatives have no objection to cutting spending, many worry that it would be politically difficult to do so because the tax cut would widen the deficit. Both arguments implicitly exaggerate the size of both the tax cut and the needed spending cuts, making them appear much larger than they actually are.

Revenue Loss: 1 Percent of GDP. The "huge" tax cut proposed by Dole that both liberals and many conservatives feared would emaciate the federal government would have lowered revenues by only 4 percent over six years. With GDP expected to total $54 trillion between 1997 and 2002, the $548 billion tax cut amounted to just 1 percent of GDP, or 0.5 percent less than federal revenues have risen just since early 1993.

Similarly, the cuts in projected spending necessary to pay for the Dole plan were modest, only 5.6 percent lower than what was otherwise projected. This would pay for the tax cut and balance the budget in 2002 without the necessity of touching Social Security or Medicare.

Paying for the Tax Cut by Holding Down Spending Increases. Although many people are legitimately concerned about the deficit, arguments about government spending actually are about cutting planned *increases* in federal spending, not about reducing the current level of federal spending.

- Federal spending in 1996 is set at $1.566 trillion.
- Federal spending in 2002, without any reductions in planned increases, is expected to be $1.968 trillion, or an increase of 26 percent from 1996.
- With the spending "cuts" necessary to pay for the Dole tax cut proposal, federal spending in 2002 would be $1.783 trillion, or an increase of 14 percent from 1996.

"Under Dole's plan, spending still would have increased 14 percent by 2002."

The truth of the matter, then, is that the Dole plan was quite modest. As Figure IX-4 indicates:

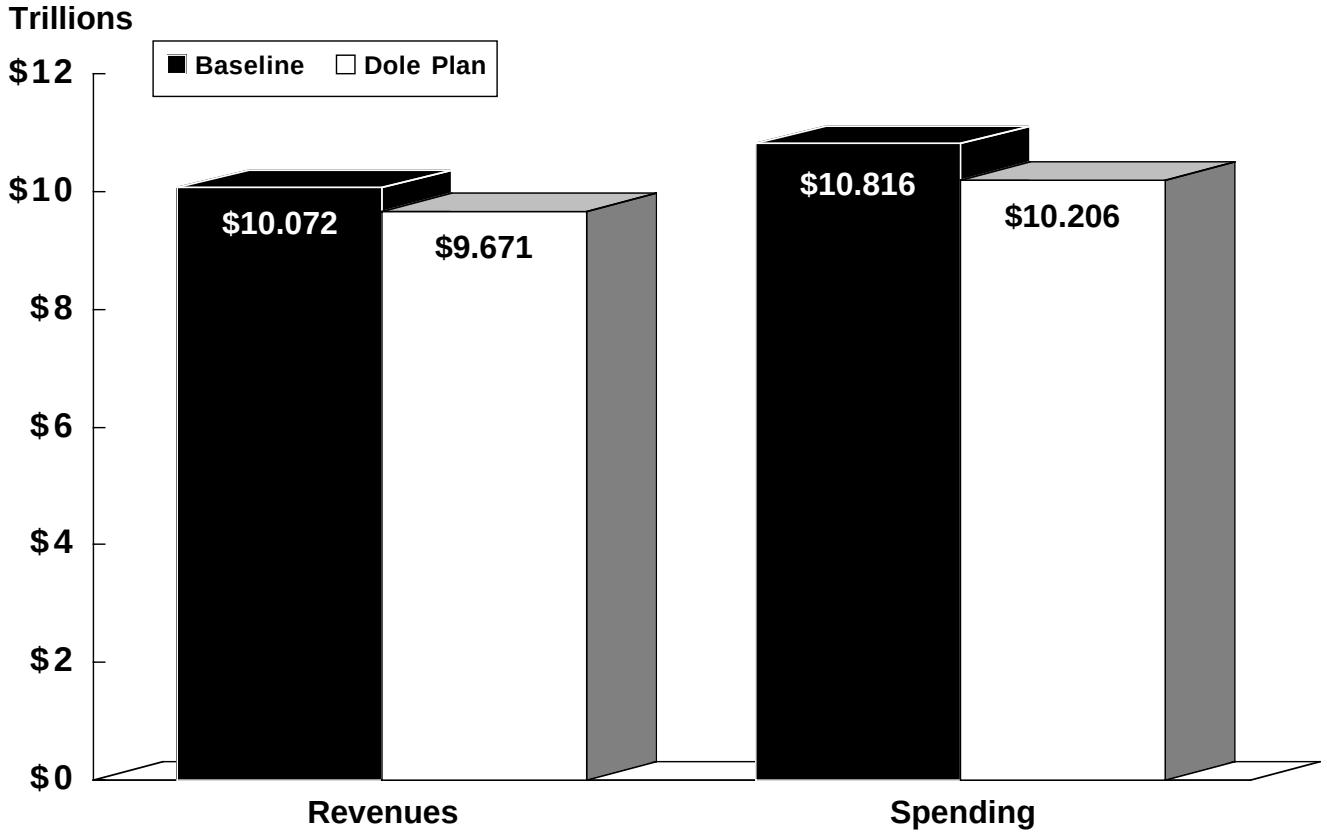
- Over the period from 1997 through 2002, the federal government expects to collect more than $10 trillion and spend almost $11 trillion.
- Enactment of the tax cuts proposed in the Dole plan would only lower revenues to slightly less than $10 trillion and spending to just over $10 trillion.

Paying for the Tax Cut through Higher Economic Growth. If a tax cut produces economic growth, an important consideration is the amount of new tax revenue the growth produces for the government, or as economists

FIGURE IX-4

Dole Plan vs. Baseline Spending and Revenues

(6-year totals)



Source: Dole Campaign.

"Increasing economic growth 0.1 percent per year would lower the deficit $60 billion over seven years."

term it, the "feedback" effect. There is virtual consensus spanning the political spectrum that substantial revenue feedback would result from tax cuts. And the impact on growth need not be large for there to be large revenue effects. According to a table in the federal budget for fiscal year 1997:

- A sustained increase in growth of 1 percent per year would increase federal revenues cumulatively by $420 billion between 1996 and 2002, while lowering spending by $183 billion.
- Thus even an increase in growth of 0.1 percent per year would lower the deficit by some $60 billion over seven years.

Cutting Taxes to 1992 Level. In the first three years of the Clinton administration, Americans paid $151.1 billion more in federal taxes than if federal receipts had remained at their 1992 level of 19.2 percent of GDP. An across-the-board 15 percent reduction in individual income tax rates would lower federal receipts as a share of GDP to what they were in 1992.

A 15 percent tax rate reduction would stimulate economic growth and provide some relief to taxpayers, but it would not solve the tax problem. It is

just a down payment. To bring federal taxes to a tolerable level will require not just tax reform, but a complete overhaul of the federal budget. Ultimately, tax reduction must be accompanied by spending reduction because it will be impossible to lower taxes as much as needed while federal spending consumes over 20 percent of our national output.

Evidence from Economic Modeling

The Dole tax plan had three major components.

- All individual income tax rates would be reduced by 15 percent; thus, a current 15 percent rate would be reduced to 12.75 percent and a current 28 percent rate to 23.8 percent.
- Capital gains taxes would be reduced from 28 percent to 14 percent for taxpayers earning more than $40,100 and from 15 percent to 10.5 percent for taxpayers earning less than $40,100.
- Tax credits would be allowed for children under 18 — a maximum of $500 for single heads of households earning incomes up to $75,000, for married individuals filing separate returns with incomes up to $55,000 and for married couples filing joint returns with household incomes up to $110,000. (The credit would be reduced by $25 for every $1,000 of additional income for all three types of households.)

There were other components in the Dole tax plan, but the economic effects were minor and were not considered in the following discussion.

Modeling the Economy. In recent years, economists have developed a method for calculating the consequences of the complex economic interactions caused by changes in the tax code. The method uses a computable general equilibrium (CGE) model. Although different scholars use different variations of this model, the core concept is well understood and has appeared many times in the economic literature.

"We used an economic model to calculate the effects of the Dole tax proposal."

Following is a description of the results of using a CGE model to calculate the effects of the Dole proposals on the various sectors of the economy, changes in the income of different income groups and the effect on government revenues.

The model divides the economy into 14 production sectors and 14 consumption sectors. The goods and services consumers buy come from combinations of output from various primary production sectors. For example, the sale of food products to consumers requires outputs from the subsidized crop, other crop, livestock and food processing sectors integrated with outputs from the services sector such as advertising and distribution.

The model compares relative prices and quantities of the output of the various production and consumption sectors before and after the implementation of the changes proposed by Dole to see how they would have changed and how the changes would have interacted to cause other changes. In turn, these changes would have affected the economic welfare of the various income groups and thus of government revenues.

Effects on the Economy

"Increase disposable income would increase consumption and stimulate demand for goods and services."

The Dole plan sought to increase the rate of economic growth and to increase disposable incomes by reducing the amount going to taxes. The proposed tax cuts and child tax credit would have resulted in expanded output in every sector of the economy except subsidized agricultural crops. A large increase in disposable income would increase consumption of every type, which in turn would stimulate the demand for producer goods and services.

Effects on Production. The demand for producer goods and services created by increased consumption would be reflected most strongly in the increased production of food and tobacco (up 3.7 percent), as shown in Table IX-1. In addition:

TABLE IX-1

Effects of the Dole Tax Plan on Production Sectors

	Change in Quantity (Percent)
Manufacturing	**1.5**
Services (except finance)	**3.1**
Financial Services	**3.5**
Food and Tobacco	**3.7**
Chemicals & Plastics	**1.9**
Wood Products	**1.9**
Petroleum Refining	**1.9**
Crude Oil & Natural Gas	**2.8**
Livestock	**2.9**
Program Crops	**-0.5**
Nonprogram Crops	**2.4**
Coal Mining	**2.2**
Other Mining	**1.2**
Logging	**0.5**

- Financial services and other production services would grow 3.5 percent and 3.1 percent, respectively, because of the demand created by the growth in other production sectors.
- The output of livestock would grow by 2.9 percent to accommodate the increase in food consumption.
- Crude oil and natural gas production would grow by 2.8 percent (and be accompanied by a decrease in oil imports) due to increased exploration resulting from the lowering of the capital gains tax rate.

The expansion of the production sectors is generally accompanied by an increase in the *net* import of producer goods, with three exceptions. This general increase in net imports is not surprising, given the structure of the tax cuts. The Dole tax plan reduced income taxes but not business taxes. This would encourage households to increase consumption, which in turn would encourage producers to produce more goods and services. However, producers would not increase output as much as if business taxes were also decreased, so net imports would increase.

There are three exceptions: 1) goods from foreign manufacturing, 2) foreign crude oil and natural gas and 3) foreign refined petroleum and associated products. Net imports of manufactured goods would decrease by 0.03 percent, so the "giant sucking sound" that concerned Ross Perot during the debate over the North American Free Trade agreement is not apparent.

"Domestic production of crude oil and natural gas would increase while net imports would decrease by 2.3 percent."

More significantly, dependence on foreign oil would go down. The large increase in domestic production of crude oil and natural gas pointed out above would be accompanied by a decrease of 2.3 percent in net imports of goods produced in this sector by foreign producers. Similarly, the net imports of goods from the foreign refining sectors (refined oil, kerosene, distillates and residual fuel oil) would decrease by 1.4 percent. These goods are typically imported from Canada and Mexico because they are more volatile than crude oil and are not usually imported from overseas sources.

The decrease in production of subsidized crops (also referred to as "program crops") is explained by the fact that land would be needed for livestock and nonsubsidized crops (vegetables, fruits, and nuts). As the demand and, more importantly, prices for these other agricultural products increased, farmers would be less dependent on subsidies they could receive for subsidized crops.

Effects on Consumption. Every consumer sector of the economy would have received a strong boost from the Dole plan. As Table IX-2 shows, increases in output would have ranged from 3.0 percent to 5.3 percent, except for savings, which would have increased by 7.9 percent. Other than savings:

- The largest expansions would be in gasolines and fuels (5.3 percent), transportation (5.3 percent), furnishings and appliances (5.2 percent) and reading and recreation (5.2 percent).

"Increases in consumer sectors of the economy would have ranged from 3.0 percent to 5.3 percent, except for savings, which would have increased by 7.9 percent."

TABLE IX-2

Effects of the Dole Tax Plan on Consumption Sectors

Consumption Sector	Change in Quantity (Percent)
Consumer Services (except finance)	5.1
Housing	4.0
Food	4.6
Motor Vehicles	4.9
Reading & Recreation	5.2
Savings	7.9
Clothing & Jewelry	5.0
Utilities	4.4
Financial Services	3.0
Furnishings & Appliances	5.2
Nondurable Household Items	4.9
Alcohol & Tobacco	4.5
Gasoline & Fuels	5.3
Transportation	5.3

- The smallest increases would be in consumer financial services (3.0 percent) and housing (4.0 percent), in both instances because so much of the available capital would go to production sectors.

Effects on Savings. One of the important effects of the Dole plan would have been the large increase in savings (7.9 percent). There are two major reasons for this. First, savings includes purchases of stocks and bonds and the reduction of the capital gains tax rates encourages these. Second, as discussed below, disposable income would have increased among all income groups, and as incomes increase households save more. The increase in savings would have encouraged future economic growth.

Effects on Job Creation. The increased output resulting from implementation of the Dole plan would have caused private-sector employment to grow by 2.8 percent, or 2.9 million full-time jobs. As Table IX-3 shows, services other than financial services, which now employ about two-thirds of the private-sector workforce, would have created about three-fourths of the new jobs, with that sector's workforce growing by 3.1 percent.

Effects on Income. One criticism of the Dole plan, other than that it would have increased the federal deficit, was that those with high incomes would receive the greatest benefit. Much of the gain from the Dole proposals would indeed have gone to those who pay the greatest amount of taxes. However, the resulting increase in economic activity would have benefited all income groups, including even those who pay little or no taxes. As Table IX-4 shows:

- People with disposable incomes of less than $13,000 a year would have averaged a gain of 3.8 percent.
- The smallest gain, 2.9 percent, would have gone to people with disposable incomes between $25,800 and $38,600 a year.
- People with disposable incomes of $64,500 or more would have averaged a gain of 7.0 percent.

Effects on Government Revenues. Critics of the Dole plan, led by President Clinton, maintained that it would "blow a hole in the deficit." Supporters of the plan contended that new tax revenue generated by the resulting economic growth — the "feedback" effect — would reduce the net amount of revenue lost to the tax cuts.

The Kennedy administration tax cut in the early 1960s had an estimated feedback of between 25 percent and 75 percent; that is, federal revenues

"Private sector employment would grow by 2.8 percent, or 2.9 million full-time jobs."

TABLE IX-3

Increase in Employment Due to the Dole Tax Plan
(in thousands of jobs)

Sector	Current Employment*	Jobs Created**
Manufacturing	18,609	276.9
Services (except finance)	68,615	2,146.3
Financial Services	7,005	247.4
Food and Tobacco	1,673	61.2
Chemicals & Plastics	1,990	38.3
Wood Products	1,265	24.4
Petroleum Refining	139	2.7
Crude Oil & Natural Gas	310	8.8
Coal Mining	99	2.1
Other Mining	160	2.0
Agriculture	3,308	60.7
Total	103,173	2,870.8

* Current employment based on estimates of jobs in September 1996 (seasonally adjusted) obtained from the Bureau of Labor Statistics, except for agriculture. For agriculture, we use estimated agriculture employment from the BLS estimate for 1992 and the BLS estimate of an average increase of 0.1 percent per year to get the base estimate of employment for 1996, and then estimate the increase that would be caused by the Dole tax plan.

** All increases are based on the percentage change in output in the various sectors. To get the percentage change in the aggregated agriculture sector, we use a weighted average of the changes in the four agriculture sectors (program crops, nonprogram crops, livestock and logging).

"The increase in economic activity would benefit everyone."

TABLE IX-4

Income By Group[1]

Income (1988 Dollars)	Income (Current Dollars)	Change in Disposable Income (Income Percentage)
$0 - $9,999	$0 - $12,881	+ 3.8%
10,000 - 19,999	12,882 - 25,764	+ 4.4%
20,000 - 29,999	25,765 - 38,646	+ 2.9%
30,000 - 39,999	38,647 - 51,529	+ 4.7%
40,000 - 49,999	51,530 - 64,412	+ 6.5%
50,000+	64,413+	+ 7.0%

[1] The Bureau of Labor Statistics classifies income groups both by six ranges of income and in quintiles. Our model uses the six ranges of income (each of which is approximately of equal size except for the $40,000-$49,999 range) because it makes it easier to apply marginal income tax rates.

were reduced by $12 billion, but between $3 billion and $9 billion of the direct cost was recovered after two years through increased economic growth. Lawrence Lindsey, a professor at Harvard University, calculated that the Reagan administration tax cut in the 1980s had a feedback of 70 percent by 1985. The Congressional Budget Office estimated in 1978 that a one-third reduction in income tax rates at that time would produce 24 percent feedback the first year.

The model finds that the Dole tax plan would have resulted in a revenue loss of 6.2 percent before consideration of new revenue from economic growth, but that when the revenue from growth is considered, the revenue loss would have been 4.0 percent — a feedback of 35.5 percent in the first year.

Tax Cuts Before Reform?

Bob Dole made across-the-board tax rate reduction the centerpiece of his campaign economic agenda.

Some of his advisers, however, were said to believe tax reform would be a better issue for him politically. In fact, there is no conflict between the twin goals of tax reduction and tax reform. Americans need both. The only question is what to do first.

The strongest argument for doing tax reduction first is that it would take Congress at least two years to complete major tax reform once it began the process. Since it has not yet begun, holding off on tax cuts until tax reform is completed would require taxpayers to wait until 1999 at least for relief. That is too long. The American people need a tax cut now.

"Workers with incomes between $20,000 and $60,000 are crushed by taxes."

Furthermore, we must take account of the fact that taxes are continuously rising. The wage base for Social Security taxes increases annually, and as workers manage to achieve some growth in their real incomes they get pushed into higher tax brackets. A single worker with a taxable income of just $24,000, for example, will go from paying 15 percent federal income tax to 28 percent on his or her next dollar of income. With Social Security taxes on top of that on all earnings up to $62,700, workers with incomes between $20,000 and $60,000 are among the most heavily taxed people in America.

The 15 percent tax rate reduction proposed by Dole would not have solved the tax problem. It would have been just a down payment. As long as federal spending continues to consume more than 20 percent of national output, it will be impossible to lower taxes as much as needed. Tax cuts and spending cuts must be made together.

X. Tax Reform

The Armey Flat Tax

Rep. Dick Armey (R-TX) has introduced the Freedom and Fairness Restoration Act (H.R. 1040 in the 105th Congress). This act would reform the U.S. tax system, slash government spending and rein in federal regulation. It is the most radical reform proposal in recent memory to receive serious consideration on Capitol Hill.

Tax Reform: Trading Deductions for a Lower Tax Rate. The key element of the Armey plan is tax reform. Based on a proposal developed by Stanford University professors Robert Hall and Alvin Rabushka, the plan would scrap virtually all current deductions, credits, exclusions and exemptions, as well as the five current tax brackets. In their place, it would establish a single tax rate — 20 percent the first two years and 17 percent thereafter — on a much broader tax base.

The Armey plan does not promise a free lunch. Lower tax rates are possible only if the tax base is expanded by ridding the tax code of deductions and exclusions — even such popular items as the mortgage interest deduction. This means that in return for lower rates, people will have to subject more of their income to taxes.

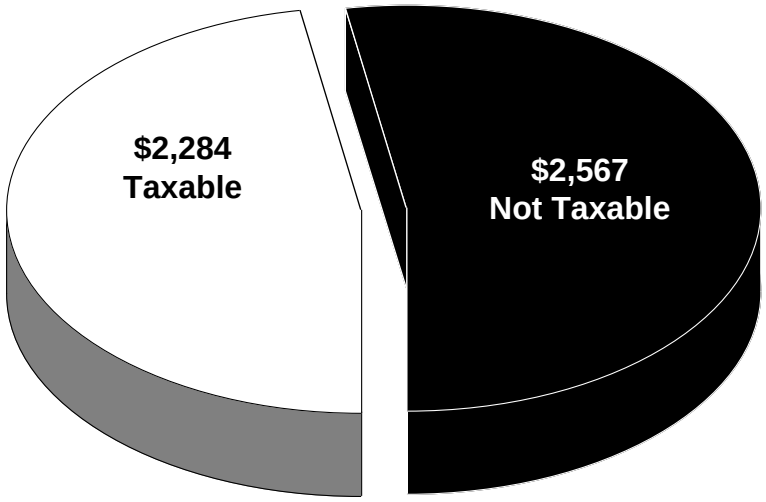
"More than half of all personal income goes untaxed."

- Under the current tax system, more than one-half of all personal income goes untaxed because of various deductions, exclusions and exemptions (see Figure X-1).

FIGURE X-1

Personal Income

(Billions of $)



Source: Internal Revenue Service, 1991 data.

- If all personal income were subject to a single, flat-rate tax, a rate of less than 10 percent would bring the federal government just as much revenue as it collects today.

A 17 Percent Tax Rate for Individuals. Armey isn't proposing to go all the way to a 10 percent tax. Generous personal exemptions under the plan prevent the rate from going below 17 percent. Taxes under the plan, however, would be low, flat and simple. For individuals, the tax base would consist of all wages, salaries and pensions.

- From this gross income, a married couple filing jointly could deduct a personal allowance of $22,000.
- The personal allowance would be $11,000 for single persons and $14,400 for a single head of household.
- In addition, taxpayers could deduct $5,000 for each dependent.
- *Thus a family of four would have to earn $32,000 before it paid a penny of federal income tax.*

"A family of four would have to earn $32,000 before paying federal income tax."

In addition to exempting about half the households in America from any personal income tax, the Armey plan's tax system would be so simple that *all taxpayers could fill out their returns on a postcard*. [See the diagram.]

A 17 Percent Tax Rate for Business. Business taxes would be almost as simple. For them, the tax base would consist of total receipts less cash wages and purchases of goods, services and materials used in business, as well as all capital equipment. Companies would pay the same tax rate as individuals on the remaining balance. As a consequence, even the largest corporations could file their tax returns on a postcard-size form.

A Tax Cut. If the Armey plan for tax simplification were completely revenue neutral, it would require a tax rate in the range of 19 to 20 percent. Establishing a rate of 17 percent, therefore, constitutes a tax cut. The loss of revenue is paid for by capping government spending, including so-called entitlements. Also, the 17 percent rate is phased in, starting at 20 percent and falling to 17 percent after two years. Thus the deficit would not rise under the Armey plan.

Abolishing the Double Taxation of Savings. All income is taxed only once in the Armey plan, in sharp contrast to our current tax system. Today we tax profits first at the corporate level and again when they are paid out to the company's owners, the shareholders, in the form of dividends. We also double-tax saving relative to consumption by taxing income when it is earned and again when it earns a return. We also effectively double-tax all capital income by imposing a capital gains tax on the increase in value of capital assets, even though we already tax the return on such assets (e.g., interest, dividends, rent, etc.). *The Armey plan eliminates double taxation by abolishing all taxes on interest, dividends and capital gains.*

Dick Armey's Flat Tax Form

Your first name and initial; if joint return, also give spouse's name and initial	**Your Social Security Number**
Present home address	**Spouse's Social Security Number**
City, Town, or Post Office, State and Zip Code	**Your occupation**
	Spouse's occupation

1. Wages, Salary and Pensions.....
2. Personal allowance.....
a. $22,000 for married filing jointly.....
b. $11,000 for single.....
c. $14,400 for single head of household.....
3. Number of dependents, not including spouse.....
4. Personal allowances for dependents (line 3 multiplied by $5,000).
5. Total personal allowances (line 2 plus line 4).....
6. Taxable wages (line 1 less line 5, if positive, otherwise zero).....
7. Tax (17% of line 6).....
8. Tax already paid.....
9. Tax due (line 7 less line 8, if positive).....
10. Refund due (line 8 less line 7, if positive).....

There is no convincing argument for taxing capital gains, since the value of a capital asset is only a function of the return on that asset, which we already tax. This is most clearly shown in the case of bonds, which automatically rise in value when interest rates fall and fall in value when interest rates rise. Since we are already taxing interest income, it makes no sense to levy an additional tax on the bond itself, since the bond has no value without the interest. The same is true of corporate stock and commercial real estate, whose value is entirely a function of the profit or rent they generate. The failure to index the capital gains tax for inflation creates even more distortion.

"The Armey plan abolishes all taxes on interest, dividends and capital gains."

Stimulating Economic Growth. Our current tax system taxes capital excessively. This discourages investment, saving and capital formation, which are the foundations of economic growth. Slower growth, in turn, reduces employment, productivity and wages. Thus all Americans ultimately pay the price for our ill-designed tax system.

For these reasons, most economists now agree that the best tax system is one that taxes consumption only. Congress has before it many other proposals that would move us in the direction of an economy-wide consumption tax. However, only the Armey plan would do so while also simplifying and reducing taxes for most Americans.

Except for those who now receive tax money from the government rather than pay it (because of the Earned Income Tax Credit), all taxpayers would pay less under the Armey plan. Moreover, even though everyone would pay the same 17 percent tax rate, because the personal allowances do not increase with income the effect is to make the tax burden progressive, although less so than at present.

Starting Point for Tax Reform. The Armey plan is the most consistent and comprehensive tax reform proposal currently under consideration. It would eliminate the inequities of the current system, promote growth and improve fairness and simplicity. It is internally consistent and intellectually sound. It should be the starting point for all future discussions of tax reform.

Principles of the Flat Tax

Today's graduated income tax system is a morass of deductions, exemptions, allowances, credits and other loopholes. According to Stanford University tax specialists Robert Hall and Alvin Rabushka:

- The Internal Revenue Service has 480 tax forms and another 280 forms to tell you how to fill them out.
- The IRS sends out 8 billion pages of forms and instructions to more than 100 million taxpayers every year — requiring the chopping down of 293,760 trees.
- All the IRS regulations and tax court rulings take up 336 feet of shelf space.
- An IRS study estimated that taxpayers spend 5.4 billion hours on paperwork at a cost to the private sector of 24 cents for every dollar of taxes collected.
- Other studies put the cost at 65 cents per dollar collected — even more for certain types of taxes.

There is a better way. Under a flat tax, *all* income is taxed, and it is taxed at the same rate. Furthermore, income is taxed only once, at its source, when it is realized. Let's take a closer look.

"It costs the privte sector between 24 cents and 65 cents per $1 it pays the IRS."

All Income Is Taxed. Surprisingly, the amount of revenue the federal government collects from the personal income tax is only 9.5 percent of total personal income. If corporate income is included, federal income taxes take only 11 percent of income. Thus, in principle, government would have just as much money if it levied an 11 percent, across-the-board tax on all personal and corporate income. Today's deductions, exemptions and loopholes result in more than half of all personal income not being taxed at all.

Most flat-tax proposals would require a tax rate higher than 11 percent — say 17 or 20 percent — because they allow two deductions: (1) a generous personal exemption and (2) an immediate write-off of all investments in capital goods. (See the discussion below.)

All Income Is Taxed at the Same Rate. Under the current tax system, a housewife can enter the labor market in a minimum-wage job and be taxed at a 40 percent marginal tax rate because of her husband's earnings. Because of the tax on Social Security benefits and the Social Security earnings penalty, some elderly workers face marginal tax rates in excess of 100 percent. Under a flat tax:

- The last dollar of income is taxed at the same rate as the first taxable dollar of income.
- A dollar of corporate income is taxed at the same rate as a dollar of personal income.

All Income Is Taxed Only Once. Under the current system, investment income can be taxed two, three or even four times. Income is taxed first at the corporate level. When the remainder comes to you in the form of dividends or interest, it is taxed a second time. If you sell the business, you can be taxed a third time through a capital gains tax on income your investment is expected to generate in the future. And after you die, your investment can be taxed a fourth time through the inheritance tax.

"A spouse entering the labor market at minimum wage can be taxed at 40 percent."

A flat tax system would tax income only once — when it is earned.

All Income Is Taxed at Its Source. Under the current tax system, businesses send out more than a billion Form 1099s reporting payment of dividends and interest. Each taxpayer is supposed to be taxed on these payments at that individual's tax rate. However, less than half of interest income actually is reported on individual tax returns. The flat tax would eliminate this leakage by taxing business income at its source:

- The corporation (or business) would pay taxes on its income and would not be allowed to deduct interest or dividend payments.
- Since the tax on interest and dividends would be paid at the corporate level, individuals would receive interest and dividend income tax free.

All Income Is Taxed When It Is Realized. There is no item in the national income accounts called "capital gains." Nonetheless, the capital gains tax forces people to pay taxes today on income that is expected to be earned many years in the future. For example, the expectation that a company will earn higher revenues will cause its stock price to rise. If you own shares in the company and sell them, you will be taxed on the "gain." But if expectations change tomorrow and the stock price falls, the government doesn't give a refund to the new buyer.

Whatever the merits of the argument for capital gains, if capital gains are to be taxed, capital losses should be fully deductible. But if that were the case, government would collect very little net revenue and might even lose revenue on balance.

The better approach is to stop taxing expectations and instead tax all income if and when it is realized.

Deductions and Allowances. Individuals would be able to deduct a personal allowance from their gross income. Those with gross incomes below the personal allowance would pay no income tax. For example, as discussed above, legislation introduced by House Majority Leader Armey provides for an allowance of $32,000 for a family of four. This exemption means that as many as half the households in America would pay no income tax.

The only other deduction would be an immediate write-off for investment in real capital. Businesses would no longer depreciate assets by a certain amount each year, but would expense the investment at the time it was made.

"The flat tax is actually a consumption tax."

There are only two things one can do with income: save it and spend it. Allowing full, immediate expensing of capital equipment and taxing all income only once removes savings and investment from the tax base. Thus the flat tax is truly a consumption tax.

Some flat tax proposals would continue deductions for home mortgage interest and for charitable contributions, but most would end these deductions.

No Deduction for Mortgage Interest. Home builders and lenders fear that ending the deduction for home mortgage interest would cause real estate values to plummet. However, home mortgage interest rates are expected to fall by about 2 percentage points if a flat tax is enacted, and a family earning $50,000 a year would benefit more from a 6 percent nondeductible mortgage than from an 8 percent deductible mortgage.

- Only 27 million of the nation's 116 million taxpayers claimed a mortgage interest deduction in 1992.
- Some 40 percent of homeowners have no mortgage on their homes and thus have no mortgage interest to deduct.
- Seventy-eight percent of families earning more than $100,000 took the deduction, but only 14 percent of those earning less than $50,000 took it.

Further, it is likely that any flat tax passed by Congress would allow homeowners to continue deducting interest for existing mortgages until they sold or refinanced.

No Deduction for Charitable Contributions. The deduction for charitable contributions is one of the biggest "sacred cows" in the tax code. Churches, universities and museums all fear that loss of the deduction under a flat tax would sharply reduce giving and threaten their viability.

There is no question that allowing contributions to be deducted from taxable income reduces the cost of giving. If one is in the top tax bracket, giving $1 to charity costs only 60 cents. But this also means that any reduction in tax rates will increase the aftertax cost of giving, even with the deduction.

Thus reducing the top tax rate from 70 percent in 1981 to 28 percent in 1987 doubled the aftertax cost of giving for someone in the top bracket from 30 cents to 62 cents. If one believes that tax policy is what drives charitable contributions, then this should have caused giving to decline sharply. In fact, individual giving increased after rates were cut — from $49 billion in 1980 to $107 billion in 1989.

The reason is that charitable contributions are not just a function of tax policy. When the economy is expanding and incomes are growing, people are more able to contribute to charity.

Another factor is that government welfare spending displaces private charity. In a February 1984 article in the *Journal of Political Economy*, Russell Roberts found that private relief expenditures rose steadily in the United States until 1932 and declined steadily thereafter as government welfare spending rose. He concluded that government spending crowded out private spending almost dollar for dollar. A similar analysis by Burton Abrams and Mark Schmitz in the December 1984 *National Tax Journal* found that "cuts in government programs may elicit significant additional interest in private contributing." Thus President Reagan's spending cuts may have been partly responsible for the rise in charitable giving.

In any event, only 23.3 percent of taxpayers deducted any charitable contributions in 1995, according to the Joint Committee on Taxation. And according to *Independent Sector*, many of those who contribute most generously have incomes too low to itemize. In 1993 families with incomes below $10,000 contributed an average of 2.7 percent of their income to charity, while those making $50,000 gave only 1.1 percent.

"In 1993 individuals itemized only 53 percent of all charitable contributions."

Lastly, it is clear that much giving is totally unrelated to deductibility. As Ralph Reed of the Christian Coalition has noted, "The motivations for giving are not fundamentally economic, but involve emotional impulses and other intangible influences." Thus in 1993 only 53 percent of all charitable contributions were itemized on individual tax returns. This suggests that many of the charitable institutions people care most about are likely to be unaffected by the flat tax.

No Deduction for State and Local Taxes and No Tax Advantage for Municipal Bonds. The elimination of these provisions would put an end to the unwise practice of using the federal tax system to subsidize spending by state and local governments.

No Deduction for Nonpension Employee Benefits. Under the current system, wage and salary income is taxed but compensation in the form of fringe benefits is not. This is the big reason employee benefits have grown from 20 percent of payroll in 1953 to more than 41 percent today. The tax subsidy for such items as employer-provided health insurance is inefficient and unfair because most of the benefits go to people who least need them — families in the top fifth of the income distribution get six times as much

subsidy as those in the bottom fifth. Further, current law encourages wasteful spending on health care and penalizes employers and employees who keep health costs under control.

Advantage of the Flat Tax: Fairness. Those who complain that the rich would gain are too caught up in the politics of envy to acknowledge that others would gain even more. Every time the nation has significantly lowered the top marginal tax rate, total tax revenue and the share of taxes paid by the highest-income earners has gone up. It happened in the 1920s and during the Kennedy and Reagan administrations.

Advantage of the Flat Tax: Simplicity. Under a flat tax, most individuals and businesses would fill out a tax return the size of a postcard.

"The flat tax would add as much as 2 percentage points to the nation's economic growth rate."

Advantage of the Flat Tax: Pro-growth. Because the flat tax is pro-savings and pro-investment, it would add as much as 2 percentage points to the nation's economic growth rate. And even if it only increased the annual growth rate from the current 2.5 percent to the 3.3 percent rate of the Reagan era:

- Over six years, that would add $2.3 trillion to the nation's output of goods and services.
- It would produce $550 billion of additional revenues for government — more than enough to pay for all the tax cuts House Republicans have fought for, including the $500 per child tax credit.

Benefits of the Flat Tax

A flat or single-rate income tax would replace the current system of five rates and hundreds of deductions, credits, exclusions, etc. This change is grounded in widely accepted principles of taxation. Following is a brief review.

Simplicity. At least since Adam Smith, simplicity in taxation has been considered a virtue. By simplicity we mean not only that the tax system is conceptually easy to understand, but also that the cost of complying with its requirements is low.

Our current tax system fails both tests. It is conceptually incomprehensible, even to tax professionals, and imposes large compliance costs on taxpayers. The principal cost is the time we must spend keeping records, filing forms and paying the tax. A government study estimated that Americans spend some 5 billion hours per year just doing that.

Some critics of the flat tax ridicule the idea that reducing the size of the tax return to a postcard contributes to meaningful simplification. They point out that only 9 percent of filers of the current 1040EZ form, which is just one page, require professional assistance. This only shows that true simplicity comprises more than simple forms; it requires a simple tax system as well.

Creating a simple tax system requires stripping away unnecessary exemptions, deductions, credits and exclusions. It means stripping away unnecessary rates and unnecessary levels of taxation. It means moving the point of collection as close to the source as possible. And it means moving any necessary complexity away from individuals and toward businesses, which are better equipped to deal with it.

The flat tax achieves all of these goals. Thus it would significantly simplify the tax system.

Efficiency. All taxes impose a cost on the economy over and above the amount of actual revenue collected. Economists call this the excess burden or deadweight cost of the tax system. It is in addition to the compliance cost.

Although all taxes impose some deadweight cost, the magnitude of the cost varies enormously, depending on how the tax system is structured. Two different tax systems raising the same amount of revenue can impose significantly different burdens on the economy. At the low end is the head tax or poll tax. Since every taxpayer is liable for a specific dollar amount of tax, there are no penalties for those who work, save and invest. At the other end is the steeply progressive income tax, under which the same income is double and triple taxed. This is the tax we have now.

Various economic studies have found that in addition to the direct tax burden, the cost of the U.S. tax system to the private sector is very high.

"At present, it costs the system 24.4 percent to collect each additional dollar of taxes."

- A 1976 study in the *Journal of Political Economy* by Professor Edgar Browning found that the cost of taxes on labor was between 9 percent and 16 percent of each additional dollar collected.
- A 1984 study by Professor Charles Stuart, published in the *American Economic Review,* found that the U.S. tax system as a whole costs 24.4 percent of each additional dollar collected; depending on what assumptions are made, this figure could be more than 100 percent.
- A 1985 study by Charles Ballard, John Shoven and John Whalley, published in the *National Tax Journal,* estimated that economic distortions cost between 13 percent and 24 percent of revenue collected.
- Another study that same year by the same economists, published in the *American Economic Review,* concluded that the cost of the U.S. tax system was between 15 percent and 50 percent of each additional dollar collected.
- A 1987 study by Edgar Browning, published in the *American Economic Review,* found the cost of the U.S. tax system was between 31.8 percent and 46.9 percent of revenue, with plausible assumptions raising this figure to as much as 300 percent!

- A 1991 paper by Professors Dale Jorgenson and Kun-Young Yun in the *Journal of Accounting, Auditing and Finance* put the cost at 18 percent.

Jorgenson and Yun's 18 percent figure implies that our system of collecting taxes costs approximately $250 billion per year. By collecting the same amount of revenue in a way that does not discourage work, saving and investment, we can potentially gain $1,000 per person each year.

The flat tax achieves this goal by eliminating distortions in the tax base and the rate structure and eliminating the tax bias against saving and investment. And without progressivity, taxpayers are no longer pushed into a higher tax bracket by inflation.

"By changing our tax collection method, we could gain $1,000 per person per year."

Fairness. In Washington, fairness has traditionally been defined only one way: the rich should pay more. Of course, this can be achieved simply by a flat rate. Someone with an income 10 times higher than another would pay 10 times more. To many Americans this is the essence of fairness. But under progressive tax rates, someone with an income 10 times higher would pay more than 10 times the amount of taxes. During World War II the top tax rate reached 94 percent. As recently as 1981 it went as high as 70 percent. Today it is 39.6 percent. (See Figure X-2.)

There are other concepts of fairness. Under "horizontal equity," people with the same incomes would pay the same taxes. Our current system violates this principle because one's tax liability depends not just on the amount of income, but on the form of that income (wages vs. business income) and the tax deductions, exclusions, credits and exemptions to which one is entitled.

Another principle is the "benefit principle," which says that one's tax liability ought to be related to the benefits one receives from government. In fact, Professor Richard Epstein of the University of Chicago Law School argues that the Fifth Amendment to the Constitution requires the benefit principle. Of course, our current system does not in any way relate taxes to benefits. While a flat tax will not fix this problem, Epstein believes that the flat tax is more constitutionally sound than a progressive income tax.

Finally, there is a question of fairness in having a tax system that imposes differentially high income tax rates on a minority. In a recent article in the *National Tax Journal*, Professor James Buchanan, a Nobel laureate, argued that the most "politically efficient" system of taxation "would involve a flat-rate, proportional tax on all sources of income, without deduction, exclusion or exemption."

Economic Effects of the Flat Tax

The current tax system taxes income inefficiently and causes the national income to be smaller than it otherwise would be in three ways: (1) by failing to tax capital and other production inputs at a uniform rate, the tax

"The current tax system is inefficient — and it lowers the national income."

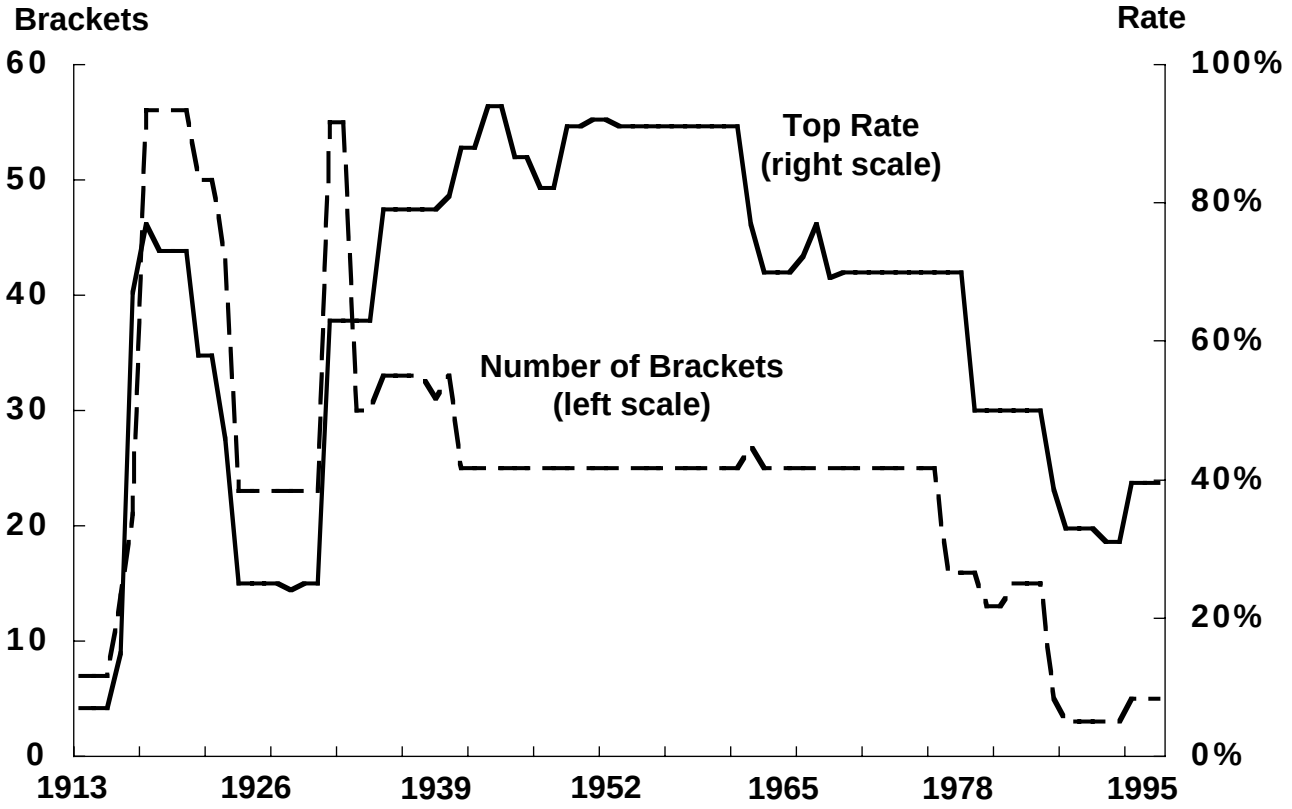
system prevents resources from being allocated to their highest valued use; (2) because of exemptions, deductions and loopholes, marginal tax rates on all inputs are much higher than they need to be; and (3) the taxation of investment income leads to a lower capital stock than would otherwise be the case.

Opponents of the flat tax claim that it would impose considerable burdens on the poor because it would eliminate the Earned Income Tax Credit and on workers because it would tax their benefits, including health insurance and the half of payroll taxes currently paid by employers. They further claim that it benefits wealthy individuals because it would abolish the personal income tax on interest, dividends and capital gains (which proponents view as double taxation because these gains are taxed at the business level) and would abolish inheritance taxes. Moreover, they claim, the flat tax would increase federal deficits and the national debt.

Modeling the Economy. In recent years, economists have developed a way of calculating the consequences of the complex economic interactions caused by changes in the tax code. The method makes use of a computable general equilibrium (CGE) model. Although different scholars use different

FIGURE X-2

Number of Tax Brackets and Top Federal Income Tax Rate



Source: Commerce Clearing House.

variations of this model, the core concept is well understood and has appeared many times in the economic literature.

"A model is used to show the total effects of the flat tax."

A CGE model can be used to calculate the effects of the flat tax on the various sectors of the economy, changes in the income of different income groups and the effect on government revenues. The findings of the model, based on levying a 17 percent flat tax, differ considerably from the pronouncements of those who ignore the totality of economic changes a flat tax will produce as the effects work their way through the entire economic system.

The model divides the economy into 14 production sectors and 14 consumption sectors. The goods and services consumers buy come from combinations of output from various primary production sectors. For example, the sale of food products to consumers requires outputs from the subsidized crop, other crop, livestock and food processing sectors integrated with outputs from the services sector such as advertising and distribution. The model compares relative prices and quantities of the output of the various production and consumption sectors before and after the imposition of the flat tax rate to see how they change and how the changes interact to cause other changes. In turn, these changes affect the economic welfare of the various income groups, which affects government revenue.

Why the Flat Tax Is Efficient

Because there is only one tax rate, because the only exemption is a personal allowance and because all income is taxed only once, the flat tax removes distortions of the current tax system that prevent resources from being allocated to their highest valued use.

Uniform Taxation of Capital Inputs. Under the current tax system, the different marginal tax rates and varying tax treatments cause capital and other inputs to be taxed differently from industry to industry, as Table X-1 shows. Thus, for example, although the average effective tax rate on capital for the overall U. S. economy is 36.4 percent:

- The average rate on capital for the processed food and tobacco production sector is 46 percent, but the rate for tax-subsidized agricultural crops is only 26 percent.
- Manufacturers pay an average rate of 40 percent, but the services sector (other than financial services) pays an average rate of 32 percent.

As a result, there is overinvestment in subsidized crops and in services other than financial services, and underinvestment in processed food and tobacco and manufacturing. The flat tax would move the taxes on inputs closer to a uniform rate, removing the distortions that inhibit the growth of national income.

Removing Exemptions, Deductions and Loopholes. More than half of all personal income is not taxed under the current system. Under the pro-

"The current tax system causes capital and other inputs to be taxed differently from industry to industry."

TABLE X-1

Effective Tax Rate on Capital in Production Sectors

Sector	Average Tax Rate on Capital
Manufacturing	40%
Services (except finance)	32%
Financial Services	45%
Food and Tobacco	46%
Chemicals and Plastics	38%
Wood Products	30%
Petroleum Refining	39%
Crude Oil and Natural Gas	37%
Livestock	30%
Program Crops	26%
Nonprogram Crops	29%
Coal Mining	32%
Other Mining	37%
Logging	29.5%

posed flat tax reform, except for a personal allowance all income is taxed, but taxed only once, at its source and at one rate. There are no other exemptions, no deductions, no loopholes.

Removing the Anti-Savings Bias. Under our current tax system, people are taxed on what they earn and save, taxed again when the savings earn a return and taxed yet again when they die. Thus the system as it exists is biased against saving and toward consumption, although Congress has passed some special provisions to encourage saving (tax-free retirement accounts, for example). This multiple taxing of investment income has hampered economic growth by causing the United States to have a lower capital stock than it otherwise would have. Under the flat tax, earnings from saved income are not taxed at the individual level. Investment in real capital assets is expensed at the time it is made, rather than being depreciated. Thus the flat tax is pro-saving and pro-investment.

The Flat Tax and Growth

Removing the distortions of the current tax system by replacing it with a flat tax would have a highly stimulating effect on the nation's economy and its output. In addition to removing the distortions caused by inequitable tax rates, the flat tax would result in an increase in disposable income at all income levels, discussed below. In turn, the increase in disposable income would bring about an increase in consumption across almost all sectors, which would increase the demand for producer goods and services.

Effects on Production. Giving equal tax treatment to all inputs would result in higher growth in every production industry except currently subsidized agricultural crops; the reason in that case is the loss of tax subsidies. As shown in Table X-2:

- Growth would be especially high in the chemicals and plastics industries and in manufacturing — each more than 3.5 percent.
- The food and tobacco sector and the noncoal mining sector would have increases of almost 3.5 percent.

The increased output in manufacturing, chemicals and plastics, food and tobacco and noncoal mining is especially high because these industries are so important in supplying other industries — most of which also expand to produce consumer goods and services. To illustrate the interaction of these industrial sectors:

- The manufacturing and chemicals and plastics industries supply capital goods that other industries use to produce consumer goods and services.
- The increased output by manufacturing and chemicals and plastics requires more new or refined material from the noncoal mining sector.

In the same way, the increased output in the food and tobacco sector leads to an expansion in livestock husbandry and nonprogram crops — that is, crops that do not receive government tax subsidies, such as fruit, vegetables and nuts. However, output of subsidized crops such as corn, wheat and cotton

"Giving equal tax treatment to all inputs would result in higher growth in every production industry except currently subsidized agricultural crops."

TABLE X-2

Effects of a Flat Tax on Production Sectors

Production Sector	Change in Quantity (Percent)
Manufacturing	3.6
Services (except finance)	2.8
Financial Services	1.5
Food and Tobacco	3.5
Chemicals & Plastics	3.6
Wood Products	3.1
Petroleum Refining	2.8
Crude Oil & Natural Gas	2.6
Livestock	2.5
Program Crops	-0.8
Nonprogram Crops	1.7
Coal Mining	1.9
Other Mining	3.5
Logging	0.0

"Removing the distortions caused by the wide variation in tax rates on producers will lead to growth in consumption."

TABLE X-3

Effects of a Flat Tax on Consumption Sectors

Consumption Sector	Change in Quantity (Percent)
Consumer Services (except finance)	2.3
Housing	1.5
Food	3.6
Motor Vehicles	3.2
Reading & Recreation	3.2
Savings	7.4
Clothing & Jewelry	3.6
Utilities	2.9
Financial Services	-0.2
Furnishing & Appliances	3.2
Nondurable Household Items	3.9
Alcohol & Tobacco	3.9
Gasoline & Fuels	3.2
Transportation	2.8

falls, reflecting the loss of subsidies enjoyed under the current tax code. The loss of subsidies is also the reason for almost no increase in output for the logging sector. The wood products sector, with 3.1 percent growth, will get its raw material from imports.

Effects on Consumption. Two consequences of the flat tax — a growth in aftertax income, to be discussed below, and removing the distortions caused by the wide variation in tax rates on producers shown in Table X-1 — lead to a growth in consumption. Obviously the growth in production is fueled by this growth in consumption. The model has 14 consumption sectors, and all but one show growth, mostly between 2 percent and 4 percent. (See Table X-3.) The exception is the consumer financial services industry, where growth will be slightly negative because so much of the available capital is going to production sectors.

Effects on Housing. Although home mortgage interest will no longer be deductible under the flat tax, the housing sector will grow 1.5 percent more than it otherwise would. This expansion can be attributed primarily to the increase in disposable income of all income groups, which is discussed below.

Effects on Savings. One of the most significant effects of the flat tax is that it will cause savings to grow by more than 7 percent — more than twice as much as any other sector of the economy. This is particularly important because savings are needed to fuel future economic growth. There are two major reasons for the high growth in savings. First, dividends and interest are not taxed at the individual or household level under the flat tax (having already been taxed at the corporate or business level), which encourages real

investment in the economy. Second, income increases across all income groups under the flat tax, and as incomes increase households save more. This increased saving is measured by the model.

Effects on Income. Critics of the flat tax allege that fundamental tax reform would benefit the rich at the expense of the middle class. Some maintain that low income families would also be worse off if the Earned Income Tax Credit (EITC) were removed, as it would be under the Armey-Shelby proposal or the Hall-Rabushka proposal.

These criticisms, however, are based on a simple-minded application of the tax law to existing incomes. The critics ignore the fact that the flat tax will affect different people in different ways and will effect changes throughout the economic system. We cannot know whether a particular income group would be better off or worse off until we know how that group's aftertax income changes. The model accounts for these changes and finds:

- The elimination of inefficiencies produced by the current tax system will cause the economy to be larger than it would be otherwise, and the gains are widely distributed; *every income group will gain as a result of the flat tax.*
- Among all income groups, *the lowest-income Americans will gain the most* (in percentage terms) even with the elimination of the EITC.
- *In percentage terms, the gains of the highest income group will be third highest among the six income groups.*

"The lowest-income Americans would gain the most from a flat tax."

As Table X-4 shows, the *lowest* income group realizes the highest *percentage* gains from adoption of a flat tax despite the abolition of the EITC.

TABLE X-4

Income Group[1]

In 1988 Dollars	In Current Dollars	Change in Disposable Income
0-$9,999	**0-$12,881**	**+ 7.6%**
$10,000-$19,999	**$12,882-$25,764**	**+ 1.6%**
$20,000-$29,999	**$25,765-$38,646**	**+ 2.5%**
$30,000-$39,999	**$38,647-$51,529**	**+ 1.4%**
$40,000-$49,999	**$51,530-$64,412**	**+ 1.0%**
$50,000 and up	**$64,413 and up**	**+ 2.4%**

[1] The Bureau of Labor Statistics classifies income groups both by six ranges of income and in quintiles. Our model uses the six ranges of income (each of which is approximately of equal size except for the $40,000-$49,999 range) to make it easier to apply marginal income tax rates.

"The lowest-income group receives a relatively higher percentage of its income from land and capital."

TABLE X-5

Percent of Income Groups' Income by Sources

Income Group (1988 dollars)	Land	Labor	Capital	Total*
$0 - 9,999	2.8%	61.1%	36.0%	99.9%
$10,000 - 19,999	1.9%	81.8%	16.3%	100.0%
$20,000 - 29,999	0.9%	85.8%	13.3%	100.0%
$30,000 - 39,999	0.7%	86.8%	12.6%	100.1%
$40,000 - 49,999	0.4%	88.3%	11.3%	100.0%
$50,000 +	0.3%	84.6%	15.1%	100.0%

Source: Bureau of Labor Statistics.

* Some totals are not 100% because of rounding.

The relatively high 7.6 percent gain to the lowest income group can be explained in part by the fact that this group pays no income tax with the advent of the flat tax. Therefore, this group's aftertax wage rate increases despite a decrease in before-tax wages of one-third of 1 percent, making it *willing* to supply a larger quantity of labor relative to the upper-income groups; and the expansion of virtually all the sectors in the economy means that the lower-income group is *able* to supply more labor and therefore earn more income.

Land, Capital and the Lowest-Income Group. An additional and extremely important factor is that the lowest-income group receives a relatively high percentage of its income from land and from capital, as shown in Table X-5. This does not mean that this group owns a large percentage of all land and capital, but rather that the group benefits more than others on a percentage basis from the increase in land rents and in the return to capital after the flat tax is imposed.

The percent of income from capital for the lowest-income group may be surprising. It may be due to several reasons. Some in this group are self-employed and take little in salary while owning the company brings income from capital, some are retired or semiretired individuals and some are individuals who depend on interest and dividends that usually would place them in a higher-income group.

The second highest percentage gain in disposable income (2.5 percent) is realized by the third-lowest income group ($20,000 - 29,999). This is largely an aftertax wage effect. This income group gains considerably from allowances under the flat tax, resulting in a sizable increase in the aftertax wage rate. Hence, individuals in this group are willing and able to supply a larger quantity of labor and enjoy a relatively high gain in disposable income by doing so.

Effects on Government Revenues. The model differs from Treasury Department findings that a 17 percent flat tax would reduce government revenues; instead we find that it increases government revenues 1.8 percent annually. The difference probably can be accounted for by the fact that our model allows for behavioral changes resulting from changes in incentives and accounts for effects throughout the economy. It finds that the increase in government revenues is driven by the increases in the majority of sectors in the economy and accompanying increases in employment of labor, capital and land which, in our experience in CGE modeling, are relatively large.

Sensitivity Analysis. As with any simulation exercise, these results must be regarded with some caution. However, sensitivity tests indicate that our results are robust. This in turn suggests that many of the fears expressed about a flat tax are unwarranted.

A Flat Tax That Works

An increasingly common criticism of the flat tax is that it is untried, untested and therefore too risky to adopt.

While it is true that neither the United States nor any other major country has ever replaced its individual income tax with a flat tax, it is not true that we have no experience with such taxes.

- One-fourth of all states with income taxes have a single rate.
- A majority of states impose corporate income taxes at a single rate.
- All sales taxes, including all federal excise taxes, are imposed at a single rate. No one pays more tax per gallon of gasoline, for example, because they earn more money or consume more gasoline.

"President Franklin Roosevelt proposed the Social Security system, a flat-rate tax."

The best example of a flat-rate tax is the payroll tax for Social Security. When President Franklin Roosevelt proposed the Social Security system, he strongly endorsed the principle of a flat-rate tax. His purpose was to emphasize that it was a "contribution" to which workers had a legal right.

It has stayed that way ever since. The payroll tax is a flat 5.6 percent tax rate on both employer and employee on all wages up to $62,700. There are no exemptions whatsoever and no taxes at all on income from capital or wages above the maximum.

Thus it essentially is a flat-rate consumption tax. Because it has no exemptions, the payroll tax is the most administratively simple tax the federal government has. And because it does not apply to capital or high-wage incomes, its efficiency cost is very low. That is, it discourages very little economic activity per dollar of revenue — far less than the income tax, which raises about the same revenue.

Yet despite the fact that the Social Security program is by far the most successful program the Democratic Party has ever come up with, Democrats would universally condemn it if it were proposed for the first time today. The

tax would be considered far too regressive, injurious to labor and much too easy on the wealthy.

Applying current Democratic thinking to Social Security would have killed the program in the cradle. The economic cost of a "progressive" Social Security tax would have prevented the rate from rising as much as necessary to raise current revenues.

All flat-rate tax advocates really want is to make the income tax more like the Social Security tax — a flat tax that works.

Benefits of a National Sales Tax

In addition to the Armey proposal for a flat rate income tax, a more fundamental tax reform idea that has garnered congressional support is scrapping the income tax altogether and replacing it with a national sales tax. Reps. Dan Schaefer (R-CO) and Billy Tauzin (R-LA) have introduced the National Retail Sales Tax Act (H.R. 1325); Sen. Richard Lugar (R-IN) supported income tax abolition and the sales tax in his campaign for the 1996 Republican presidential nomination; and House Ways and Means Committee Chairman Bill Archer (R-TX) says he personally prefers this alternative.

"Sales tax supporters propose to eliminate the income tax altogether."

This support for a national sales tax (NST) must be distinguished from the idea of instituting a national sales tax (or a value-added tax) as a way to raise more money for the federal government. The intent of most sales tax supporters is to completely replace the income tax with a sales tax. While the Schaefer-Tauzin proposal includes features supported by all NST supporters, there are additional features that others might include, or specific provisions with which they might differ.

Features of a Proposed Sales Tax. The Schaefer-Tauzin bill would repeal the federal personal and corporate income taxes, inheritance and gift taxes, and excise taxes not dedicated to trust funds. In their place, it would institute a federal sales tax added to the sales price of goods or services sold to domestic end users — that is, at the retail level.

The legislation sets the sales tax at 15 percent — which the authors of the bill claim is about the "revenue-neutral rate," one which will yield the same amount of net revenue to the federal government as the taxes it replaces. It in effect amends House and Senate rules by making it "out of order" for them to even consider legislation increasing the sales tax rate without a two-thirds vote of approval.

The sales tax would apply to purchases by individuals, businesses, nonprofit organizations and local, state and federal governments; however, purchases of goods and services at intermediate stages of production — that is, used in the production of other taxable items — would be exempt, as would exports. The tax would be collected by businesses and self-employed individuals and remitted to state tax authorities — minus a credit that would

compensate businesses for about half the cost of collection and record-keeping.

State governments would pass the revenue on to the U.S. Treasury, minus compensation for the cost of administering the tax. Since the states would administer the sales tax, and income tax reporting requirements would be eliminated, the Internal Revenue Service would no longer be necessary: it would be abolished and replaced by a smaller Federal Excise Tax Bureau.

"The Internal Revenue Service would be eliminated."

Another important provision of the Schaefer-Tauzin bill is a per person rebate to every family equal to the amount of the tax that would be paid on consumption expenditures up to the poverty level. This would be a refundable tax credit against payroll or self-employment taxes owed, meaning that those persons with no wage income subject to the payroll tax could receive a rebate check. (Responsibility for collecting taxes for Social Security and Medicare would be transferred to the Social Security Administration.) Thus for example:

- A family of four would have received a refundable credit of 15 percent of the poverty-level income of $18,588 had the Schaefer-Tauzin sales tax been in effect in 1997.
- That means they would have received a credit against Social Security and Medicare taxes of $2,788.20 or a rebate of the difference between the payroll taxes they owed (if any) and the rebate amount.

Taxing Consumption. Both the sales tax and the flat tax are true consumption taxes, although they attack the problem from opposite sides of the same coin. All income is either spent on current consumption, held as cash or put in some form of savings or investment for future consumption. Thus consumption is the flip-side of income, and like a flat tax, a retail sales tax would remove the penalties on savings and investment in the current tax system that perversely encourage consumption and debt-financed spending. The flat tax does so by taxing income only once; the sales tax does so by taxing retail purchases.

Simplicity. A sales tax such as that proposed in the Schaefer-Tauzin bill would be much simpler to administer than the income tax. Instead of more than 100 million income tax filers, only the businesses and self-employed individuals who collected the sales tax would file reports.

Economist Arthur P. Hall of the Tax Foundation found that either a flat tax or an NST would drastically reduce the costs of complying with the tax system.

- Hall projected the cost of complying with the overall federal tax system in 1996 at $225 billion, with the personal and corporate income tax accounting for $157 billion of this.
- If a flat rate income tax (with continued withholding) had been in effect in 1996, it would have reduced compliance costs by 94 percent to $9.4 billion.

- A national sales tax might reduced compliance costs that year by about 95 percent, to $8.2 billion, with the entire burden falling on retail and service businesses (before any compensation for remitting the tax).

"The current tax system imposes a huge drag on the economy."

Efficiency. Even larger than the compliance costs imposed by income tax system is the drag on the economy caused by the tax system, called the excess burden or deadweight loss. All taxes create some economic distortions, but economists say the cost of the current, progressive tax system ranges from a third-of to more-than the amount of taxes collected.

- A 1985 study by Charles Ballard, John Shoven and John Whalley estimated that economic distortions cost between 13 percent and 24 percent of total revenue collected — at a marginal cost for each additional tax dollar of between 15 percent and 50 percent.
- A 1987 study by Edgard Browning found the cost of the U.S. tax was between 31.8 percent and 46.9 percent of revenue, with plausible assumptions raising this figure to as much as 300 percent!
- A 1991 paper by Dale Jorgenson and Kun-Young Yun put the cost of the tax system at 18 percent of revenue collected, implying an economic loss of about $250 billion a year.
- Economists Gary and Aldona Robbins estimated inefficiencies in the economy due to tax distortions cost Americans $642.7 billion in 1992 — about $2,650 for every man, woman and child.

Most of this deadweight loss would be eliminated by a flat rate income tax or sales tax. For example, studies show the large marginal tax rate reductions in the national sales tax combined with neutral tax treatment of savings vs. consumption would increase economic growth.

- Harvard economist Dale Jorgenson found a 13 percent initial increase in gross domestic product and a 9 percent long-range increase.
- Similarly Boston University economist Laurence Kotlikoff predicted a 7 percent to 14 percent increase in national output within 20 years, with about half occurring within two years.

Fairness. Progressive income taxation penalizes each additional dollar of earnings or production by imposing a higher marginal rate, whereas a sales tax taxes each dollar of consumption at the same rate. Thus a sales tax is "fairer" in the sense that it does not discriminate for or against any good or service and does not distinguish among taxpayers according to their income. But because they are proportional taxes, both the sales and flat income tax have been labeled as regressive — implying that a heavier burden falls on lower-income groups.

It is true that lower-income people tend to use more of their income for current consumption; moreover, a greater percentage of their consumption

"The Schaefer-Tauzin bill would offer a rebate that would make the sales tax fair for lower-income people."

tends to be for "necessities," rather than "luxuries." The Schaefer-Tauzin plan addresses these issues by a per person rebate of the tax that would be paid on consumption expenditures equal to a poverty-level income, similar to the generous personal allowance in the Armey flat tax bill. Since the rebate is universal — there is no income qualification — it is fair to every taxpayer and does not require maintaining income records for purposes of means testing.

However, the rebate necessitates a higher tax rate.

- If the sales tax had been put in place for 1997, Arthur Hall of the Tax Foundation estimated, a 13.82 percent rate would have replaced the revenue generated by the taxes it replaced (using the tax base specified by Schaefer-Tauzin).
- With a rebate under the Schaefer-Tauzin plan, the revenue-neutral rate would have been 16.42 percent.
- Tax experts David Burton and Dan Mastromarco found that with different assumptions about the tax base, an 11.8 percent sales tax rate would have raised the same revenues as the current system in 1995.
- According to their Cato Institute study, a rebate as in Schaefer-Tauzin would have required a 14.2 percent rate.

A suggested alternative way to reduce the burden on lower-income groups is to exempt some "necessities" from the sales tax. But this would add back into the system some tax-caused distortions — such as between investment and consumption of exempt goods and services versus others. It would also allow the opportunity for political mischief, as various producer and consumer groups lobbied for an ever-expanding list of necessities.

Visibility. One of the advantages of the NST over other taxes is that it is immediately visible — since the tax is paid by the end-purchaser and added to the cost of the sale — unlike the cost of income and payroll taxes that are hidden in the final price of a good or service. Supporters suggest that due to this feature, congressional attempts to raise the rate would meet with greater taxpayer resistance. (For similar reasons, Rep. Armey originally proposed eliminating income tax withholding and requiring monthly remittance of income taxes owed as part of his flat tax proposal.)

Less Intrusive Government. One paramount benefit of the NST to some supporters is that it would allow the abolition of the Internal Revenue Service and the tax code it administers. Income tax compliance and enforcement entails a loss of privacy and constitutional safeguards for due process; many perceive it as a threat to democratic government.

Moreover, the sales tax introduces an element of voluntariness into the tax system. Individuals could choose when they pay the tax by timing their purchases, and they could avoid the tax to some extent by saving and pass on their estate to their children tax-free. And by removing biases in favor of

current consumption or specified investments, the NST would eliminate attempts at social engineering using the tax code.

Finally, unlike the income tax, the sales tax is an indirect tax — one levied on transactions rather than individuals. This is the tax system originally envisioned in the U.S. Constitution; thus rather than being revolutionary, a NST would be a return to traditional constitutional principles.

Effect on State Taxes. A national sales tax might also reduce the additional compliance costs and deadweight costs represented by the state tax systems. Just as many states now piggyback a state income tax on top of the federal one — as a percentage of whatever federal taxable income a person owes — presumably some states would replace their state income and sales taxes with a broad-based state sales tax levy added to the federal one. Forty-five states and the District of Columbia currently impose some type of sales and use tax.

"Critics maintain that the rate required for a national sales tax would be too high."

Objections to a Sales Tax. Critics of a national sales tax object that it would become or have to be supplemented by a value-added tax (VAT) — which is hidden from the consumer in the final price of a product and thus easy to raise — or that it would become a supplement to, or be supplemented by, an income tax. An NST as a supplemental source of federal revenue, as the VAT is used in Europe and Japan, is of no benefit, since it would only fuel additional growth of government, without making the economy any more efficient.

Some critics suggest that one or more of these alternatives would inevitably be chosen because the sales tax rate required is so much higher than state sales tax rates now in effect that avoidance and noncompliance with the tax would become widespread — leading to a spiral of increasing tax rates and lower collections. However there are other factors supporters say should be kept in mind:

- With the removal of the income tax, average prices of consumer goods should fall by about the same amount as the additional sales tax.
- The system should be perceived as "fairer," encouraging tax compliance.
- Although tax avoidance and noncompliance rise with tax rates, consumers tolerate much higher rates on some combined federal-state excise taxes — for instance, on gasoline and tobacco.
- The marginal tax rate under a sales tax would be much lower than that posed by the current income tax system, and the number of tax filers would be reduced by more than 90 percent; therefore compliance problems should be less not more.
- While initially the rate would be much higher than any current state sales tax, economist Laurence Kotlikoff predicts that increased economic growth would allow the NST rate to decline in future years to 10 to 12 percent.

Still Needed: Constitutional Guarantees. The Schaefer-Tauzin bill recommends that the 16th amendment to the Constitution, which authorizes an income tax, be repealed. But until a new amendment is passed to repeal it, there is nothing to prevent Congress from again imposing an income tax.

Although the Schaefer-Tauzin bill makes it "out of order" for either house of Congress to consider raising the sales tax rate above 15 percent without the consent of two-thirds of the members, there is no way to enforce the provision because Congress would continue to have the right, with the agreement of the president, to change laws by a simple majority vote.

Given the fundamental reform of the tax system implied by the NST, appropriate constitutional guarantees should be implemented. This could be done with a single constitutional amendment repealing the authority of Congress to impose an income tax; forbidding the imposition of a VAT; authorizing Congress to institute a sales tax; limiting other excises or import duties to the same rate as the sales tax; and requiring a supermajority of Congress (i.e., two-thirds or three-fourths) to increase any rate and/or limiting the percentage amount of any increase. Unless constitutional tax limitation is an integral part of the NST, it will probably be impossible to gain the political support necessary for passage.

The Value-Added Tax

"Since the value-added tax is hidden in the price of goods, governments can easily raise it."

One of the beauties of the valued-added tax is that it is hidden in the prices of goods. Although people know they are paying a VAT when they buy most goods and services, they tend not to object as strenuously as when they must send a check off to the government for their income tax. And since prices change with great frequency anyway, incremental increases in the VAT tend not to arouse much opposition. For this reason the French government recently found it easy to raise the standard VAT rate in France by 2 percentage points, from 18.6 percent to 20.6 percent.

In 1965, before the VAT was adopted, total taxes as a share of gross domestic product in Europe averaged 27.3 percent, according to the Organization for Economic Cooperation and Development. This was only slightly higher than the figure for Australia and the United States, where taxes as a share of GDP averaged 23.2 percent and 25.8 percent, respectively.

In the late 1960s and early 1970s, most of the nations of Western Europe adopted VATs, and the rest joined in the late 1980s and early 1990s. In fact, it is a requirement for entry into the European Union. Today Australia and the United States are the only OECD countries that do not have a VAT.

Funding Leviathan. The VAT fueled vast expansion of government in Europe. Today, taxes in Europe are significantly higher than in Australia and the United States (see Figure X-3). Total taxes as a share of GDP averaged 41.4 percent in Europe in 1992, according to the most recent OECD data.

the United States (see Figure X-3). Total taxes as a share of GDP averaged 41.4 percent in Europe in 1992, according to the most recent OECD data. By contrast, taxes in Australia and the United States are not much higher than they were in 1965, at 28.5 percent and 29.4 percent of GDP, respectively.

VAT Is Efficient. Ironically, the reason why the VAT has led to such an increase in taxation is that it is probably the most efficient tax ever devised — efficient in the limited sense that it discourages productive economic activity less than other taxes raising the same amount of revenue.

All taxes discourage production, some more than others. Economists call this the deadweight cost of the tax. Thus the true burden of a tax system is the total tax revenue raised plus the excess burden. Estimates of the excess burden of the United States tax system run into the hundreds of billions of dollars per year.

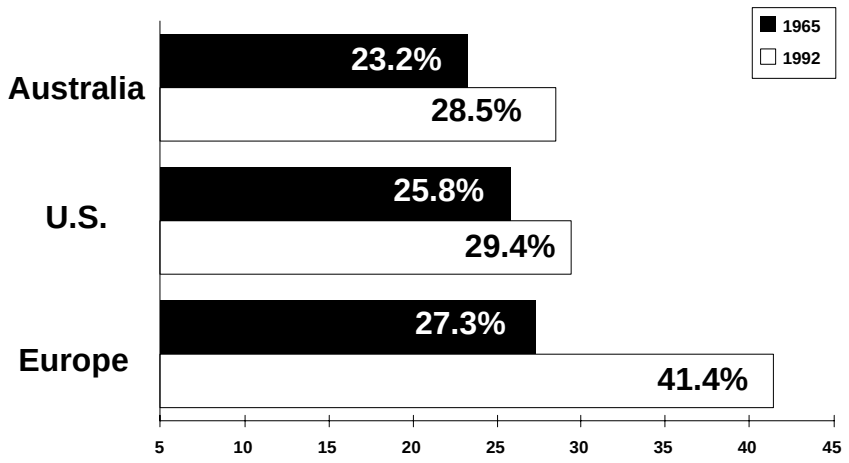
High marginal tax rates on entrepreneurial activity are especially burdensome. Taxes on consumption, however, penalize productive activity much less. Thus a revenue-neutral shift from a tax system that penalizes work, saving and investment to one that taxes consumption would significantly reduce the excess burden. It is equivalent to an actual tax cut. Professor Dale Jorgenson of Harvard University estimates that such a shift in the United States tax system would lead to an immediate increase in national wealth of well over $1 trillion.

Since the excess burden is part of the tax burden, it stands to reason that to the extent there are economic and political limits to taxation they apply to the total cost of the tax system, including the excess burden. And there

"Australia and the United States are the only major industrialized countries without a value-added tax."

FIGURE X-3

Total Taxes as a Share of GDP



Source: OECD.

there is the underground economy, which estimates put at roughly 10 percent of GDP in most industrialized countries. Therefore, the more efficient a tax system is, in the sense of having a low excess burden, the more revenue a government can raise before reaching the limit.

This is the key to understanding why the VAT led to the expansion of government in Europe. By eliminating inefficient taxes — mostly turnover taxes that tended to cascade, impending trade and investment — and replacing them with value-added taxes, the nations of Europe were able to dramatically reduce the excess burden of their tax systems. They could thus raise the overall level of taxation much higher than would have been possible otherwise. Had they attempted to raise the same amount of revenue without the VAT, they would have encountered severe economic and political difficulties.

"The VAT fueled a vast expansion of the welfare state in Europe."

It is not surprising, then, that nations that have had VATs the longest have imposed the greatest rate increases. The 12 OECD countries that adopted VATs before 1973, for example, have seen their VAT rates rise by an average 71 percent, while those with VATs adopted since 1985 have raised rates by an average of just 14 percent.

Giving European politicians a powerful tax that could be raised incrementally without generating either significant politicial opposition or negative economic effects set the stage for a vast expansion of the welfare state. In 1965 government spending as a share of GDP in Europe averaged 34.6 percent according to the OECD. By 1993, spending had risen to 52.1 percent.

Fueling the Poverty Trap. Much of this increased spending went to welfare benefits that sharply cut the cost of not working. This has created a poverty trap in which the combination of direct taxes and lost benefits reduces the real amount of return on work to almost nothing for many people. For example:

- An OECD jobs study noted that in the United Kingdom if a married man with two children earning £100 per week were to receive £1 extra he would keep just three pence.
- First he would pay 20 pence in income taxes and 9 pence in social security. Then he would lose 50 pence in family benefits, 14 pence in housing benefit, and 4 pence in local tax refund.
- This is equivalent to a 97 percent marginal tax rate!

Welfare for businesses expanded as well. According to another OECD study, industrial subsidies are at least four times higher in Europe than in the United States. While industrial subsidies amounted to just 0.5 percent of GDP in the United States in 1986, they consumed 2.6 percent of GDP in Denmark, 2.9 percent in the Netherlands, 3.3 percent in France, 4.1 percent in Norway and 7.4 percent in Sweden. These subsidies ultimately made European businesses very uncompetitive in international markets. Although subsidies are now being reduced, it will be many years before most European businesses get their costs down to U.S. or Japanese levels.

The real burden of the VAT has not been a direct tax effect. Rather, it has impoverished Europe by allowing politicians to easily raise revenue, which in turn has fueled a vast expansion of government spending. This spending inevitably went into programs such as welfare and industrial subsidies that reduced the incentive to work and made European businesses uncompetitive.

But ultimately there is a limit to taxation, even with a VAT, and Europe seems to have reached it. Taxes and spending as shares of GDP seem to have finally leveled off in Europe, after decades of steady increases. International competition and the decline of trade barriers have forced cutbacks in industrial subsidies, while budget deficits and rising unemployment are forcing welfare reforms. And there is increased talk of using VAT revenue to reduce marginal income tax rates, instead of just spending it.

VAT Burden on Japan. On April 1, 1997 the Japanese value-added tax (VAT) rose from 3 percent to 5 percent. The increase was enacted in 1994 but postponed until now.

A key reason for Japan's economic success in the 1950s and 1960s was that it had the lowest taxes among the major industrial democracies. According to the Organization for Economic Cooperation and Development (OECD),

- Total taxes as a share of gross domestic product (GDP) in Japan were 17.1 percent in 1955 and 18.3 percent in 1965.
- By contrast, the comparable figures for the United States were 23.6 percent and 24.3 percent, respectively.
- But beginning in the late 1970s, Japan began raising taxes sharply. Taxes in Japan are now higher than those in the U.S. and rising more rapidly.
- According to the latest OECD estimate, by 1998 total government receipts will reach 33.8 percent of GDP in Japan, compared to 31.5 percent here.

"Japan's VAT rate increased 40 percent in 1997."

In recent years the VAT has been fueling the heavier tax burden in Japan. This tax was first proposed by Prime Minister Nakasone in the mid-1980s and it was so unpopular that it eventually forced him to leave office. In spite of this, his successor, Prime Minister Takeshita rammed through the new tax in 1988. It took effect in 1989 at a 3 percent rate amid 60 percent public disapproval.

The growth of taxation in Japan bears much of the responsibility for the nation's dismal growth rate. Real GDP grew less than 1 percent in 1994 and 1995. Ironically, in 1996 the VAT stimulated the growth rate, which rose to 3.6 percent. This was because consumers rushed to buy goods, especially houses, before the higher VAT rate took effect. But the effect was purely temporary. The OECD expects growth to fall back to just 1.6 percent this year.

"Press reports indicate that President Clinton favors a VAT."

In the long run, higher taxes always depress growth. Japan is only the latest country to learn this lesson. For good or ill, the VAT is here to stay, and the United States may soon join the club. Pressure for U.S. tax reform is strong, and press reports indicate that President Clinton favors a VAT. Many members of Congress appear enamored of the VAT's border adjustability, believing that it subsidizes exports and penalizes imports. (Actually, it just puts them on the same footing.) In 1996, Senate Democrats introduced a tax package that would have replaced the current corporate income tax with a VAT.

While it is too soon to say whether the United States will follow Europe to a VAT, the European experience with the tax is certain to play a major role in the debate.

XI. Other Tax Issues

The Marriage Penalty

Many married couples pay more taxes than they would if they were unmarried. This penalty can amount to several thousand dollars per year even for moderate-income families. The 1993 tax increase made the problem worse. The House Republicans' Contract With America proposed abolishing the marriage penalty altogether.

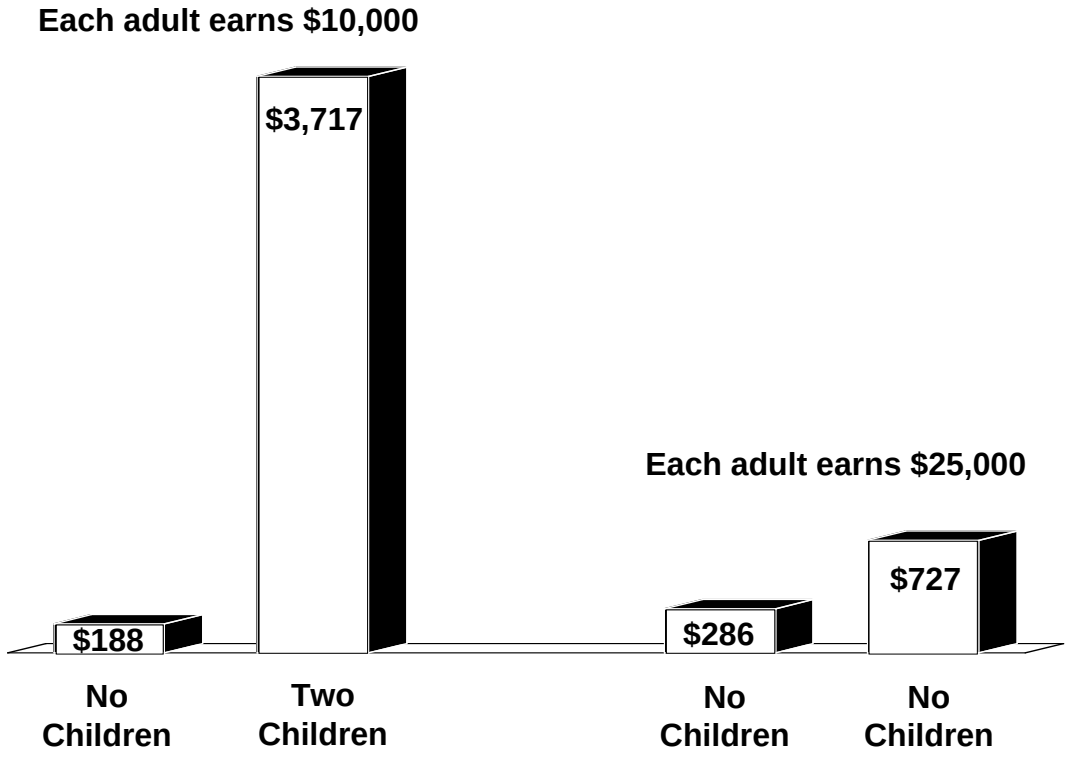
The History of the Penalty. Prior to 1948 the tax code made no distinction between married couples and individuals. In that year Congress changed the law to allow income splitting. In effect, couples were taxed like two single taxpayers even if only one earned income. The result was to sharply lower tax rates for married couples, creating a de facto subsidy for marriage.

"The marriage penalty can amount to several thousand dollars per year."

By 1969 this subsidy had grown so large that a single person could pay 40 percent more in taxes than a married couple with the same income. This

FIGURE XI-1

The Marriage Penalty



Source: Daniel R. Feenberg and Harvey S. Rosen, "Recent Developments in the Marriage Tax," National Bureau of Economic Research Working Paper No. 4705, April 1994, p. 20.

led Congress to create separate tax schedules designed to reduce the marriage subsidy to no more than 20 percent.

An unintended consequence of the 1969 law change was to create the first marriage penalty. The penalty was most likely to emerge when a married couple both worked — important because in the early 1970s the number of working women increased sharply. In 1969 the female labor force participation rate was 42.7 percent; by 1979 the rate had risen to 50.9 percent. Thus as more women entered the labor force, an increasing number of couples were subject to the marriage penalty.

Why Is There a Penalty? The basic reason is our progressive tax rates. The second earner in a family (the lower paid of the two) has his or her income added to that of the primary earner and thus is often taxed at a higher marginal rate. For example, under current law, if the primary earner had $22,000 of taxable income, he or she would pay tax at a 15 percent rate. If the secondary earner also made $22,000, the family's total income would be in the next higher tax bracket and the secondary worker would pay 28 percent on the last $4,000 of his or her income. The marriage tax would amount to $520, the difference between 15 percent and 28 percent on the couple's income above $38,000, which is the cutoff for the 15 percent bracket. Were they unmarried, both would pay just 15 percent on all their income.

Congress's first response was to create a special tax deduction in 1981. It allowed couples with two incomes to deduct 10 percent of the earnings of the lower-paid spouse in addition to their other deductions. In 1986, Congress replaced the two-earner deduction with a new standard deduction designed to eliminate the marriage penalty. Although these changes substantially mitigated the penalty, in 1988 some 40 percent of families still paid for being married — a tax price that averaged $1,100.

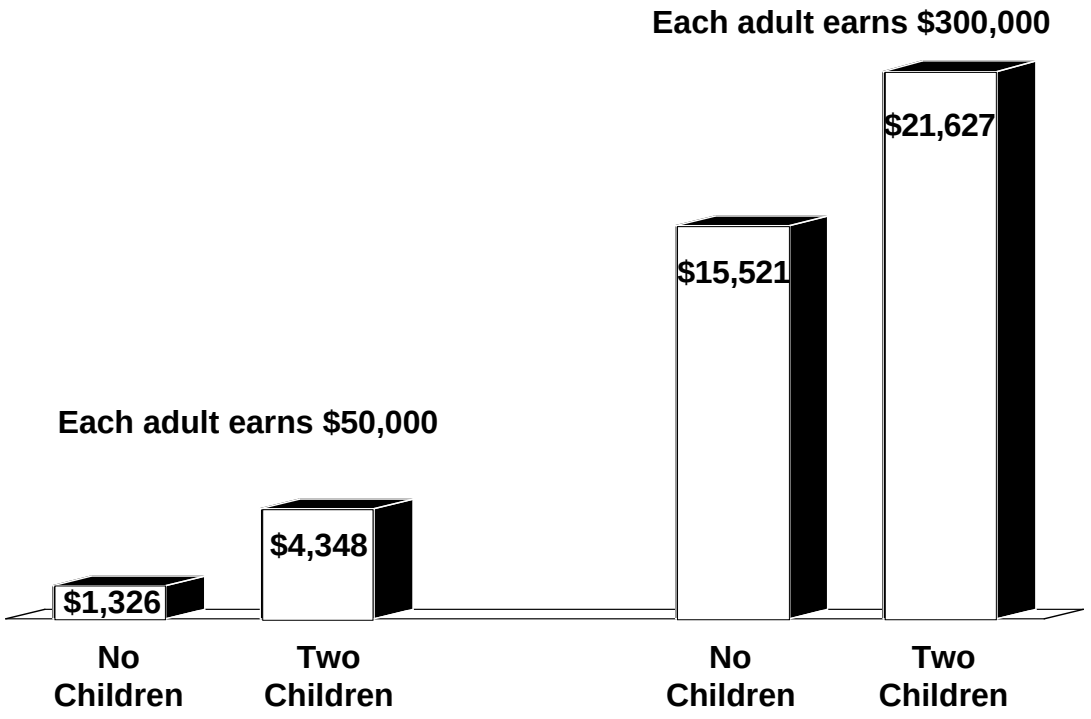
"The 1993 tax increase exacerbated the marriage penalty problem."

Adding to the Burden. The 1993 tax increase exacerbated the marriage penalty problem by creating two new tax brackets, a 36 percent rate beginning at $140,000 of income for married couples and a "millionaires' surtax" of 39.6 percent, which starts at $250,000 of income. The new brackets create more opportunities for the secondary earner to be pushed into a higher tax bracket than if he or she were single.

In addition, 1993 changes in the Earned Income Tax Credit (EITC) had the effect of increasing the marriage penalty. This is because as the credit is phased out it creates a higher de facto marginal tax rate of 21 percent. According to the November 7, 1994 *Forbes*, by 1996 a married couple with four children and income of $11,000 each would get a credit of $1,375. However, if the couple split and each took two children, both would be entitled to a credit of $3,560. Thus they would have a total credit of $7,120, or a $5,745 reward for getting divorced. On a total income of $22,000 per year, their penalty for being married would be enormous.

FIGURE XI-2

The Marriage Penalty



Source: Daniel R. Feenberg and Harvey S. Rosen, "Recent Developments in the Marriage Tax," National Bureau of Economic Research Working Paper No. 4705, April 1994, p. 20.

The Child Penalty. The Clinton tax changes increased the marriage penalty for the rich and the poor. Those in the middle were largely unaffected. But the changes also penalized married couples with children more than those without children.

Take a couple each earning $10,000 a year. As Figure XI-1 shows, if they have no children, the marriage penalty is $188. If they have two children, the penalty soars to $3,717. That is a tax of $1,265 per child

"The penalty for a couple earning $50,000 each is $1,326 if they have no children and $4,348 if they have two — a penalty of $1,511 per child."

As Figure XI-2 illustrates, the penalty for a couple earning $50,000 each is $1,326 if they have no children and $4,348 if they have two — a penalty of $1,511 per child. And a couple earning $300,000 each pays a penalty of $15,521 if they have no children and $21,627 if they have two — a penalty of $3,053 per child.

Abolishing the Penalty. The Republican Contract With America proposed eliminating the marriage penalty altogether. Since the penalty results partly from the effects of a tax subsidy program, the net cost of eliminating it would be only about $6 billion on a static basis. But since this effectively would entail abolishing the EITC, it is not likely to be done because it would constitute a large tax increase on the poor. If the penalty were eliminated only

for those with a positive tax liability, the cost would be $33 billion. The latest increase, obtained by Clinton, could be repealed for $10 billion.

In the end, the only sure way to abolish the marriage penalty may be to abolish progressivity altogether and institute a flat-rate income tax, such as that proposed by Rep. Dick Armey.

Do Higher Cigarette Taxes Make Sense?

The good news is that higher cigarette taxes cause people to quit smoking. The bad news is that as fewer people smoke, the federal government gets far less revenue from cigarette tax hikes than many people expect. And to the extent that higher cigarette taxes increase federal revenues, they take most of the money from the families that can least afford it.

"Higher cigarette taxes would take most of the money from those who can least afford it."

The Case for Higher Cigarette Taxes. In 1993, President Clinton and the Democratic leadership hoped to pay for health care reform in large part by increasing taxes on tobacco products. The original Clinton bill would have added a 99-cent tax on every pack of cigarettes to the current federal tax of 24 cents and state and local taxes of about 28 cents. The versions of the Clinton plan introduced by Sen. George Mitchell (D-ME) and Rep. Richard Gephardt (D-MO) would have increased the federal cigarette tax to 69 cents a pack, while the Senate Finance Committee health bill would have raised the tax to $2.24 a pack.

Proponents argued that an increase in federal tobacco taxes would offset some of the burdens smokers place on the economy. The tax increase also would, they said, deter people from smoking.

Are these arguments sound? Let's take a closer look.

Do Smokers Impose Costs on the Rest of Society? Apparently some, but less than most people think. The Centers for Disease Control contends that smokers incur $50 billion in health care expenses — an amount equal to $2.06 per pack at current smoking levels. However, smokers mainly pay their own way. Of the $2.06, only 89 cents represents costs for nonsmokers — primarily borne in the form of taxes to support Medicare and Medicaid.

Moreover, smokers create a positive if ghoulish benefit for nonsmokers. Because they die earlier, smokers avoid health care expenses that might have otherwise been incurred over a longer life. They also save society money in Social Security payments and private pension benefits. When that element is factored in, a Rand Corporation study found that the net cost smokers create for nonsmokers equals about 28 cents a pack at 1993 prices.

Is an Increase in the Tobacco Tax Needed to Make Smokers Pay Their Own Way? No. Since current federal and state taxes total 52 cents a pack, smokers are paying more than their fair share.

"Smokers are paying more than their fair share."

Granted, there is some dispute about whether 28 cents is the right estimate. That number does not include the effects of secondhand smoke, which the Environmental Protection Agency (EPA) says causes 3,000 lung cancer deaths a year. Yet the EPA conclusion is based on a controversial review of other studies and is not taken seriously by most scholars.

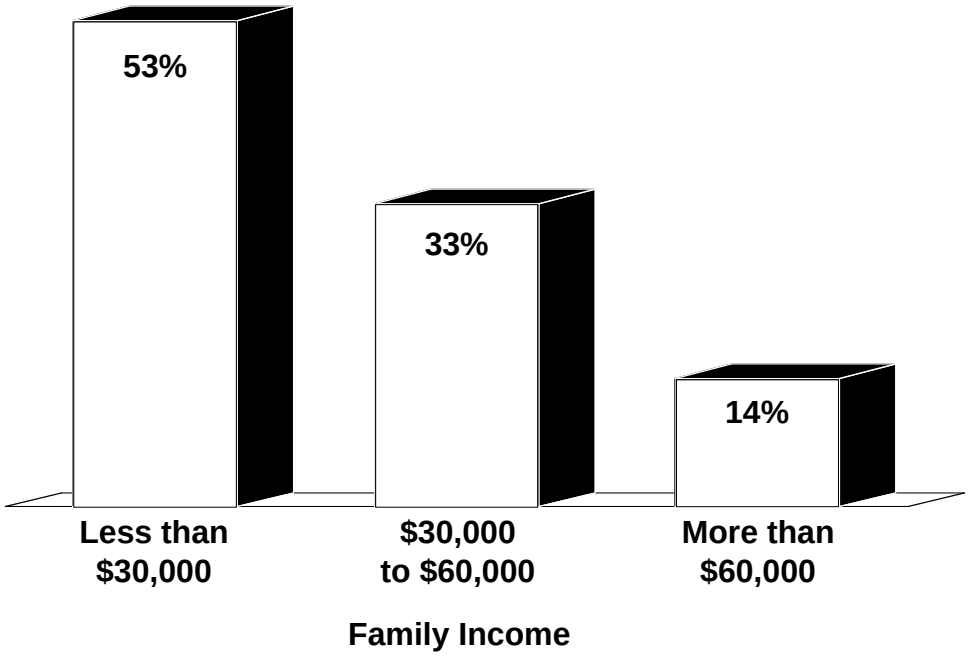
A more profound problem is that the Rand estimate omits the extra costs of miscarriages and neonatal intensive care attributed to pregnant women who smoke. Yet all things considered, the Congressional Research Service is probably correct to conclude that the external cost argument does not justify any increase in tobacco taxes.

Who Pays Tobacco Taxes? Primarily, lower-income families. Other things equal, the lower a person's income, the more likely that person is to smoke. For that reason a tax on tobacco is perhaps the most regressive of taxes — even more regressive than taxes on beer, wine or gasoline. A study by KPMG Peat Marwick found that:

- Families making less than $30,000 per year pay more than half of all the taxes paid on cigarettes.

FIGURE XI-3

Who Pays Cigarette Taxes?



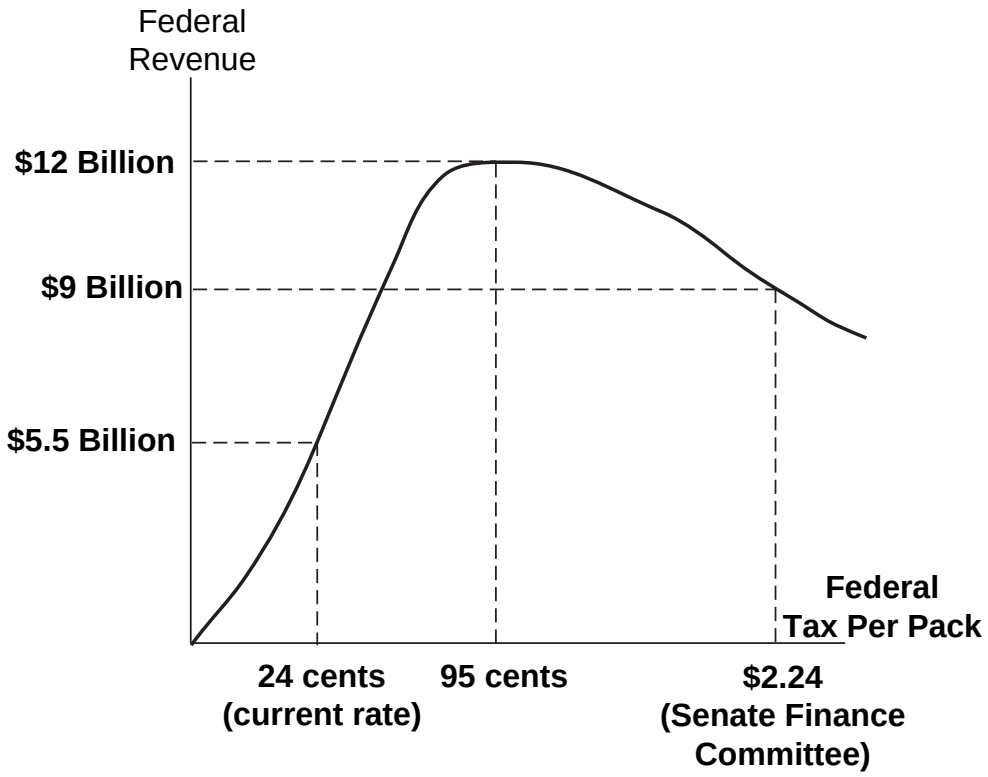
Note: The figure shows the share of all cigarette taxes paid by different income groups.

Source: "Measuring the Impact of Increasing Excise Taxes on the Progressivity of the Federal Tax System," The Policy Economics Group, KPMG Peat Marwick, March 1993.

"The most additional revenue cigarette taxes could raise is about $6.5 billion."

FIGURE XI-4

Revenues From Cigarette Taxes



Note: Includes the effects of state and local taxes of about 28 cents per pack.

Source: Gary S. Becker and Michael Grossman, "And Cigarette Revenues Up in Smoke," *Wall Street Journal*, August 9, 1994.

- By contrast, families making more than $60,000 pay only 14 percent.
- As a percent of income, lower-income families bear almost five times the burden of high-income families.

Do Higher Cigarette Taxes Cause People To Quit Smoking? Yes. And that might be a justification for a higher tax. But the more people quit, the less revenue would be collected.

Nobel prize winner Gary Becker and his colleague Michael Grossman estimate that if the federal cigarette tax were increased to 95 cents, smoking would be cut in half. At a tax of $2.24, cigarette consumption would go down by 73 percent. It would take several years to get the full effect of the drop-off, as some people smoked less, some quit smoking altogether and teenagers, who are especially sensitive to price, decided not to smoke.

Despite the fact that tobacco may be addictive, the U.S. evidence is that smokers respond to economic incentives. There is evidence from other countries as well. Since 1982, Canada has doubled its cigarette tax to $6 a pack and cigarette consumption has dropped by 40 percent.

How Much Additional Money Could Be Raised from Higher Tobacco Taxes? Economists Becker and Grossman estimate that a 10 percent increase in cigarette taxes eventually leads to an 8 percent decrease in cigarette consumption. Above a tax rate of about 95 cents, further increases in the tax rate would lead to lower tax revenue. (See Figure XI-4.) The most additional revenue that can be raised with cigarette taxes is about $6.5 billion, say the economists, not the $30 billion that the antismoking lobby claims.

Even if Little Revenue Is To Be Raised, Should We Increase Cigarette Taxes To Discourage Smoking? Not if we want to be consistent in our social policies.

There is no question that we could begin to change people's behavior with taxes on saturated fat, unsafe sex and such risky activities as hot air ballooning, scuba diving, hang gliding and motorcycle riding. But we do not.

"Living in a free society means being free to take risks."

Part of what living in a free society means is having the right to take risks without asking others' permission and without paying others a fee for the privilege of exercising that right.

Acknowledgments

This book is based in part on research and writing by the following individuals:

John C. Goodman, President of the National Center for Policy Analysis. Dr. Goodman is the author of seven books and numerous articles. He has written widely on health care, Social Security, privatization, welfare and other public policy issues. In 1988, he won the prestigious Duncan Black aware for the best scholarly article on public choice economics.

Bruce Bartlett, Senior Fellow, NCPA. Mr. Bartlett was Deputy Assistant Secretary for Economic Policy, U.S. Department of the Treasury, from 1988 to 1993 and Senior Policy Analyst in the White House Office of Policy Development from 1987 to 1988. He served as Executive Director of the Joint Economic Committee of Congress from 1983 to 1984, and as Deputy Director from 1981 to 1982. He is the author of four books, and his twice weekly column on economic policy is nationally syndicated.

Barry J. Seldon, Associate Professor of Economics and Political Economy, University of Texas at Dallas, and Senior Fellow of the NCPA. Dr. Seldon's publications have spanned topics from research and development and advertising to public finance, public choice and political support. His research often considers the impact of and private-sector response to public policy.

Roy G. Boyd, Professor of Economics at Ohio University. Dr. Boyd developed a computer general equilibrium model of the United States economy for the U.S. Department of Agriculture, and has modeled the national economies of Mexico and the Philippines. His research has often focused on the effects of tax policies on the natural resource sectors of the economy.

Joe Barnett, writer/researcher, NCPA. Mr. Barnett is editor of *Policy Digest*, NCPA's daily summary of public policy research, and is assistant editor of the bimonthly *Executive Alert.* He also edits studies and other publications for the institute. He has been a legislative assistant to U.S. Congressman Ron Paul and a graduate teaching assistant.

About the NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute, funded exclusively by private contributions. The NCPA developed the concept of Medical Savings Accounts, which are included in the 1996 health care bill passed by Congress and have been adopted by a growing number of states. Many credit NCPA studies of the Medicare surtax as the main factor leading to the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, that a capital gains tax cut would increase federal revenue and that the federal government gets virtually all the money back from the current child care tax credit. Its forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free enterprise health care task force report, written by 40 representatives of think tanks and research institutes, and a first-of-its-kind, pro-free enterprise environmental task force report, written by 76 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. According to NCPA reports:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

What Others Say About the NCPA

"...influencing the national debate with studies, reports and seminars."

— TIME

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— CHRISTIAN SCIENCE MONITOR

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— EVANS AND NOVAK