The Heritage Foundation Issue Bulletin

No. 237 | The Heritage Foundation • 214 Massachusetts Avenue, N.E. • Washington, D.C. 20002-4999 • (202) 546-4400 • http://www.heritage.org

June 25, 1997

HOW TO GET THE BEST TAX BILL

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INTRODUCTION

House and Senate lawmakers are preparing to vote on tax bills developed by their tax committees. Two major obstacles will hinder their efforts. First, lawmakers somehow have to provide meaningful tax relief even though the net tax cut of $85 billion agreed to by President Bill Clinton only amounts to about 1 percent of projected federal tax revenue over the next five years. Moreover, Members of Congress will also have to contend with a political complication: The White House has resuscitated the appeal-to-class approach to tax policy in an effort to minimize pro-growth tax cuts and instead use the monies to expand federal welfare spending.

In order to get the maximum benefit for Americans out of a modest tax cut, legislators should make sure that the tax bill conforms to certain key principles. More specifically, Members charged with reconciling the differences between the House and Senate bills should make sure that the tax provisions are consistent with long-term tax reform. Congress should ensure that these provisions meet the following criteria:

1. Tax rates on productive behavior should be reduced.
2. The bias against savings and investment should be lowered.
3. Taxpayers should be able to protect more of their income from taxes.
4. Government micromanagement of private decision making should be decreased.
5. The tax code should be simplified.

Judged by these standards, and considering the obstacles outlined above, both the House and Senate tax-writing committees have produced reasonable tax cut packages. Nonetheless, portions of each tax bill fail to meet any of these five criteria. If Congress acts to correct these deficiencies, it will improve the final legislation substantially.

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Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Comparing the House and Senate Bills

According to the original budget agreement between President Clinton and Congress, the tax burden will be reduced by $85 billion over the next five years and $250 billion over the next ten years. The House followed through on this commitment, but the Senate short-changed taxpayers by agreeing to a five-year tax cut totaling only about $77 billion (both the House and Senate bills contain $135 billion in tax cuts over the next five years, but the Senate bill includes more tax increases).

An added difficulty is that the budget agreement provides only broad outlines of what the tax package should look like. The Administration agreed to accept some reduction in the capital gains and estate taxes, but the magnitude of the change was left unspecified. Congress, on the other hand, acquiesced to the White House demand for $35 billion in tax cuts targeted at education while still leaving some leeway concerning how that relief will be provided.

Congress's task now is to pass legislation to put meat on the bones of these agreements. Lawmakers in the House and Senate need to revise the bills submitted by their tax-writing committees and ensure not only that they bear the outlines of the agreement, but that the final legislation is also sound tax policy.

Capital Gains Taxes

House bill: Under the Ways and Means bill, the top tax rate on capital gains would be reduced from 28 percent to 20 percent (and down to 10 percent for taxpayers in the 15 percent tax bracket). Perhaps most important, beginning in 2001, the legislation protects taxpayers from having to pay the tax on inflationary gains for any asset held for at least three years. The House bill also phases in a reduction in the corporate capital gains rate, from 35 percent today to 30 percent in 2000. And the legislation protects from capital gains taxation the first $500,000 in gains from the sale of a principal residence.

Senate bill: The Senate Finance Committee capital gains provisions are not as generous. Like the House legislation, the Senate proposal would reduce the tax rates on capital gains to 20 percent and 10 percent. There would be no reduction in the corporate capital gains rate, however, and the Senate version fails to include an indexing provision. The Senate bill also differs from the House bill by including a special 10 percent rate for any gains realized by the sale of small business stock—if the investor acquired the stock when it was first made available.

What Congress should do: The proper tax rate on capital gains is zero, but the rate reduction in both bills is an improvement over current law. Because lawmakers appear unwilling to eliminate the tax this year, the indexing provision in the House bill is very desirable, since even modest levels of inflation cause dramatic increases in the effective capital gains tax rate on assets held for longer periods of time. The Senate's special 10 percent tax rate for small business stock would be a boost for venture capital, but the provision as now written discriminates against other types of investments and could be complicated to administer.

The Death Tax

House bill: The Ways and Means bill makes two significant changes in the death tax. First, it expands the "unified credit," or the up-front exemption of a taxable estate, from its current $600,000 to $1 million over ten years. Second, it provides long-overdue

indexing to the taxable value of annual gifts and other important elements of current estate tax law.[2]

Senate bill: The Finance Committee–passed version of death tax relief follows the Ways and Means version with some differences. First, the Finance Committee bill increases the unified credit to $1 million, but does so over nine years instead of ten. The committee also recommends indexing of certain assets beginning in 1999. The Finance version, however, also includes an estate tax exclusion, or carve-out, for certain types of family-owned businesses.

What Congress should do: As one of the worst forms of double taxation in the code, the death tax should be eliminated. Simply stated, this tax causes the liquidation of private capital and transfers that wealth from the productive sector of the economy to the government.

To keep the momentum going forward toward repeal of the death tax, Congress should do two things. First, Congress should explore ways to unify the estate and capital gains tax systems with the addition of a lifetime exemption to cover the otherwise taxable disposition of assets between decedents and their heirs. Second, with repeal of the levy not likely this year, it should increase the exemption amount from $600,000 to $1 million in five instead of nine or ten years. The economic benefits likely would be even greater if lawmakers instead reduced the tax rate on estates, which can be as high as 55 percent.

The Child Tax Credit

House proposal: The Ways and Means-passed version of the child tax credit offers a $400-per-child credit effective on January 1, 1998, which increases to $500 per child in 1999. This credit is limited to dependent children below age 17 and is phased out for families earning above $110,000 per year. This proposal would require low-income families to deduct their applicable Earned Income Tax Credit (EITC) from their income tax liability before they calculate how much of the $500-per-child tax credit they can receive.

Senate proposal: The Finance Committee–passed version of the child tax credit offers a $500-per-child credit effective on July 1, 1997 (with families able to claim a pro-rated share on their April 1998 tax returns).[3] Like the House version, the Finance version would be limited to dependent children below age 17 and is phased out for families earning above $110,000 per year. Unlike the House version, low-income families in the Senate bill would be able to claim the $500 credit against their tax liability before deducting their EITC. Second, parents with children ages 13 to 16 would have to deposit the $500 credit into an education individual retirement account (IRA) or a prepaid tuition plan. This provision is optional for children under age 13.

What Congress should do: The Senate version of the child tax credit provides families with an immediate $500-per-child credit effective July 1, 1997, which taxpayers will find more attractive than the House version's $400 phased-in credit. Congress should reject, however, the provision in the Senate version that would force parents with children ages 13 to 16 to deposit the $500 credit into an education savings account. The

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2 For a review of the arguments supporting death tax repeal, see William W. Beach, "The Case for Repealing the Estate Tax," Heritage Foundation *Backgrounder* No. 1091, August 21, 1996.

3 This 1997 provision is applicable only to families with children under age 13.

Senate action is understandable because lawmakers were trying to fulfill the leadership's unwise commitment to provide $35 billion of tax relief for education while simultaneously steering clear of many of the President's ill-advised proposals. Nonetheless, the government should not dictate how these families spend their own money.

This is especially true because—as most families already know—studies show that children ages 12 to 17 are more expensive to raise than younger children. According to the most recent U.S. Department of Agriculture annual report on expenditures on children by families,[4] children ages 12 to 14 cost $970 more to raise each year than do children age 2 and younger. Indeed, the annual cost of raising a child ages 15 to 17 is $1,100 more than the cost of raising an infant.

Finally, the object of the $500-per-child tax credit is to reduce a family's total federal income tax burden. This includes regular income taxes as well as payroll, or FICA, taxes. Congress should use the $500-per-child tax credit along with the EITC to come as close as possible to eliminating the total income tax liability (income taxes plus payroll taxes) of low-income families without actually exceeding it. Any payments, or refunds, that exceed a family's total tax liability should be considered welfare payments and should be avoided.

The Senate tax plan comes closer to meeting this objective than the House plan. The Senate bill would allow a low-income family (generally earning below $30,000 per year) to claim the $500-per-child credit before claiming one-half of their normal EITC refund. For many families earning between $17,000 and $24,000 per year, this provision would eliminate their income tax liability and a large portion of their payroll tax burden.

Individual Retirement Accounts

House bill: The legislation creates a new series of "back-ended" IRAs. Unlike current IRAs, which allow taxpayers to put pre-tax income into accounts and then pay the tax on the money when it is withdrawn (including on interest and other earnings), back-ended IRAs eliminate the double tax on savings by using the opposite approach. Contributions to the accounts would be in after-tax income, but there would be no second layer of tax on the money (including on interest and other earnings) when it is withdrawn. Taxpayers would be limited to $2,000 of annual contributions, and the money would have to remain in the account for at least five years or until the taxpayer turned 59me disabled.

Senate bill: In addition to the back-ended IRA included in the House bill, the Senate tax bill also expands traditional IRAs. Under current law, these "tax-deferred" IRAs are phased out as income rises and are not available at all to couples making more than $50,000 per year and individuals making more than $35,000 annually. If the bill is approved, those limits gradually would be raised so that they would be at least partially available to couples making up to $100,000 per year and single people making $60,000 per year. Moreover, the House bill allows money to be withdrawn penalty-free from these accounts for first-time home purchases and long-term unemployment expenses.

What Congress should do: It is economically self-destructive to impose a special tax penalty on saved income. Any reform to protect that income from double taxation, whether through the back-ended IRA or the tax-deferred IRA, is both consistent with tax reform

4 U.S. Department of Agriculture, *Expenditures on Children by Families, 1996 Annual Report,* Miscellaneous Publication No. 1528–1996, May 1997.

and long overdue. Ultimately, the back-ended IRA probably is superior because it involves considerably less paperwork on the part of the taxpayers and administrative oversight on the part of the IRS.

Education Provisions

House bill: The Ways and Means proposal includes a new tax credit that would match up to 50 percent of the first $3,000 a family spends on higher education expenses during the first two years of their children's college education. Only families earning less than $80,000 per year would be eligible for the full credit. The House proposal also would allow contributions of up to $5,000 per year to back-ended education investment accounts (EIAs) or qualified prepaid tuition programs. Also, families would be able to withdrawal money from their existing IRAs tax-free to pay for qualified higher education expenses. Finally, the Ways and Means proposal would extend—through the end of 1997—the current exclusion from taxable income of any contribution made by an employer toward an individual's continuing education.

Senate bill: The Senate Finance Committee proposal includes a tax credit identical to the House version except that the credit would be applicable to up to 75 percent of expenses at a junior college. Also, like the House bill, the Senate Finance proposal would establish tax-free EIAs. Contributions to these new accounts and qualified tuition savings programs, however, would be limited to $2,500 per year. Unlike the House Ways and Means Committee proposal, the Senate plan would mandate that parents with children ages 13 to 16 deposit their $500-per-child tax credit into an EIA. The Senate IRA proposal is identical to that in the Ways and Means plan. And the Senate Finance Committee would extend permanently the current exclusion for employer-provided educational assistance. Finally, the Senate would allow a deduction from taxable income for interest payments on student loans.

What Congress should do: In most key respects, the House education tax package deserves higher marks than the Senate version. Congress should use this as a starting point in crafting its final education tax package. Specifically, lawmakers should drop the President's ill-advised tax credit and the interest deduction provision. If Congress is intent on providing some credit for college expenses, a much better alternative would be to extend the $500-per-child tax credit to cover all dependents including those of college age. Also, Congress should strengthen the savings provisions already in the bill by eliminating any cap on annual contributions or withdrawals. Finally, the Senate bill's mandate on parents with children ages 13 to 16 should be dropped to provide these families with the maximum flexibility in using their own hard-earned money.

The Alternative Maximum Tax

House bill: The Alternative Minimum Tax (AMT) forces individuals and businesses to overstate their income for tax purposes. Instituted in 1986 for the sole purpose of extracting more tax revenue, the AMT is widely recognized as one of the more complicated anti-growth features of the tax code. The Ways and Means Committee legislation would eliminate the tax on corporations with sales of less than $5 million per year and reduce the burden of the tax for larger companies. For individuals, the bill for all intents and purposes would increase the amount of income a taxpayer would have to earn before being subject to the tax.

Senate bill: The Senate Finance Committee proposal provides AMT relief only for individual taxpayers. Like the House bill, it would ease the burden of the AMT by boosting the income level at which the tax takes effect.

What Congress should do: In a tax code cluttered with inefficient and complicated tax provisions, the AMT may qualify as the worst provision. Congress should repeal the AMT.

The Tobacco Tax

House bill: The House Ways and Means Committee bill does not increase tobacco taxes.

Senate bill: The Finance Committee bill would boost the tax on a pack of cigarettes—currently 24 cents a pack—by an additional 20 cents. This was done largely to finance additional entitlement spending.

What Congress should do: Lawmakers should be cutting taxes, not raising them, and they certainly should not be raising taxes to finance new spending. Moreover, there is something particularly distasteful about politicians imposing their values on society by taxing politically incorrect products and services. What would be next: new taxes on food based on fat content? Increases in the tobacco tax should be rejected.

DISMISSING THE APPEAL TO CLASS

As Congress prepares to cut taxes for the first time in 16 years, the White House is arguing that both House and Senate versions of the tax bill are unfair because the richest 20 percent of the country will get about two-thirds of the tax relief if either of the bills becomes law. Not only are the Clinton Administration's calculations wrong, but these figures are irrelevant to sound tax policy. These estimates presume that there is a correct distribution of after-tax income and that it is the role of government somehow to ensure that outcome. Moreover, these calculations are derived from static models, meaning that the figures inevitably fail to capture how changes in taxpayer behavior can affect revenue collection—and hence the actual burden resulting from the change.

When the White House complains about the top 20 percent, it neglects to reveal just who fits into this "rich" category. Although most Americans think of the rich as people like Bill Gates and Michael Jordan, Tax Foundation figures reveal that it only takes an income of a little more than $56,000 per year to be in the top 20 percent of earners. The Department of the Treasury claims the figure is significantly higher, but its income figures (using an artificial number known as Family Economic Income) can be derived only by including questionable or absurd items in taxpayer income. For example, the Treasury includes as income such items as the payroll taxes paid by employers. Most incredible of all, it defines as "income" the amount of money that taxpayers would receive if they were to rent out their homes.

To be fair, however, noting that the income level necessary to reach the top 20 percent is only about $56,000 does not answer the Administration's charge that it is unfair for those in that top 20 percent to get two-thirds of the tax cut. Again, however, this is a meaningless statistic because it is wrong and mistakenly assumes that government can and should use tax policy to redistribute income. What makes this debate particularly ironic is that the Tax Foundation figures show that these "rich" taxpayers already pay more than 74 percent of the income taxes collected today. If the simplest definition of fairness is used—an

across-the-board reduction in the tax burden—the so-called rich are not getting a big enough tax cut.

Of course, just as tax cuts should not be used artificially to skew the after-tax income of those with lower earnings, neither should it be the purpose of tax cuts to boost the after-tax income of those with higher earnings. Instead, the tax code should raise the (preferably) limited amount of money government demands in the simplest, least destructive manner possible while simultaneously ensuring that all taxpayers are treated equally. This is why tax cuts always should be designed to move the tax code in the direction of a flat tax, regardless of whether static models show a particular income class getting a supposedly disproportionate "share" of the tax relief.

Ideally, lawmakers should dispense with these calculations altogether. Not only are they meaningless to sound tax policy, but they also are consistently erroneous. In short, the models that produce these numbers inaccurately assume almost no changes in taxpayer response to changes in tax rates and assume that the economy will be unaffected by any changes in tax rates. In the real world, taxpayers do respond to incentives, and the economy's rate of growth is affected by the size and structure of the tax burden.

Consider what happened just last decade. In 1980, the top tax rate was 70 percent, and the richest 1 percent were shouldering 17 percent of the total income tax burden. By 1988, however, the top tax rate had fallen to 28 percent, meaning that those with the highest incomes got a disproportionately large tax cut. What happened to tax collections from the rich? Did they fall, as critics of Reaganomics had predicted? Just the opposite: The richest 1 percent of taxpayers wound up paying 27 percent of the income tax by 1988, a dramatic increase in their share of actual taxes paid. The reason is simple; when tax rates are lower, rich people are less likely to hide, shelter, and under-report income. In short, upper-income taxpayers are willing to work, save, and invest in the above-ground economy so long as Uncle Sam refrains from confiscating an excessive percentage of their earnings.

The same thing happened in the 1920s and 1960s. Sweeping tax rate reductions during those decades were condemned as favoring the rich, but in each instance the actual share of taxes paid by upper-income taxpayers rose. This historical record amply illustrates why estimates of tax distribution by income class, in addition to being irrelevant, are factually inaccurate. White House attacks on congressional proposals to reduce capital gains and death taxes should be vigorously disputed.

CONCLUSION

The tiny amount of tax relief allowed by the budget agreement may not be much, but it is the first tax cut in 16 years. Because the tax cut is so small, however, it will be even more important for policymakers to craft tax cuts intelligently. In order to address the myriad problems of the U.S. tax system, lawmakers would have to rip up the tax code and replace it with a flat tax, but that is not likely to happen for several more years. In the interim, Congress should be applauded for trying to reduce the tax burden and get government out of the business of income redistribution.