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The House Plan to Cut Taxes

Any tax relief is to be welcomed, but the tax cuts passed by the Republican majority in the House are a hodgepodge and more similar to the Democrats' "targeted" tax breaks than to the modern Republican goal of reducing taxes at the margin. Some aspects of the bill have considerable merit from the standpoint of equity but, as they represent a pure loss of revenue with little effect on the disincentives of the tax code, we believe they could be done more efficiently. Where the bill cuts tax rates, we believe that its provisions are overly complex and excessively limited, in the instance of gains taxes, and an unwarranted handout in the instance of Social Security benefits.

The House passed the "Contract with America Tax Relief Act" in April. It remains to be seen how much, if any, of the proposal will become law. Republicans appear to be split on whether they should cut taxes this year or apply and spending cuts toward deficit reduction. House Speaker Newt Gingrich, among others, insists that taxpayers ought to reap directly the benefits of anticipated cuts in the growth of spending and claims that Congress can eliminate the deficit over 7 years even if taxes are cut. Others, including Pete Domenici, chairman of the Senate Budget Committee, prefer to reduce the deficit first and cut taxes later. Just 2 weeks ago, Republicans in the Senate voted against including tax cuts in their bill to balance the budget. If the House and Senate eventually agree on a compromise tax cut plan, there remains the possibility that President Clinton will veto it.

If a bill is enacted, almost certainly its goal will be, as the title of the House plan suggests, tax relief rather than tax reform. Major changes in the tax system may yet happen: Gingrich and Sen. Dole have appointed Jack Kemp to head a national Commission on Economic Growth and Tax Reform, which will review the current tax system and propose broad changes in keeping with the Republican goals of fairness, simplicity, and reducing the distorting effect of taxes on decisions to work, save, and invest. The committee's proposals could include switching to a single-rate, so-called flat income tax, which Rep. Dick Armey and Sen. Arlen Specter endorse, or scrapping the income tax altogether in favor of a consumption tax, which Rep. Bill Archer supports. Kemp favors a "flat, fair, and simple postcard system." In any event, the Commission will not present its recommendations until late this year or early next year. In the meantime, Congress is likely to consider various modifications of the House plan, which would tinker with the current tax system rather than overhaul it.

The plan is a hodgepodge of tax breaks, the aims and beneficiaries of which are indicated by the inflated titles of its subsections: American Dream Restoration, Senior Citizens' Equity, Job Creation and Wage Enhancement, Family Reinforcement, and Social Security Earnings Test. In short, there is something for everyone, but, as discussed below, some of the proposals have more merit than others.

New Tax Credits

The House plan provides for four new tax credits. The one that would affect the most taxpayers is a credit of $500 per child that a taxpayer claims as a dependent. This is to be phased out on incomes over $200,000. Both the credit and the phase-out threshold would be indexed annually for price inflation after 1996.

In our view, this credit would advance the cause of horizontal equity, *i.e.*, the goal of having people in similar taxable circumstances pay similar amounts of tax. The current system of a $2,450 tax exemption and a $600 tax deduction for dependents translates into a maximum tax savings of $1,200. This is an insultingly inadequate adjustment for the financial burdens of child rearing. The savings are even less for most families because exemptions and deductions are worth less to lower bracket taxpayers. In contrast, a tax credit is worth more to lower income taxpayers, because it reduces their taxes by a larger percentage. (The $500 credit is the

To our readers: As many of you may know, a tornado struck Great Barrington, Massachusetts, in the early evening of Monday, May 29th. The storm's path followed a course about 3 miles distant from AIER's campus, which suffered no damage. The homes of our staff were spared as well. As shown in the above photo, however, others in the community were not so lucky. We are grateful for the many calls we received from concerned well wishers both here and abroad, and are happy to be able to say that our work continues without interruption.

equivalent of an additional $3,333 exemption to people in the 15 percent tax bracket but only a $1,262 exemption for those in the top bracket.)

We believe that the credit could be made even larger, and refundable, if it replaced the dependent exemption and the complex, fraud-ridden, earned income credit. We also believe that the credit should not be phased out for high income taxpayers. At any given income level, taxpayers with no dependents clearly are better off financially than taxpayers with dependents.

The House plan also proposes a tax credit of $500 for taxpayers providing custodial care to parents or grandparents living with them. Under current law, taxpayers can claim a personal exemption for parents or grandparents whom the taxpayer financially supports. The credit would provide additional relief to such taxpayers, and would be more equitable than simply enlarging the exemption for the reasons discussed above. However, the credit also would give a break to taxpayers who may not be incurring any expenses to care for sick parents or grandparents at home. Unlike children, older people usually have financial resources of their own, such as savings, pensions, Social Security, and the proceeds from the sale of a home. Taxpayers caring for parents could, and some undoubtedly do, tap into these resources to cover the costs of providing them with care and shelter. In situations where the parent has sufficient financial resources, this credit is hard to justify.

The third tax credit would reduce by up to $145 the so-called "marriage penalty." This is the tax code anomaly that results in married couples paying more taxes than unmarried couples. The amount of the credit would be the excess of the joint tax over the sum of the taxes for each spouse if they were single. This could be messy to calculate, the more so because the proposal would take only earned income (wages and salaries) into account. It is not clear whether the proposed new IRS table to be used to figure the credit would make things easier. Nevertheless, no one would argue that couples should pay more taxes because they have a marriage license, and the credit would help reduce this inequity.

The House plan provides another tax credit of up to $5,000 for the costs of adopting a child. This would be phased out on incomes over $60,000 and eliminated for incomes over $100,000. Assuming their adoption costs were at least $5,000, this could reduce the Federal tax liability of many couples to zero in the year of adoption. If the intention here is to reward adoption, the credit should be available to all taxpayers regardless of income. If the goal is to provide an adjustment for the high initial costs of adding a child to the family, it would be more equitable to extend the credit to reimburse parents for uninsured expenses associated with the birth of a child.

Expanded IRAs

The House plan would expand individual retirement accounts (IRAs). Currently, taxpayers may contribute up to $2,000 per year to an IRA, and depending on their income and pension coverage at work they may deduct all, part, or none of their contribution from taxable income. The interest, dividends, and capital gains on all IRAs accumulate tax free, but these and any deductible contributions are taxed when withdrawn. The House plan creates a new American Dream Savings Account (ADS) that would be similar to a nondeductible IRA except that certain withdrawals would be tax free. To qualify for this exclusion, taxpayers would have to maintain the account for at least 5 years, and either be over age 59½ when they withdraw funds or, if younger, use the withdrawal to cover the cost of buying a first home; to pay for the higher education of the taxpayer, a spouse, child, or grandchild; or to pay for certain medical expenses, including the cost of premiums paid for long-term care insurance. Withdrawals not meeting these requirements would be subject to the usual taxes and penalties.

Unlike IRAs, taxpayers over age 70½ could contribute to ADS accounts and would not have to take any mandatory distributions. The maximum annual contribution to an ADS would be $2,000 in 1996 and indexed thereafter for price inflation. (Had the current $2,000 limit on IRAs been indexed since it was set in 1982, it would now be more than $3,000.) Through 1997, individuals could roll over existing IRA funds into ADS accounts, but they would not thereby escape paying income tax on these funds: rollovers would be taxed as income, although this income would be treated as if it were received over 4 years and there would be no tax penalty for early withdrawal.

These looser restrictions make nondeductible IRAs more attractive than they have been, but whether they will lead to an increase in overall savings is less clear. Most of the people eligible to make IRA contributions, even deductible ones, do not. They either do not have the money or do not wish to put it into these restricted accounts. Many of the those who do contribute simply shift savings into the account to take advantage of the tax-favored treatment. It is likely that the same thing would happen with ADS accounts: many people with savings will transfer currently held funds into the new accounts, while future savings will be channeled into them as a substitute for, rather than a supplement to, other savings accounts.

Social Security Benefits

The House plan would repeal President Clinton's 1993 increase in the tax on Social Security benefits. Currently, benefits for lower income taxpayers are tax free, while taxpayers with incomes above $25,000 (single persons) or $32,000 (joint returns) are subject to tax on up to 50 percent of their benefits, and those with incomes above $34,000 ($44,000 on joint returns) pay tax on up to 85 percent of their benefits. The bill would gradually roll back the 85 percent rate to 50 percent by 2000.

Critics of taxing Social Security benefits above a certain income threshold often claim that this "punishes the successful," *i.e.*, individuals with relatively high incomes. In our view, people with substantial incomes should not be receiving Government checks, period. That they can do so through Social Security helps explain why most workers now pay more in payroll taxes than they do in income taxes. In any case, we believe that Social Security benefits should be treated for tax purposes the same as income from pensions, wages, interest, or dividends. They should be taxed as ordinary income.

One argument against this approach is that taxing benefits would hurt retirees who depend on their Social Security income to get by. However, any income tax liability would reflect the taxpayers' financial circumstances. Retirees with low incomes (presumably the truly needy fall into this category) would pay no tax, while those with higher incomes would pay the same taxes as people who have similar incomes but derive them from sources other than Social Security.

Another objection is that Social Security retirement benefits represent a return of the individual's "contributions" to Social Security during his working years. This view reflects the widespread misperception that Social Security is basically a pension plan administered by the Government. In fact, a worker's payroll taxes are not deposited in an account in his name, invested, and returned to him during retirement. The benefits paid out today are financed entirely by payroll taxes collected from the current work force, not by accumulated savings. Leaving this distinction aside, if the tax treatment of benefits were to be made comparable to that of income received from private pension plans, benefits should only be tax exempt up to one's lifetime total of taxes paid as "employee's

contribution." For most people, this amount is much less than the total benefits they collect during retirement.

The House tax bill also proposes to increase the earnings limit applied to people who continue working after they begin to receive Social Security retirement benefits. Currently, benefits are reduced $1 for every $2 or $3 earned above a certain limit, depending on the person's age. For workers aged 65-69, the current $11,280 earnings limit would increase to $15,000 next year and reach $30,000 in 2000. (Presumably the limit for workers aged 62-64, currently $8,160, also would increase, but the amount is not specified in the bill.)

It is another peculiarity of Social Security that a retiree who reports a given income from wages receives a smaller benefit than if he reports the same income from interest, dividends, and other nonwage sources. Reducing benefits on the basis of only labor income is unfair. We do not believe that if the income tax is to be fair, that *any* income should be exempt, especially income from Government programs. Taxing benefit checks would amount to a partial "means-test," without creating another intrusive bureaucracy.

Capital Gains

The House plan would allow individuals to deduct 50 percent of their net capital gains from gross income, retroactive to January 1, 1995. At present, capital gains are fully taxable at the same rates as other income up to a maximum tax rate of 28 percent. Thus the proposed change would effectively reduce the maximum tax on capital gains to 19.8 percent (0.5×39.6, the maximum tax on ordinary income). Moreover, the bill proposes to tax only *indexed* capital gains (gains adjusted for price inflation). Indexing capital gains is a useful reform if done properly. Capital gains accrue over periods of time when the purchasing power of the dollar has diminished. In an environment of chronic inflating, a dollar of nominal gain (which is what currently is taxed) represents less real income than a dollar of, say, wages or dividends, which is earned contemporaneously with the payment of the tax. In fact, many presently held assets now are worth *less* in real terms than when they were purchased, even if their nominal-dollar value has increased. In such instances, a tax on nominal capital gains amounts to a tax on wealth.

Unfortunately, the proposed indexing is unnecessarily complicated and limited in scope. It would apply only to certain assets held by individuals for more than 3 years. Common stock, tangible property used for business, and owner-occupied homes would qualify for indexing, while bonds, collectibles, and other assets would not. Corporate shareholders would not be entitled to index their assets.

In addition, indexing would apply only to price inflation occurring after January 1, 1995. Asset holders would not be compensated for the deterioration of the purchasing power of the dollar prior to 1995.

For qualified assets, the capital gain would be calculated as the difference between the price at which it is sold and its indexed basis. The indexed basis would

The Right Way to Index

As a means of fostering sound economic calculation, indexing is a poor idea. Indexing can never fully substitute for a stable currency. If all transactions and contracts were somehow indexed so that there were no gainers or losers from the debasement of currency, there would, in fact, be no reason not to have stable currency in the first place.

Markets adjust to changing currency values. Today's levels of wages and salaries, consumer prices, dividends, and asset prices of all kinds reflect the decreased real value of the dollar. Although it makes good sense to index tax brackets, exemptions, credits, and other parameters of the tax laws that are denominated in dollars, current payments subject to tax need not be indexed. The major exception to this is where the payments and receipts used to calculate income subject to tax are in dollars of different purchasing power. This is what happens when long-term capital gains are realized and the dollars used to purchase the asset were more valuable than the dollars received when it was sold.

In recognition of this, Congress traditionally has taxed capital gains at a lower rate than it has taxed current income flows. At present this is limited to "capping" the gains tax rate at 28 percent, but historically it has been far more usual for Congress to allow investors to exclude a portion of capital gains, so that the effective tax rate was less than that on other forms of income. This is what the House Republicans now want to do again for gains on assets purchased before 1995.

A lesser rate on capital gains is a singularly ham-handed way of adjusting for the debasement of the dollar. (It also is a strong invitation for accountants and lawyers to devise ways to transform ordinary income into capital gains via "tax shelters" of little economic merit.) To their credit, the House Republicans also want to provide for indexing (adjusting the dollars used for purchases to the purchasing power of the dollars received in sales).

However this is only to apply to the effect of price inflation for years after 1994, and only on specific types of assets (stocks, business property, and owner-occupied homes). That they want to exclude items such as collectibles and second homes from indexing suggests that the House Republicans are no more immune to the fantasy that politicians know what kind of assets are best for the country than were their Democrat predecessors. The exclusion of bonds seems harder to fathom, especially since the "inflation premium" included in interest income is to remain fully taxed.* Perhaps politicians cannot bear the thought of what voters might do if they actually calculated what they have lost every time a fixed-dollar instrument matured.

We believe that the needed reform is to allow for full indexing of the cost basis used to calculate taxable gains or losses — bringing the purchasing power of the dollars used to purchase an asset, and to calculate the gain or loss, up to that of the dollars received and used to pay the tax. To avoid the mischief created by a differential rate on gains, such indexed gains should be fully included in taxable income (on which the top rate should be as low as possible — another issue) and the extent to which capital losses could be used to offset other income should be increased (it has been $3,000 since 1978!) and indexed. As far as we are aware, the major objection to full indexing, which nearly all analysts agree would put the taxation of gains on an equal footing with other forms of income, is the budgeteers simply have no idea how it would affect receipts. This says a lot about the real priorities of our elected officials.

* In 1981, then Secretary of the Treasury Donald Regan proposed excluding a portion of interest receipts from taxable income, to allow for the fact that the "inflation premium" of interest rates rendered a portion of interest payments equivalent to a return of principal. If this were done then there would be no need to index gains and losses on fixed-dollar investments, but Regan's proposal sank without a trace.

be the adjusted basis (the purchase price net of any adjustments) multiplied by the increase in the general price level since the asset was acquired, as measured by the implicit price deflator for Gross Domestic Product. Presumably, this price index was chosen over the more familiar CPI because it includes business equipment and other capital items excluded from the CPI.

Although this calculation sounds daunting, individuals who directly hold indexed assets presumably could use a table to adjust each asset's basis for price inflation. However, it could be difficult for investors who held assets before January 1, 1995 and want to index subsequent gains to determine their market value as of that date.

Investors in mutual funds would face an additional complication. Mutual funds hold portfolios of assets, some of which would qualify as indexable and some of which would not. According to the proposal, the capital gain realized upon selling shares in a mutual fund would be indexable only in proportion to the percentage of indexed assets held by the fund. For example, suppose an investor buys a share of the XYZ Balanced Growth Fund for $10 and sells it 5 years later for $17. Further suppose that XYZ holds 60 percent of its assets in indexed stocks and the rest in bonds, money market funds, and other unindexed assets. The investor would be entitled to index 60 percent of his $7 capital gain for price inflation. Moreover, it is not clear how the capital gains distributions made each year by mutual funds to their shareholders would be treated under the bill. These gains often represent a mixture of gains on the sale of bonds (unindexed) and stocks (indexed) and perhaps would require the same type of proportionate indexing.

This sounds like an accounting nightmare for taxpayers or mutual fund managers or both. The House plan could be made less complex and more equitable by applying indexing to all assets, and basing the adjustment on historical price inflation rather than limiting it to the post-1995 depreciation of the dollar.

If adequate indexing were permitted, one of the rationales for making 50 percent of capital gains deductible would be eliminated. Other arguments have been advanced in support of this deduction, the most common being that a preferential rate on capital gains is needed to encourage initiative, innovation, and risk-taking. However, such incentives can create distortions of their own. Investments in schemes designed to convert ordinary income into subsequent capital gains often divert funds to purposes that contribute little to employment, production, or sound economic growth.

A New Government Trust Fund

The House plan would allow taxpayers to designate on their tax returns that up to 10 percent of their taxes be used to reduce the public debt. Any revenue so designated would go into a new Public Debt Reduction Trust Fund. Unfortunately, like trust funds maintained by the Federal Government for Social Security and other programs, this one would be nothing more than a bookkeeping entry. The Government can only reduce the nominal public debt by eliminating the deficit and running budget surpluses. If it simply diverts a portion of revenues to retiring Treasury bonds when they mature (which is what would happen through the new trust fund), there will be that much less revenue to cover other outlays. The shortfall will have to be covered by additional borrowing. The supposed "reduction" in public debt will be offset by an increase in deficit borrowing, and the net impact on the public debt will be zero.

Other Proposed Changes

Among other things, the House plan also proposes to reduce the alternative capital gains tax on corporations from 35 to 25 percent; allow homeowners to deduct a capital loss on the sale in 1995 or later of their principal residence (currently, no such deduction is allowed); reduce the extent to which taxpayers may use capital losses to offset income (beginning in 1996, it would take $2 in capital losses to offset $1 of ordinary income, instead of the one-for-one offset now permitted); change the rules on depreciation of business property, allow small business to write off more of their capital purchases as expenses, and phase out the application of the alternative minimum tax to corporations; allow more taxpayers to write off the costs of a home office; increase the maximum annual deductible IRA contribution for a married couple with one working spouse, from $2,250 to $4,000; and gradually increase the so-called unified credit for estate and gift taxes, thereby increasing the amount of taxable gifts and legacies exempt from such tax from $600,000 to $750,000 in 1998 (after which this amount, and the current $10,000 annual limit on gifts excluded from tax, would be adjusted annually for price inflation).

The Cost

The changes proposed by the House are estimated to cost $189 billion in lost tax revenue over the next 5 years. In other words, cumulative revenue over this period will be $189 billion lower than it would be if the tax laws were not changed. Although some critics portray this as a major tax cut that the country cannot "afford," it is small in relation to the roughly $7 trillion the Government is expected to collect in revenue over the next 5 years. In any case, revenue projections are notoriously unreliable. They are based on a "static analysis," *i.e.*, changed incentives in the tax laws are assumed not to lead to significant shifts in the economic decisions people make. In the case of the $500 tax credit for children, which accounts for half of the $189 billion cost estimate, this assumption may be reasonable, because marginal tax rates are little changed by the amount of tax credits. In contrast, the proposed changes in the capital gains tax would reduce the portion of any additional capital gain that is taxed away, which *could* lead to an increase in reported capital gains and in capital gains tax receipts. However, no one can say with certainty what the magnitude of this effect would be.

We do not know which portions of the House plan will become law. Both Democrats and Republicans support the $500 per child tax credit, but disagree on the income threshold for eligibility. Reportedly, there is more support for making capital gains partially deductible than for indexing them. The prospects for any tax cuts also depend on whether the recent slowdown in the economy deteriorates into recession. Finally, whether any tax cuts reduce the total burden of Government depends on whether Republicans cut spending as well. The portion of Government not financed by explicit tax revenues is financed by borrowing, which entails interest costs, and hidden taxes associated with inflating. There is a real risk that Republicans will cut the growth of tax revenues but not the growth of spending, thereby repeating the mistake of the Democratic Congresses of the 1980s.

PRICE OF GOLD

	1993	*1994*	*—— 1995 ——*	
	Jun. 3	*Jun. 2*	*May 25*	*Jun. 1*
Final fixing in London	$374.70	$383.25	$385.80	$383.50

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