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HOW CONGRESS CAN DELIVER THE BEST TAX CUT PLAN FOR THE MONEY

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INTRODUCTION

Tax writers in Congress soon will face the tough task of crafting a \$135 billion tax cut package that meets all the commitments made in the recent five-year balanced budget agreement between Congress and President Bill Clinton.¹ This agreement promises to deliver a wide range of tax cuts; specifically, among the things being promised are:

- Tax credits for families with children;
- A reduced capital gains tax rate;
- A reformed death tax (estate tax);
- An expansion of individual retirement accounts (IRAs); and
- Tax assistance for educational expenses.

¹ The "net" size of the tax cut package will shrink to \$85 billion after \$50 billion in proposed tax increases are deducted.

But because the budget deal allots only about 60 percent of the money needed to fully fund all of these commitments, lawmakers face a dilemma: Can they craft a tax plan that delivers the maximum amount of tax relief to the maximum number of Americans without undermining the integrity of each of the individual measures?

The answer is yes. The result by no means would be the perfect tax cut plan; but if Congress's tax writers keep in mind a few simple principles, they can craft tax cuts that work well for families and for the U.S. economy:

1. **Taxpayers must see an immediate benefit from the 1997 budget agreement.** The tax cuts should not be phased in over the next five years in order to reduce their "cost" to the Treasury. Taxpayers should not have to wait until after the turn of the century to see the benefits of this deal.
2. **The tax package must produce good tax policy.** It should not make the current system more complex and thus undermine the future potential for tax reform.
3. **The tax cuts must be broad-based and benefit the greatest number of Americans possible.** Lawmakers should avoid means-testing or other devices that exclude some families to the benefit of others. Moreover, they should not create special or targeted tax breaks that benefit a select group of individuals or industries at the expense of others.
4. **The tax package must aid in the task of balancing the budget.** The tax cuts should be designed to generate the maximum amount of jobs and economic growth. Tinkering with some tax cuts may reduce their "static" cost to the Treasury, but they ultimately will fail to produce enough economic benefits to help balance the budget.
5. **The tax cuts must promote good economic actions and not lead to unintended detrimental consequences.** Tax cuts for education, for example, should promote long-term savings rather than subsidize college fees or encourage more family debt. Subsidizing college fees and debt will boost higher education costs, whereas long-term savings will control higher education costs.

THE HERITAGE TAX CUT PLAN

Based on these simple principles, Heritage Foundation analysts have crafted a sound tax cut plan that can deliver the maximum tax relief to aid America's families while promoting job creation and economic growth. Specifically:

1. About 82 percent of the tax cuts in the Heritage plan are designed specifically to benefit American families.
2. The remaining 18 percent of the tax cuts are designed to generate greater investment and economic growth than possible under the current policies.
3. This new growth would lead to \$2,000 in higher disposable annual income for the average American household and an average of 281,000 more jobs per year over the next five years.
4. Some 73 percent of all taxpayers who would benefit from the Heritage tax cut plan currently have regular² incomes below \$75,000 per year, and 82 percent have regular incomes below \$100,000 per year.

As shown in Table 1 and illustrated in Charts 1 and 2, the central elements of the Heritage Foundation tax cut plan include:

1. **A \$500-per-child tax credit for 25 million families earning up to \$110,000 annually and caring for 47 million children under the age of 18.** Over 87 percent of the families eligible for this credit earn below \$75,000 per year, and 97.7 percent earn below \$100,000 per year. For the typical family with two children, \$1,000 in tax relief would pay for one monthly mortgage payment and a month of groceries. Families could begin taking advantage of this \$500-per-child credit in filing their April 1998 tax returns.

Amount of tax relief over five years: \$72.7 billion.

2. **A “back-ended” HOPE education savings account that would make the buildup of earnings in all state-based savings plans and all private savings plans tax-free.** This plan would help the families of 19 million children save for college.

Amount of tax relief over five years: \$5.2 billion.

3. **An extension of the \$500-per-child tax credit to cover dependents between the ages of 18 and 21.** This part of the \$500-per-child credit would cover the majority of college students and could be used to pay for any higher education expense, including room and board, books, or other living expenses. Nearly 8 million college-age students and their families would benefit from such an extension.

Amount of tax relief over five years: \$16.8 billion.

4. **A 50 percent exclusion of individual capital gains declarations and a 20 percent reduction in the tax rate for corporate capital gains.** Reducing the taxes levied on capital gains would produce an immediate gain in federal revenues and a solid, sustainable boost to the general economy. Lower capital gains taxes encourage large and small investors to move their funds from less productive to more productive companies, thus freeing an estimated \$7 trillion in assets currently locked up because of high taxes.

Amount of net tax relief over five years: \$23.8 billion.

5. **Reform of the death tax by increasing to \$1 million the value of estates excluded from taxation and extending the time taxpayers have to pay the death taxes.** Federal law currently permits estates of \$600,000 or less to avoid death taxes. Increasing to \$1 million the threshold at which estates would be subject to death taxes will take nearly half of all taxable estates off the tax rolls.

Amount of tax relief over five years: \$10.6 billion.

6. **An “American Dream” savings account or IRA.** This new IRA feature would allow workers to put up to \$2,000 in after-tax dollars into a retirement account but be able to withdraw the buildup tax free once they retired.

Amount of tax relief over five years: \$2 billion.

2 “Regular” income includes income from all other sources except capital gains.

Heritage economists employed the most current and extensive data available to estimate the effects of these policy changes. Analysts constructed each of the revenue estimates shown in Table 1 from data contained in the Bureau of the Census Current Population Survey, the Internal Revenue Service (IRS) Public Use File for 1993, or both. The annual Current Population Survey represents the largest regularly produced collection of demographic data available to the general policy community. The IRS Public Use File is the largest machine-readable sample of individual income tax returns available. Both databases contain tens of thousands of observations selected by the Census or the IRS using stratified random sampling techniques, and each database accurately reflects the true, real world values for variables used in this Heritage analysis. The dynamic analyses were conducted using the WEFA Group's Mark 11 economic model.³

Table 1

Heritage Foundation Tax Cut Plan

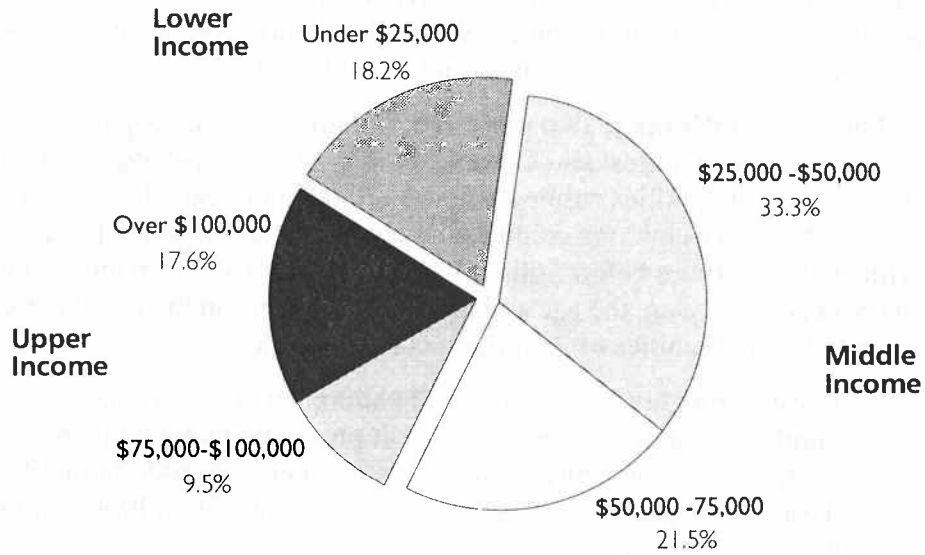
Tax Cut Recommendation	Effective Date	1997	1998	1999	2000	2001	2002	Total FY 1998 to FY 2002
Tax Cuts for Families								
1) \$500-Per-Child Tax Credit for dependents under age 18. Phased out for families earning above \$110,000	7/1/97	-\$2.78	-\$9.16	-\$17.90	-\$17.40	-\$16.80	-\$16.10	-\$77.36
2) Create a \$500-Per-Child Credit for 18 to 21-year-old dependents. Phased out at \$110,000 in income	7/1/97	-\$0.23	-\$3.50	-\$3.43	-\$3.37	-\$3.29	-\$3.19	-\$16.78
3) Create a HOPE Education Savings Account Unlimited nondeductible contributions	10/1/97	\$0.00	\$0.80	-\$1.20	-\$1.60	-\$1.60	-\$1.60	-\$5.20
4) "American Dream" Savings Account	10/1/97	\$0.00	\$1.20	\$1.60	\$1.00	\$0.20	-\$2.00	\$2.00
5) Estate and Gift Tax Reform: Raise threshold to \$1 million	1/1/97	\$0.00	-\$0.66	-\$1.35	-\$2.08	-\$2.88	-\$3.68	-\$10.65
Total Tax Cuts for Families		-\$3.0	-\$11.3	-\$22.3	-\$23.4	-\$24.4	-\$26.6	-\$108.0
Tax Cuts for Jobs and Economic Growth								
1) 50 Percent Exclusion on Individual Capital Gains	1/1/97	\$1.20	\$14.40	-\$3.50	-\$6.60	-\$9.90	-\$10.90	-\$16.50
2) Cut the Corporate Capital Gains Tax Rate from 35% to 28%	1/1/97	-\$0.60	-\$1.30	-\$1.40	-\$1.40	-\$1.50	-\$1.60	-\$7.20
Total Tax Cuts for Jobs and Economic Growth		\$0.6	\$13.1	-\$4.9	-\$8.0	-\$11.4	-\$12.5	-\$23.7
Total Five-Year Tax Cut Plan		-\$2.4	\$1.8	-\$27.2	-\$31.4	-\$35.8	-\$39.1	-\$131.7

Source: Heritage calculations; see Technical Appendix.

3 The WEFA Group's Mark 11 U.S. Macroeconomic Model was developed in the late 1960s by Nobel Prize-winning economist Lawrence Klein and several of his colleagues at the University of Pennsylvania's Wharton School of Business. It is widely used by *Fortune* 500 companies and by prominent federal agencies and economic forecasting departments.

Chart 1

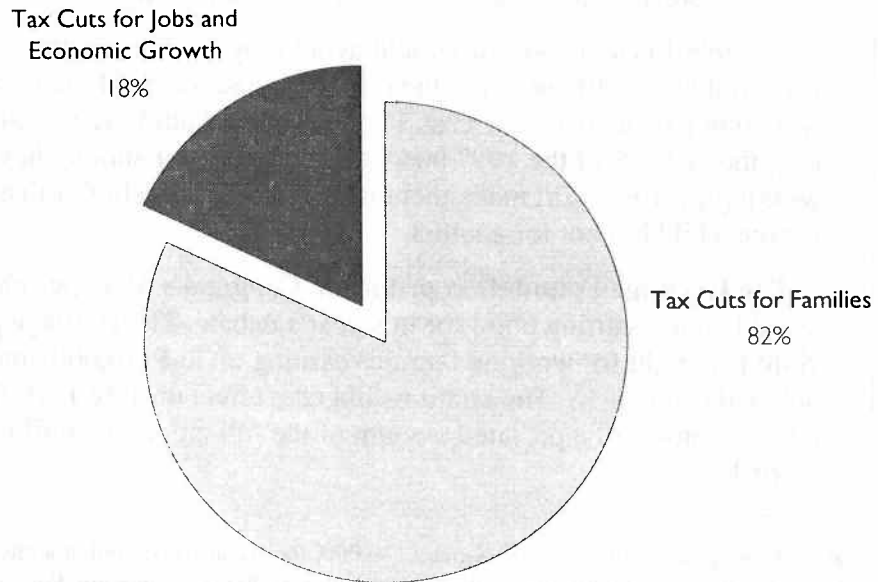
Estimated Distribution of Total Tax Relief by Income Group



Note: Figures do not include impact of IRA or Education Savings Account proposals.
Source: Heritage calculations; see Technical Appendix.

Chart 2

Families Benefit Most from Heritage Tax Cut Plan



Source: Heritage calculations; see Technical Appendix.

TAX CUTS FOR FAMILIES

The \$500-Per-Child Tax Credit

There is broad agreement in Washington, D.C., that working families with children are overtaxed and that tax credits for children should be included in this year's tax cut package. Members of Congress and the White House, however, have put forward very different proposals for delivering tax cuts to families with children.

The President's plan. Two years ago, Congress passed (as part of the Balanced Budget Act of 1995, which President Clinton vetoed) a \$500-per-child tax credit for children under age 18 in families earning below \$110,000 per year.⁴ By contrast, Clinton has proposed a \$300-per-child tax credit for dependent children below the age of 13 in families with annual incomes below \$60,000.⁵ When the President's plan is compared with Congress's tax credit plan, the age and income restrictions in the Clinton proposal would deny tax relief to the families of 23 million children.⁶ Specifically:

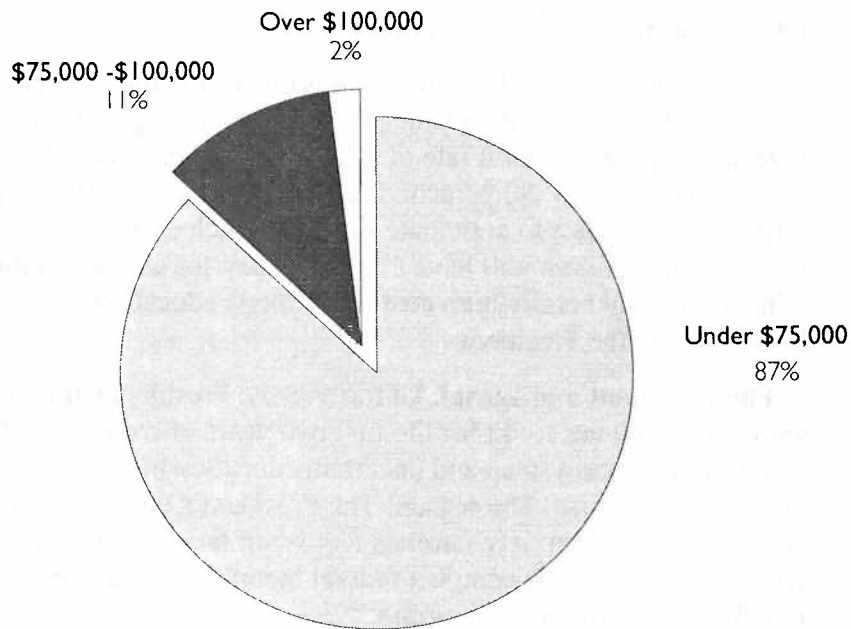
- Because roughly 25 percent of all children are over the age of 12, millions of families would be denied a tax cut at precisely the time in which the cost of raising a child becomes more expensive. This provision in the President's proposal denies tax relief to the families of at least 2.8 million children earning under \$30,000 per year.
- Although some 87 percent of all children live in families earning below \$75,000 per year, the Administration's income restriction would deny \$2.6 billion in tax relief to nearly 6 million families with children who are eligible under Congress's plan.
- Worse still, families would have to wait until tax year 2000 for the value of the President's tax credit to increase to \$500 per child.

Congressional tax writers should avoid ploys such as further means-testing the \$500-per-child tax credit, lowering the eligibility age for children, or phasing in the credit as a way to reduce its five-year cost. Families should not have to wait until the next century to reap the benefits of the 1997 budget agreement. Nor should they have to discover that working overtime will make them ineligible for tax relief or that they would get a tax cut for one child but not for another.

The Heritage Foundation proposal. Congress's \$500-per-child tax credit proposal should be the starting point for this year's debate. The Heritage plan includes a \$500-per-child tax credit for working families earning up to \$110,000 annually with dependents below the age of 18. The credit would take effect on July 1, 1997, so that families could take advantage of a prorated amount of the full credit when filing their tax returns next April 15.

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- 4 For taxpayers filing jointly with incomes above \$110,000, the credit phases out at a rate of \$25 for each \$1,000 above the threshold (a range of \$20,000), thus fully phasing out at \$130,000 in income. For single filers, the credit begins to phase out at \$75,000 in income.
 - 5 The Administration's \$300-per-child credit begins phasing out for families with incomes above \$60,000 and reaches zero at \$75,000 in family income. The credit increases in value to \$500 per child in tax year 2000.
 - 6 For a complete analysis of these differences, see Scott A. Hodge, "Balanced Budget Talking Points #5: Clinton's \$300-Per-Child Tax Cut Plan Denies Tax Relief to 23 Million Children," Heritage Foundation *F.Y.I.* No. 78, December 11, 1995.

\$500 per-Child Tax Credit Benefits Middle-Income Families



Source: Heritage calculations; see Technical Appendix.

Unlike Congress's proposal, the Heritage plan would include a Dependent Care Tax Credit (DCTC) bonus option. Under current law, working families with children in day-care settings can deduct between 20 percent and 30 percent of a maximum of \$2,400 in professional child care expenses. The average value of the DCTC claimed by families is \$249 per child.⁷ The Heritage plan would allow these families to take either the DCTC or the new \$500-per-child tax credit—whichever is of greater value to them—but not both. Most families would choose the new \$500-per-child tax credit because of its greater value and the fact that it would not be limited to daycare expenses.

This bonus option would lower the five-year cost of the \$500-per-child tax credit plan while still guaranteeing that 25 million families, who care for 47 million children, would be eligible for the full \$500 in tax relief for every child. Over five years, this plan would deliver \$77 billion in tax relief to families with children.

Among other benefits of the \$500-per-child tax credit plan:

- For a typical family of four, \$1,000 in tax relief would pay the mortgage and feed the family for one month, or pay the utility bills for 11 months, or buy nearly 20 months of clothing for the children.
- For a family with two children and earning \$30,000 per year, the \$1,000 in tax relief would cut their income tax burden by 51 percent. Meanwhile, a family of four earning \$40,000 per year would see their tax burden cut by 30 percent, a family earning \$75,000 would see their tax burden reduced by 12 percent, and a family earning \$100,000 per year would receive a tax cut of just 7.4 percent.

7 The Heritage Foundation analysis was based on 1993 IRS Public Use Files.

- As shown in Chart 3, at least 87 percent of the overall benefits of the \$500-per-child tax credit plan would go to families with adjusted gross incomes below \$75,000 per year—middle-income families by any standard—and over 98 percent would go to families earning below \$100,000 annually.

Helping Families Afford College

The rising cost of higher education is one of the major concerns facing American families today. Over the past 18 years, the cost of a college education has increased some 221 percent, while the general rate of inflation and the average household income have increased only about 80 percent. Furthermore, the cost of college is uncertain, making it difficult for families to anticipate just how much they must put aside or how much debt they or their children will have to incur to pay for a college education. Both the uncertainty and the generally high cost of a college education are matters of concern to Congress and the President.

The President's proposal. Unfortunately, President Clinton's proposed HOPE scholarship—a \$1,500 tax credit for the first two years of college—is the wrong policy for American families facing steep and uncertain education bills. In fact, the President's plan would make matters worse. The reason: The President's HOPE scholarship would inflate tuition costs,⁸ ignore the anxiety families feel when faced with uncertain college costs, further complicate an already complex federal income tax code, and create a new and costly middle-class entitlement program.

The Heritage Foundation proposals. Congress can deliver tax relief for higher education but without the harmful effects of the President's plan. The following two proposals would help the families of 19 million children save for college as well as an additional 8 million families with dependent children already in college. Moreover, these proposals would reward families who work hard and save for their children's college rather than subsidize consumption and debt.

- **First**, lawmakers should create a new "back-ended" HOPE education savings account (or Super-ESA). This new savings plan would allow families to deposit after-tax income into a long-term savings account or a prepaid tuition plan. Families would be able to meet their children's college costs by withdrawing the buildup of earnings in these accounts tax free. Based on Heritage Foundation estimates, HOPE education savings accounts would provide the families of some 19 million children with \$5.2 billion in tax relief over five years.

The Super-ESA is a perfect complement to the \$500-per-child tax credit. The child tax credit would give families the means to save for higher education, while the Super-ESA would give them the tool to reach that goal. For example, if the parents of a newborn child chose to invest the entire \$500 credit each year in a HOPE account instead of using the tax relief for immediate needs, they could expect to have more than \$16,000 in their savings account by the time the child goes to college. As shown in Table 2, this is enough to purchase 5.9 years of education at the typical state university.⁹ The President's plan, on the other

8 For an explanation of how the President's HOPE scholarship plan would inflate tuition, see John S. Barry, "Higher Education Tax Proposals: The Right and Wrong Ways to Take the Anxiety out of Paying for College," Heritage Foundation *Backgrounder* No. 1118, May 22, 1997.

Table 2

A Family Dedicating the Entire \$500-per-Child Tax Credit for 21 Years Could Pay for Their Child's Entire Education at an Average Public University or More than a Year's Worth at a Typical Private University

	Public University	School Years That Tax Credits Will Buy		Private University	School Years That Tax Credits Will Buy	
		Clinton's Tax Credit	\$500 Tax Credit		Clinton's Tax Credit	\$500 Tax Credit
Alabama	U. of Alabama at Birmingham	1.3	5.8	Spring Hill College	0.2	1.0
Alaska	U. of Alaska Fairbanks	1.4	6.5	Sheldon Jackson College	0.3	1.3
Arizona	U. of Arizona	1.6	7.4	Prescott College	0.3	1.2
Arkansas	U. of Arkansas	1.4	6.1	John Brown University	0.4	1.5
California	U. of California - Los Angeles	0.8	3.2	Loyola Marymount University	0.2	0.8
Colorado	U. of Colorado at Denver	1.4	6.6	Regis University	0.2	0.9
Connecticut	U. of Connecticut	0.8	3.2	Saint Joseph College	0.2	0.9
Delaware	U. of Delaware	0.8	3.3	Wesley College	0.3	1.2
Florida	Florida State University	1.7	7.9	Barry University	0.3	1.0
Georgia	U. of Georgia	1.2	5.3	Mercer University	0.2	0.9
Hawaii	U. of Hawaii-Manoa	2.0	9.5	Chaminade University of Honolulu	0.3	1.1
Idaho	U. of Idaho	1.9	8.9	Albertson College of Idaho	0.2	0.8
Illinois	U. of Illinois at Chicago	1.1	4.7	Loyola University College	0.2	0.9
Indiana	Indiana University - Bloomington	0.8	3.6	Huntington College	0.3	1.2
Iowa	U. of Iowa	1.3	5.6	Drake University	0.2	0.8
Kansas	U. of Kansas	1.7	8.0	Benedictine College	0.3	1.2
Kentucky	U. of Kentucky	1.3	5.9	Centre College	0.2	0.9
Louisiana	U. of New Orleans	1.3	5.6	Loyola University in New Orleans	0.3	1.0
Maine	U. of Maine	0.9	3.8	Westbrook College	0.3	1.0
Maryland	U. of Maryland College Park	0.9	4.0	Loyola College	0.2	0.8
Massachusetts	U. of Massachusetts - Amherst	1.4	6.1	Regis College	0.2	0.9
Michigan	U. of Michigan - Dearborn	0.9	4.0	Northwood University	0.3	1.2
Minnesota	U. of Minnesota Twin Cities	0.9	3.8	Saint Mary's College of Minnesota	0.3	1.1
Mississippi	Mississippi State University	2.5	5.9	Millsaps College	0.5	2.0
Missouri	U. of Missouri Columbia	0.8	3.6	Saint Louis University	0.2	0.9
Montana	U. of Montana - Missoula	1.2	5.4	Carroll College	0.3	1.2
Nebraska	U. of Nebraska at Lincoln	1.4	6.3	Creighton University	0.3	1.1
Nevada	U. of Nevada Las Vegas	1.6	7.6	Sierra Nevada College	0.3	1.3
New Hampshire	U. of New Hampshire	0.8	3.4	Daniel Webster College	0.2	0.9
New Jersey	Rutgers University	0.8	3.3	Seton Hall University	0.3	1.0
New Mexico	U. of New Mexico	1.5	6.9	College of Santa Fe	0.3	1.0
New York	SUNY at Albany	0.9	3.8	Saint Johns University - New York	0.3	1.2
North Carolina	U. of North Carolina at Chapel Hill	3.4	21.5	Wake Forest University	0.2	0.8
North Dakota	U. of North Dakota	1.2	5.2	Jamestown College	0.4	1.5
Ohio	Ohio State University	0.9	3.9	University of Dayton	0.2	1.0
Oklahoma	Oklahoma State University	1.6	7.3	University of Tulsa	0.2	1.0
Oregon	U. of Oregon	0.9	3.8	University of Portland	0.2	0.9
Pennsylvania	Pennsylvania State University	0.6	2.4	Drexel University	0.2	0.9
Rhode Island	U. of Rhode Island	1.0	4.3	Bryant College	0.2	0.9
South Carolina	U. of South Carolina at Columbia	0.9	3.9	Wofford College	0.2	0.9
South Dakota	U. of South Dakota	1.8	8.7	Augustana College	0.3	1.0
Tennessee	U. of Tennessee - Knoxville	1.4	6.3	Maryville College	0.2	1.0
Texas	Texas A&M University	3.3	20.5	Rice University	0.3	1.0
Utah	U. of Utah	1.2	5.3	Westminster College of Salt Lake City	0.3	1.3
Vermont	U. of Vermont	0.5	2.0	Trinity College of Vermont	0.3	1.0
Virginia	U. of Virginia	0.8	3.3	Washington and Lee University	0.2	0.8
Washington	Washington State University	1.0	4.5	Gonzaga University	0.2	0.9
West Virginia	West Virginia University	1.4	6.2	University of Charleston	0.3	1.2
Wisconsin	U. of Wisconsin - Milwaukee	1.0	4.4	Marquette University	0.2	0.9
Wyoming	U. of Wyoming	1.2	5.3	(no private schools listed)		

Note: School costs are based on 1996-97 figures. Amount saved based on assumed 8% nominal return on savings and 3% inflation rate, adjusted to 1996 dollars.
Source: Heritage calculations, based on tuition costs obtained online from CollegeNET, <http://www.collegenet.com>.

- 9 These figures assume an 8 percent nominal return on savings and a 3 percent inflation rate, adjusted to 1996 dollars. School costs are based on 1996-1997 figures obtained from CollegeNET, <http://www.collegenet.com>.

hand, would provide a maximum of \$3,000 in relief. Even without any inflation in tuition costs, \$3,000 would pay for only 1.3 years at the average state college or for a single semester at the average private college.

- **Second**, ESAs, however valuable, would not benefit the families of students currently in college. To help these families, lawmakers should extend the \$500-per-child tax credit to cover all dependents between the ages of 18 and 21. This extension would cover most students in college today, and it could be used to pay for any education-related expense, including books, fees, and room and board. This extension of the \$500-per-child credit would deliver \$2,000 in tax relief to the families of nearly 8 million students during the course of a four-year college education—often the most expensive period in raising a child. Moreover, such a credit would not lead to escalation in tuition costs, as the Clinton plan would. Over five years, this plan would provide about \$16.8 billion in tax relief to hard-pressed families and students.

Helping Families Save for Retirement

The Heritage Foundation proposal. The Heritage plan would offer taxpayers a new way to preserve the value of their retirement savings by creating a new American Dream Individual Retirement Account (AD-IRA), based on the same proposal passed in the Balanced Budget Act of 1995 but vetoed by President Clinton. Contributions would be made from post-tax income, but the interest from such savings would not be taxed upon withdrawal if contributions had remained in the account for at least five years and if the retiree has reached age 59½. This is sometimes referred to as a “back-ended” IRA.

Initially, contributions to the new AD-IRA would be limited to \$2,000 per taxpayer per year (\$4,000 for a married couple), but this amount would be indexed to the rate of inflation in subsequent years. The plan also allows penalty-free withdrawals for a first-time home purchase or to pay certain educational or medical expenses. Over five years, this plan would provide taxpayers with \$2 billion in relief.

Lawmakers should remember that many Americans depend on the savings they have accumulated in their IRA (or the proposed AD-IRA) to pay for necessary living expenses during their retirement years, and allowing penalty-free withdrawals for home purchases or educational and medical expenses (often expenses that are incurred earlier in life) may deplete the retirement savings of many individuals. Therefore, Congress and the President should make sure that individuals have the opportunity to fully replenish their retirement accounts after making a substantial withdrawal from their IRAs. Alternatively, the \$2,000-per-year limit on contributions could be increased to allow taxpayers enough of a buffer to save for retirement and education, health, and home expenses.

Helping Family Farms and Businesses

Although federal estate and gift taxes often are considered another form of capital taxation, their real effect is to penalize a taxpayer's entire life of productive activity. This part of the federal tax code stems from the mistaken view that redistributing income leads to the redistribution of economic power. Nearly a century of wealth taxation, however, shows that well-to-do Americans (including a great number of middle-class families) simply find legal ways to avoid the tax collector.¹⁰

Death taxes encourage families to save less and consume more of their income, thus benefiting from the lower taxes on consumption. Death taxes also encourage families to make less productive investments—such as large life insurance policies and substantial charitable contributions—to reduce the chances that their families will have to pay a large estate tax upon their deaths. Thus, the attempt to use the tax code to redistribute economic resources leads to a distorted distribution of consumption and a less productive economy.

Taxpayers who are likely to be most affected by estate taxes are small farmers and minority and female business owners—people who have worked hard all their lives to plow their earnings back into their businesses or to accumulate assets they could leave to their children. Congress has spent the past 80 years promising economic and social opportunities to these Americans, and it is time it acted to reform the part of the tax code that directly undermines their efforts to achieve the American dream.

The Heritage Foundation proposal. Congress should repeal the death tax. Considering the limited amount of money available for tax cuts this year, however, only modest reforms are possible. In fact, one-third of the Members of both the House and Senate have co-sponsored legislation to repeal the death tax. Congress should help maintain the momentum for repeal by increasing the “unified credit” that estate taxpayers currently receive.

The Heritage proposal largely adopts the policies set forth in S. 2. Over seven years, this measure would increase the threshold at which a family pays death taxes (currently on estates valued at \$600,000 or more) to \$1 million. Such an increase would take nearly 50 percent of all taxpayers off the estate tax rolls, would provide significant relief for small business owners, and would focus nearly all tax reduction on the smallest estate.

Table 3 shows the distributional effects of increasing the unified credit to \$1 million. Only 3 percent of the benefit from this credit increase would go to taxpayers whose incomes exceed \$100,000.

Table 3

Estimated Distribution of Estate Tax Relief in Thousands of Current Dollars

Adjusted Gross Income	FY1998 Pre-Reform Revenues	Post-Reform Revenues	Revenue Effect	Percent Change in Tax Liability
Under \$30,000	\$386,788	\$0	-\$386,788	-100%
\$30,000 to \$39,999	580,182	0	-580,182	-100%
\$40,000 to \$49,999	918,563	633,026	-285,537	-31%
\$50,000 to \$74,999	3,674,254	2,532,105	-1,142,148	-31%
\$75,000 to \$99,999	2,706,382	2,470,742	-235,641	-9%
Over \$100,000	9,733,831	9,431,450	-302,381	-3%

Source: Heritage calculations; see Technical Appendix.

10 The death tax is only one of many federal taxes that place a multiple tax on income. Double taxation raises numerous ethical and economic issues. See Daniel J. Mitchell, “Taxes, Deficits, and Economic Growth,” *Heritage Lecture No. 565*, 1996.

TAX CUTS TO UNLEASH ECONOMIC GROWTH

Cutting Capital Gains Taxes

One of the most important things Congress can do this year to spur job and economic growth is to reduce capital gains taxes. Lower capital gains taxes stimulate economic growth by reducing the cost of capital: Taxes make up one part of the cost of capital, and lowering capital taxes reduces the “price” of capital to all kinds of borrowers. When borrowing costs fall, entrepreneurs create more new businesses, managers of existing businesses expand their factories and buy new machines, and families buy new cars and homes. All of this expansion in economic activity means more jobs and higher worker productivity. Productivity gains that stem from workers using new and improved machines help to increase average wages, thus returning income benefits even to households that may never have capital gains income.

Some Members of Congress still believe that lower taxes on capital gains benefit only rich taxpayers. The data, however, tell a different story. As Table 4 illustrates, nearly 88 percent of all current taxpayers with capital gains declarations on their tax returns have incomes from other sources (such as wages, salaries, self-employment, and pensions) under \$100,000; and 55 percent of all capital gains dollars are found in households with incomes below \$100,000. In other words, those taxpayers who would benefit from excluding 50 percent of capital gains from taxation are likely to be in the middle class.

Table 4

Estimated Distribution of Individual Capital Gains Tax Relief

Regular Income Before Claiming Capital Gains	Percent of Filers Who Declare Capital Gains	Cumulative Percentage	Percent of Total Value of Capital Gains	Cumulative Percentage
Under \$30,000	41.18%	41.18%	29.83%	29.83%
\$30,000 to \$39,999	11.12%	52.31%	5.25%	35.08%
\$40,000 to \$49,999	9.28%	61.59%	4.63%	39.72%
\$50,000 to \$74,999	17.42%	79.01%	8.77%	48.49%
\$75,000 to \$99,999	8.67%	87.68%	6.01%	54.50%
Over \$100,000	12.32%	100.00%	45.50%	100.00%

Source: Heritage calculations; see Technical Appendix.

Just as lawmakers should shun the “tax cuts for the rich” argument, they should reject the counsel of those tax economists who suggest that lowering the effective tax rate on capital will not result in a change in capital gains declarations. History proves otherwise. Experience with changes in capital gains tax rates over the past 25 years strongly indicates that rate decreases (or exclusions) produce more declarations of capital gains and thus more capital gains taxes. Owners of appreciated assets who face high tax rates generally hold on to their assets in anticipation of lower future rates. When rates come down, the amount of capital gains taxes goes up.

Economists estimate that trillions of dollars in unrealized capital gains (perhaps as much as \$7.5 trillion) exist in the portfolios of American taxpayers.¹¹ Some economists

have estimated that significant capital gains rate changes could produce substantial economic benefits and create revenue windfalls for federal and state governments. In a 1994 article for the *American Economic Review*, Leonard Burman and William Randolph, two leading tax economists on the staff of the Congressional Budget Office (CBO), estimated the response of taxpayers to rate reductions as being on the order of 1 to 6 in the short term.

This means that for every 1 percent drop in the rate (or the equivalent in exclusions), capital gains realizations would rise by 6 percent.¹² In other words, a 50 percent exclusion of capital gains declarations has the potential of raising declarations by 300 percent. It is from this increase in declarations that the federal government receives capital gains revenues above what it would have received without the 50 percent exclusion.

The Heritage Foundation proposal. For individual taxpayers, the Heritage plan would leave capital gains tax rates the same as current law but would exclude 50 percent of the net gain on an asset from taxation. For corporations, the plan would cut the capital gains tax rate from 35 percent to 28 percent.

For individuals, these changes mean that if an asset purchased for \$100 is sold at a price of \$200, the seller would pay capital gains tax on only half of the \$100 increased value of the asset. In this case, the taxpayer would pay a 28 percent tax rate on \$50, or \$14 in capital gains tax.

The Heritage proposal is the same as the one contained in S. 2. Heritage analysts, however, believe that its cost to the federal Treasury will not be as great as has been calculated by the staff of the Joint Committee on Taxation (JCT). Even though the committee's estimate does assume that cutting the effective capital gains tax rate through a 50 percent exclusion would generate higher declarations in the first three years after enactment, and thus higher tax revenue collections than projected under current law, it is based on the view that for every 1 percent drop in the tax rate, there will be a 4 percent increase in the capital gains tax base.

Heritage Foundation analysts have performed the same calculations assuming a more reasonable 1 to 5 ratio in the first year, or halfway between the JCT's estimate of new declarations and the estimate of Burman and Randolph. As a result, Heritage analysts believe that a 50 percent exclusion of the capital gains tax would produce roughly \$10 billion more in tax revenue collections over the first five years of the plan. Thus, Heritage analysts believe the five-year "cost" to the Treasury of this proposal is \$23.7 billion, not \$33.6 billion as estimated by the JCT.

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- 11 See, for example, Jude Wanniski's March 15, 1995, testimony before the Senate Finance Committee as cited in Stephen Moore and John Silvia, "The ABCs of the Capital Gains Tax," Cato Institute *Policy Analysis* No. 242, October 4, 1995.
- 12 Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, Vol. 84, No. 4 (September 1994), p. 803.

HOW THE HERITAGE PLAN WOULD BENEFIT JOBS AND THE ECONOMY

Within the \$135 billion constraint imposed by the 1997 budget agreement, the Heritage Foundation tax cut plan would deliver the maximum tax relief to the most Americans while generating the economic growth needed for the government to stay on course for a balanced budget. Overall, some 82 percent of the \$131.6 billion in total tax cuts would flow to American families. The remaining 18 percent would be used to reduce the tax penalties on savings and investment and to reduce the high taxes imposed on families who try to pass assets down from one generation to the next.

In the final analysis, some 73 percent of all taxpayers benefiting from the Heritage tax cut plan have regular income below \$75,000 per year, and 82 percent have regular income below \$100,000 per year (see Chart 1).

Heritage Foundation economists analyzed the tax cut plan's impact on jobs and economic growth using the January 1997 U.S. Macroeconomic Model of the WEFA Group. WEFA economists reconstructed this January model to embody CBO economic and budgetary assumptions published in January of this year.¹³ (It is fair to say that simulations of policy changes using this specifically adapted model produce dynamic results based on CBO assumptions.) Next, the elements of the Heritage tax plan were entered into the model to analyze the plan's dynamic economic impacts.

The Heritage analysis using the WEFA model indicates that a balanced package of tax cuts to help families and encourage investment will result in a stronger, more vigorous general economy. This analysis suggests that the Heritage tax cut plan would:

- **Increase household income by \$2,000.** The Heritage tax plan produces \$200 billion in additional, inflation-adjusted disposable income for households—equal to \$2,000 in higher income for the average American household. The simulation indicates that real disposable personal income rises above the CBO current law baseline in each of the five years from 1998 through 2002.
- **Spur job creation.** The strength of household income is based in large part on more jobs being created in the private economy. The Heritage tax plan produces an average of 281,000 more jobs per year over the five-year period. In fact, in FY 1999, the simulation shows that the private sector produces 380,000 more jobs.
- **Expand the tax base.** Using mostly “static” estimates that take only limited account of the tax cut's influence on the economy's performance, the Heritage tax plan would reduce revenues to the federal Treasury by \$131.6 billion over five years. The more “dynamic” analysis using the WEFA model, however, suggests that because the tax cut plan promotes stronger economic growth, the expanding tax base feeds new tax revenues back into the federal Treasury.

13 See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1998–2002* (Washington D.C.: U.S. Government Printing Office, 1997). See also the accompanying Technical Appendix for a description of The Heritage Foundation's use of the WEFA Model and various steps incorporated to simulate the budget resolution. It should be noted that the methodologies, assumptions, conclusions, and opinions herein are entirely those of Heritage Foundation economists and have not been endorsed by, and do not necessarily reflect the views of, the owners of the WEFA Mark 11 model.

These new tax revenues replace or “feed back” 53 percent of the expected revenues lost to the Treasury under a static analysis. In other words, when the tax cut plan’s effect on economic performance is accounted for, the actual “cost” of the plan to the Treasury is only 53 percent of the purely static reduction in tax revenues over five years.¹⁴

CONCLUSION

The Heritage Foundation tax cut plan achieves the agreed-upon budget deal tax target in a way that works best for American families. It also would boost the economy so that balancing the budget is still achievable. Not only does the Heritage tax cut plan help Main-street America, but it also generates the kind of economic growth that benefits every American with higher income and more jobs.

14 The accounting cost of the tax package is some \$175 billion over five years. The “feedback” effect of higher economic growth, however, combined with the increased revenues generated by higher capital gains declarations, reduces this amount by 53 percent.

TECHNICAL ASSUMPTIONS

Heritage economists follow a two-step procedure in analyzing the revenue and economic effects of proposed policy changes. First, estimates are prepared of revenue changes that stem from changes in the taxpaying population eligible for the tax change, from the base of taxable income absent any change in the economy and from the tax rates. These estimates frequently are called "static" estimates, largely because they are unaffected by changes in the behavior of taxpayers that stem from tax policy reforms. Second, these static revenue changes and other important modifications of tax law are introduced into the WEFA U.S. Macroeconomic Model. The WEFA model has been designed in part to estimate how the general economy is reshaped by policy reforms. The results of simulations performed in the WEFA model produce the "dynamic responses" to policy moves.

These notes describe how Heritage economists prepared the static estimates described in the paper and how these results and other assumptions were introduced into the WEFA model.

TAX POLICY ASSUMPTIONS

Child Tax Credit

The child tax credit analysis is drawn from tabulations using the Heritage Matched Database. To be eligible for the credit, a taxpayer must meet the eligibility criteria described in S. 2. Under the Heritage tax plan, this credit is extended to taxpayers with positive tax liabilities who have dependent children under the age of 22. Both the primary credit and its extension are phased out according to the threshold criteria set forth in S. 2. The total amount of the credit is the lowest amount of the full \$500 value of the credit, the remaining portion of the credit had it been phased down, or the total tax liability of the parent. Under the Heritage plan, an eligible taxpayer receives either the child tax credit or the Dependent Care Tax Credit that exists under current law, whichever is higher.

The year-by-year revenue effects of the child tax credit are shown in Table 1. Heritage economists used three calculations to estimate these annual revenue changes. First, the demographic data drawn from The Heritage Matched Database for 1993 (the base year) were increased for each fiscal year between 1997 and 2002 by the population growth rates for people age 22 and under produced by the Bureau of the Census. Second, Heritage economists forecasted the number of families with eligible children who fit at or under the income threshold for each of year of the five-year period. These forecasts were shaped using the Gross Domestic Deflator forecasts prepared by the WEFA Group. Third, the population and income forecasts were combined to determine the annual number of tax returns with eligible children. The credit then was applied pursuant to the rules of S. 2 to each eligible return.

Capital Gains Provisions

The Heritage Foundation's estimate of the reduced capital gains tax revenues from individuals is based on data from the 1993 IRS Statistics of Income and revenue forecasts from the Heritage Foundation Individual Income Tax Model. Heritage analysts selected only those tax returns that contained taxable capital gains in 1993, subtracted the amount of these gains from the taxpayer's adjusted gross income, and created a new income variable that summed all of the taxpayer's income except capital gains income. Forecasts of

capital gains declarations under current law were made that assumed an annual growth in the base of 4 percent and a real tax rate elasticity of -0.43 percent. These forecasted declarations and associated capital gains taxes were distributed across the new income variable.

These baseline capital gains taxes were reduced by 50 percent and designated the “purely static” revenue losses under this provision. To calculate the changes in revenues under an assumption of “unlocking,” Heritage economists assumed a transitory elasticity of -5.0 percent and -3.0 percent, respectively, for years one and two of the tax plan; a permanent elasticity of -1.8 percent was assumed for years after the second year. The application of these elasticities to the base of capital gains declarations significantly decreased the purely static revenue losses. The difference between these purely static revenue losses and the revenues stemming from “unlocking” were introduced to the WEFA U.S. Macroeconomic Model as changes in total federal revenues.

Estate and Gift Tax Provisions

Heritage Foundation estimates of the revenue impact of the increase in the unified credit and the introduction of a family-owned business exclusion are based on data from the 1993 IRS Statistics of Income and revenue forecasts from the Heritage Foundation Estate and Gift Tax Model. Heritage forecasts of estate tax revenues for fiscal years 1998–2002 were distributed across adjusted gross income following the techniques described by Daniel Feenberg, Andrew Mitrusi, and James Poterba in “Distributional Effects of Adopting a National Retail Sales Tax,” *Tax Policy and the Economy*, Conference Report, National Bureau of Economic Research, September 1996, pp. 20–22.

IRA Provisions

The Heritage Foundation’s estimates of the revenue impact of the IRA provisions in this plan are based directly on the amounts estimated by the Joint Tax Committee.

MODEL SIMULATION ASSUMPTIONS

Average Effective Tax Rate

The WEFA model contains a variable that measures the total amount of all federal taxes on individual income as a percentage of nominal personal income. Heritage adjusted downward this average effective tax rate for each of the forecast years to reflect the purely static revenue decreases resulting from adoption of the Heritage tax plan.

Monetary Policy

The model assumes that the Federal Reserve Board adopts a neutral stance with respect to these policy changes. This assumption was embodied in our simulation by excluding the stochastic equation for monetary reserves.

Labor Force Participation

A small adjustment of 0.06 index points was made in the model’s labor force participation rate to account for the dynamic effects of reforming the estate and gift tax. This adjustment in the labor force participation rate is explained more fully in William W. Beach, “The Case for Repealing the Estate Tax,” Heritage Foundation *Backgrounders* No. 1091, August 21, 1996, pp. 24–26.

Declarations of Capital Gains

Heritage economists adjusted federal tax collections to reflect a higher level of capital gains declarations. The base was increased to reflect estimated elasticities associated with significant capital gains rate reductions. See Leonard Burman and William Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, Vol. 84, No. 4 (September 1994).

Corporate AAA Bond Rates

Heritage economists decreased the corporate AAA bond rate by 60 basis points to reflect the drop in taxes on capital stemming from capital gains and estate tax reform. This variable is a component in a large WFA equation that calculates the cost of capital.

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