No. 1270 April 13, 1999

How Congress Can Use the Surplus to Cut Taxes and Begin Fundamental Tax Reform

William W. Beach

For the first time in decades, the federal government is awash in budget surpluses and energized by the prospect of more surpluses to come. Congress and the President should use this good fortune, which has been provided by America's highly productive taxpayers, to return some of these surplus tax dollars to taxpayers. Congress also should make the kinds of tax cuts that are steps to a fair, flat, and simple tax system. It can do this within the restrictions imposed by the budget resolution.

The recent announcement by the Congressional Budget Office (CBO) that the next ten federal fiscal years could produce as much as $2.6 trillion in cumulative budget surpluses is good news: It will allow Congress to cut taxes *and* reform Social Security. CBO currently forecasts $824 billion in ten-year, non-Social Security surpluses. If Congress used that money for tax cuts, all of the $1.78 trillion in Social Security surpluses would be available to reform the country's largest pension program.

Congress this year can take important steps toward providing tax relief that will be consistent with long-term tax reform, within the restrictions imposed by the budget resolution. In particular, it can take two decisive steps:

- It can move toward more fundamental tax reform by reducing taxes on labor and capital while making the tax code fairer; and
- It can begin to reform the government-controlled Social Security system by giving Americans the freedom to use some of their payroll taxes to invest in personal, private savings accounts.

Specifically, Congress could (1) provide "marriage penalty" relief to married taxpayers; (2) reduce the tax rates on long-term capital gains; (3) phase out the federal death taxes; (4) expand eligibility for educational savings accounts; (5) expand eligibility for Roth IRAs; (6) repeal the surtax on federal unemployment taxes; (7) reform the tax treatment of "cafeteria plans" so that taxpayers will not lose their annual contributions at the end of the tax year; (8) provide taxpayers who

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pay for their own health care a 30 percent credit against their federal income and payroll taxes; and (9) cut individual marginal income tax rates by 10 percent.

In addition to these tax policy changes, Congress would be able to provide additional essential funding for national defense within the budget framework. If Congress preserves Social Security surpluses for Social Security reform, taxpayers will support the changes needed in the tax code–changes that address the overall objectives of increased fairness, greater simplicity, and a reduction in their tax burden.

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The congressional leadership has signaled its intention to make tax reduction a priority. In various tax bills and in the budget resolution, Congress would return a significant portion of projected surpluses to taxpayers. This should be a top priority. Federal revenues as a proportion of economic output are approaching a post-World War II high of 21 percent, which in large part explains the $2.6 trillion in cumulative budget surpluses now forecast by the Congressional Budget Office (CBO).[2] Moreover, current federal tax laws work against savings and investment, burden all taxpayers with rules that annually cost taxpayers billions in unnecessary compliance expenses, routinely shift the payment of taxes to low- and moderate-income households, and distort economic decisionmaking.

This year, Congress can take two decisive steps:

1. It can move toward more fundamental tax reform by reducing taxes on labor and capital while making the tax code fairer; and
2. It can begin to reform the government-controlled Social Security system by giving Americans the freedom to use some of their pay-

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1. The author gratefully acknowledges the work of several Heritage analysts whose recent writing and analytical work shaped this report: Daniel J. Mitchell on fundamental tax reform and the marriage tax; Robert E. Moffit and Stuart M. Butler on the tax credit for uninsured health care expenses and the rollover of Section 125 contributions; Ralph Rector, D. Mark Wilson, Rea Hederman, and Aaron Schavey for tax modeling and, in particular, for work on the 10 percent tax cut proposal; and Baker Spring for estimates of additional defense spending. The author assumes responsibility for the information in this report.
2. See Congressional Budget Office, *The Economic and Budget Outlook for Fiscal Years 2000 Through 2009* (Washington, D.C.: U.S. Government Printing Office, January 1999). The CBO made small updates to their budget estimates on March 3, 1999; see CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2000: A Preliminary Report*, at *http://www.cbo.gov.*

roll taxes to invest in personal, private savings accounts.

In July 1998, The Heritage Foundation released an analysis entitled "A New Framework for Cutting Taxes: Reforming the Tax Code and Improving Social Security," which outlined a long-term approach to tax and Social Security reform. The framework would make America's tax policies fairer, simpler, and flatter while establishing retirement policies that give all Americans, particularly low- and moderate-income families, more freedom to create greater wealth and income for retirement.[3]

In the fiscal year (FY) 2000 budget resolution, Congress declared its intention to reserve the entire net Social Security surplus for Social Security reform. This would leave $824 billion over the next ten years for tax relief and pressing defense needs. Within this framework, Congress can take important steps toward tax relief that are consistent with long-term tax reform. Specifically, this Congress could:

- **Provide** "marriage penalty" relief to married taxpayers;
- **Reduce** the tax rates on long-term capital gains;
- **Phase out** the federal death taxes;
- **Expand** eligibility for educational savings accounts;
- **Expand** eligibility for Roth IRAs;
- **Repeal** the surtax on federal unemployment taxes;
- **Reform** the tax treatment of "cafeteria plans" so that taxpayers will not lose their annual contributions at the end of the tax year;
- **Provide** taxpayers who pay for their own health care a 30 percent credit against their federal income and payroll taxes; and
- **Cut** individual marginal income tax rates by 10 percent.

In addition to these tax policy changes, Congress would be able to provide additional essential funding for national defense within the budget framework.

HOW TO STRUCTURE TAX CUTS

The House and Senate Budget Committees adopted budget resolutions for FY 2000 on March 17 and 18, respectively. These resolutions clearly state that all of the positive cash flows in the Social Security trust fund will be preserved to reform the Old-Age and Survivors Insurance programs. These positive cash flows constitute what Washington budget watchers call the "off-budget surplus." Preserving the off-budget surplus for Social Security reform means that tax cuts would come from the "on-budget surplus."

Table 1 shows the on-budget surplus forecasts of the Congressional Budget Office.[4] In its January and March 1999 updates on budget and economic forecasts for the next ten fiscal years, the CBO predicted that the general fund would be in deficit for fiscal years 1999 and 2000 before realizing a small surplus of $11 billion in FY 2001. If the leadership of the House and Senate is in fact serious about tying tax cuts to general fund surpluses, then taxpayers will have to wait until 2001, or the first session of the 107th Congress, for tax relief.

Assuming the politics surrounding the Social Security and tax reform debates prevents off-budget surpluses from becoming part of the tax cut calculus, tax cuts should be jump started sooner rather than later. The longer these surpluses stay in Washington, the less likely they ever will be returned to taxpayers.

A reasonable tax plan within the framework emerging in Congress would allow for $755 billion in tax cuts over ten years. This would start the tax cut process through three tax policy changes—two that temporarily increase revenues and one

3. William W. Beach *et al.*, "A New Framework for Cutting Taxes: Reforming the Tax Code and Improving Social Security," Heritage Foundation *Backgrounder* No. 1199, July 1, 1998.

Table 1 B1270

Static Revenue Impact of Tax Proposals and Defense Spending Increases In Billions of Dollars

	Federal Fiscal Years											Total	
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2000–2004	2000–2009
Revised CBO Budget Assumptions*													
Baseline Revenue Forecast (Collections)	1,815	1,870	1,930	2,015	2,091	2,184	2,288	2,393	2,500	2,611	2,727	10,090	22,609
Baseline Outlays Forecast**	1,704	1,727	1,770	1,785	1,857	1,919	1,994	2,051	2,129	2,218	2,308	9,059	19,759
Additional Spending on National Defense	0	10.2	4.6	17.0	20.8	26.7	30.7	31.9	33.2	34.5	35.9	79.3	245.6
Revised Baseline Outlays	1,704	1,737	1,775	1,802	1,878	1,946	2,025	2,083	2,162	2,253	2,344	9,138	20,005
Unified Budget Surplus	111	133	155	213	213	238	263	310	338	358	383	952	2,604
Less Off Budget Surplus	127	138	144	154	162	170	184	194	204	212	218	768	1,780
Equals On Budget Surplus	-16	-5	11	59	51	68	79	116	134	146	165	184	824
Tax Policy Options													
A. Marriage Penalty Reform													
Married Taxpayers May Choose to File as Singles	0	0	-9.4	-21.2	-21.9	-22.5	-22.9	-23.4	-24.0	-24.3	-24.5	-75.0	-194.1
B. Reduce Capital Gains Tax Rate													
10% Rate (10 Percentage Point Cut)	0	14.8	18.0	2.8	-7.5	-11.0	-11.5	-12.5	-13.0	-13.6	-14.3	17.1	-47.8
C. Death Tax													
Dunn-Tanner Phase Out	0	0	-2.7	-5.6	-8.9	-12.4	-16.5	-19.4	-22.3	-26.0	-30.0	-29.6	-143.8
D. Expanded Education Savings Accounts	0	0	0.0	-0.2	-0.3	-0.4	-0.5	-0.6	-0.7	-0.8	-0.9	-1.0	-4.4
E. Expand Eligibility for Roth IRAs	0	2.8	0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.6	3.6
F. Repeal FUTA Surtax	0	0	-1.2	-1.6	-1.6	-1.6	-1.6	-1.7	-1.7	-1.7	-1.7	-6.0	-14.4
G. Reform Section 125 Rollover Provisions	0	0	-0.2	-0.6	-0.6	-0.7	-0.7	-0.7	-0.8	-0.8	-0.8	-2.1	-5.9
H. Provide a 30% Tax Credit for Uninsured Health Care Expenses	0	-0.4	-3.2	-3.0	-3.2	-3.4	-3.6	-3.8	-4.0	-4.3	-4.5	-13.2	-33.5
I. Five-Year Phase In of a 10% Reduction in Tax Rates	0	0.0	0.0	0.0	0.0	-16.0	-32.4	-48.6	-64.0	-78.0	-76.0	-16.0	-315.0
Total Income Tax Change (+/-)	0	17	2	-29	-44	-68	-90	-111	-130	-149	-153	-122.3	-755.3
Remaining On-Budget Surplus (+/-)	0	12	13.0	29.8	6.9	-0.1	-10.7	5.3	3.5	-3.4	12.2	61.7	68.7
Remaining Off-Budget Surplus for Social Security Reform	127.0	138.0	144.0	154.0	162.0	169.9	173.3	194.0	204.0	208.6	218.0	767.9	1,765.8
Percent of Budget Surplus for Social Security Reform	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	94.2%	100.0%	100.0%	98.4%	100.0%	100.0%	99.2%

* CBO budget assumption from Congressional Budget Office, *The Economic and Budget Outlook for Fiscal Years 2000 through 2009*, January 1999. CBO made minor revisions to these estimates on March 3, 1999, which are reflected in Table 1. See CBO, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2000: A Preliminary Analysis."

** CBO baseline outlays for Fiscal Years 2000 through 2002 reduced by the annual amount of additional defense spending.

that addresses the need of low- and moderate-income taxpayers for help with their medical expenses.

First, the tax rates on long-term individual capital gains in this framework would be cut by 50 percent, which means that the two rates on long-term gains fall from today's 20 and 10 percent to 10 and 5 percent. These reductions in the tax rates would produce modest revenue gains as investors divest themselves of poorly performing investments, pay capital gains taxes, and put their money in investments that earn higher rates of return. Recent experience with the capital gains tax cuts of 1997 shows that revenues grow significantly when these rates fall.

The new rates would become effective for all qualifying transactions after December 31, 1999. Not only would these new lower rates produce additional revenues in FY 2000, but they also would promote better investment decisions at a time when early signs of an economic slowdown are being seen.

Second, Congress would expand the availability of the "back-ended" individual retirement accounts called Roth IRAs. Allowing taxpayers with incomes higher than $100,000 to convert traditional IRAs into Roth IRAs will save them taxes when they cash out their IRAs and will produce immediate revenues for the federal government as taxpayers pay income tax on their old pre-tax IRAs during conversion.

Third, these additional revenues would permit Congress to offer low- and moderate-income taxpayers a tax credit equal to 30 percent of qualifying uninsured medical expenses. This tax credit would be effective for all qualifying expenses incurred after December 31, 1999. Making the credit available for expenses throughout tax year 2000 would enable qualifying taxpayers to purchase needed but currently uninsured medical care with the knowledge that only 70 percent of their family's medical outlays need be met by the family budget.

These and other tax proposals described in this paper would preserve nearly $69 billion in ten-year general fund surpluses for two purposes: the reduction of publicly held federal debt and the provision of a budgetary hedge against the inevitable failure of the economy to behave exactly in the manner the CBO assumes. Current law requires that unified budget surpluses be used to pay down publicly held debt. Thus, if Congress does nothing, federal debt will begin to fall. Although debt reduction is important, the economy and taxpayers would benefit more from a combination of tax cuts *and* debt reduction. Not only will tax cuts reduce the heavy financial burdens carried by labor and capital (thus improving the economy's efficiency and productivity), but less publicly held debt will give Washington policymakers a freer hand in financing the transition to a reformed Social Security and Medicare system.

The remaining tax cuts listed in Table 1 and described below would become available to tax-

4. The revenue and outlay data displayed in Table 1 are taken from a number of sources. For revised CBO budget assumptions, see Congressional Budget Office, *The Economic and Budget Outlook for Fiscal Years 2000 Through 2009*, and *An Analysis of the President's Budgetary Proposals for Fiscal Year 2000: A Preliminary Report*, at *http://www.cbo.gov*. The estimates for additional defense spending were prepared by The Heritage Foundation. The sources for the estimates of the individual tax policy options can be found in a number of places. For marriage penalty repeal, see Joint Committee on Taxation estimates for H.R. 2456, 105th Cong., March 12, 1998, which have been updated by The Heritage Foundation. For capital gains tax reduction, death tax phase-out, expanded education savings accounts, and Section 125 rollover provisions, see Appendix A in Beach *et al*., "A New Framework for Cutting Taxes: Reforming the Tax Code and Improving Social Security." Estimates for expanded eligibility for Roth IRAs and tax credit for uninsured health care expenses were produced by The Heritage Foundation Center for Data Analysis and are available upon request. For repeal of the FUTA surtax, see D. Mark Wilson, "How Congress Can Lower the Cost of American Jobs," Heritage Foundation *Backgrounder* No. 1213, August 14, 1998. For 10 percent tax rate reduction, see William W. Beach, D. Mark Wilson, Ralph A. Rector, Rea S. Hederman, and Aaron B. Schavey, "The Economic and Revenue Effects of Reducing Tax Rates by 10 Percent," Heritage Foundation *Center for Data Analysis Report* No. CDA99-02, also available in *Tax Notes*, Vol. 82, No. 12 (March 22, 1999), pp. 1851-1865.

payers as additional general fund surpluses emerge.

Providing Relief from the Marriage Penalty

Married couples, when both husband and wife work, frequently face marriage penalties embedded in the tax code. For example, if one earner makes $38,000, he or she will be taxed in the 15 percent bracket because that income falls under the upper limit of the 15 percent bracket, or $42,350. However, suppose the other earner makes $23,000. This taxpayer will be taxed at 15 percent only on the first $4,350 of his or her income. All of the rest will be taxed at a marginal rate of 28 percent.

Congress should reduce marriage penalties by allowing married taxpayers to choose the filing status (married filing joint or single) that most reduces their tax payments. This option is available widely in the states: Ten states allow married couples to file separately when paying state income tax; an additional 21 states have rate schedules that reduce or eliminate the marriage penalty.

In nearly half of all married households, such taxpayers will find that filing as single taxpayers will result in lower taxes. Common income (such as interest on a savings account or dividends) would be apportioned between the two taxpayers according to the percentage of total income that each earned from their jobs.

The standard deduction or the itemized deductions would be treated in a similar fashion. These married taxpayers would recombine their income when determining whether or not they are eligible for tax credits.

Savings for taxpayers: $194.1 billion over ten years; effective date: January 1, 2001.

Reducing Capital Gains Tax Rates

Congress should cut the tax rates on long-term capital gains from 20 percent to 10 percent, and from 10 percent to 5 percent for taxpayers who pay taxes at the 15 percent rate. Congress should make additional changes to simplify the complex holding rules beyond those enacted last year.

Congress reduced the top capital gains tax rate from 28 percent to 20 percent with the Taxpayer's Relief Act of 1997, which resulted in significant increases in federal revenues as investors sold appreciated assets that the higher tax rate had "locked up." This tax cut should be expanded to provide for a top rate of 10 percent. By further simplifying the complex holding period rules, Congress would reduce the compliance costs taxpayers currently face. Both reforms would lead to a fairer, simpler, and flatter tax code.

Savings for taxpayers: $47.8 billion over ten years; effective date: January 1, 2000.

Phasing Out Federal Death Taxes

Congress should enact a ten-year phase-out of death taxes by reducing estate, gift, and generation-skipping tax rates by five percentage points per year. This policy change would yield many of the same economic and fiscal benefits expected from immediate repeal. Representatives Jennifer Dunn (R–WA) and John Tanner (D–TN) have sponsored legislation this session to phase out death taxes.[5]

A 1996 analysis by The Heritage Foundation, using the WEFA Group's U.S. Macroeconomic Model, found that repealing the estate tax would have a large and beneficial effect on the economy.[6] This study showed that repeal would lead to numerous economic benefits over the nine years following repeal:

- **Economic output** would increase by an average of as much as $11 billion per year, and an

5. Death Tax Elimination Act (H.R. 8), introduced February 25, 1999.
6. William W. Beach, "The Case for Repealing the Estate Tax," Heritage Foundation *Backgrounder* No. 1091, August 21, 1996.

average of 145,000 additional new jobs could be created;

- **Personal income** could rise by an average of $8 billion per year above current projections; and
- **Federal revenues** would grow following repeal, since tax receipts generated by the extra economic growth would offset the meager revenues currently raised by the inefficient estate tax.

Richard Fullenbaum and Mariana McNeill, former economists with DRI/McGraw-Hill, recently confirmed these results in an important study for the Research Institute for Small and Emerging Business.[7] In a simulation of estate tax repeal using the WEFA U.S. Macroeconomic Model, they found that private investment would rise by an average of $11 billion over the seven years following repeal. Consumption expenditures would rise by an average of $17 billion (after inflation), and an average of 153,000 new jobs would be created in this more buoyant economy.

Savings for taxpayers: $143.8 billion over ten years; effective date: January 1, 2001.

Expanding Education Savings Accounts[8]

Congress should expand the scope of education savings accounts (ESAs) to cover not only qualifying higher education expenses at some colleges and universities, but also primary and secondary education costs and qualifying expenses at all institutions of higher education. This tax reform would eliminate the double taxation of savings for education.

Senators Paul Coverdell (R–GA), Robert Torricelli (D–NJ), and Jeff Sessions (R–AL), and Representatives Kay Granger (R–TX) and Kenny C. Hulsolf (R–MO), all have introduced legislation this session that would establish this sensible approach to education financing.[9] These bills would expand education IRAs to cover primary and secondary education expenses and would increase the annual contribution limit to $2,000 per student. The House and Senate passed similar legislation during the final days of the 105th Congress.

Ideally, both the annual contribution limit to ESAs and the income cap should be eliminated. In the end, all families should have the ability to save for a quality education for each of their children from kindergarten through graduate school.

Moreover, the coverage of tax-free education savings should be expanded to include new and innovative education investment plans. Numerous states and several private interests, for example, have established prepaid tuition plans. These programs allow families to lock in future college tuition costs at or below today's tuition rates.

Such prepaid tuition plans are attractive to families because they are guaranteed to cover the cost of a predetermined amount of future education. Thus, prepaid tuition plans not only help families save for college, but also eliminate both the uncertainty of trying to plan for ever-increasing college tuition costs and—if relieved of the current unfair tax treatment—the double taxation of education savings.

Savings to taxpayers: $4.4 billion over ten years; effective date: January 1, 2001.

7. Richard F. Fullenbaum and Mariana A. McNeill, "The Effects of the Federal Estate and Gift Tax on the Aggregate Economy," Research Institute for Small and Emerging Business *Working Paper Series* No. 98-01, 1998.
8. For more information on education savings accounts, 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. 1188, May 22, 1997.
9. Senators Paul Coverdell and Robert Torricelli, Education Savings Account and School Excellence Act of 1999 (S. 14); Senator Jeff Sessions, Collegiate Learning and Student Savings Act (S. 13); Representative Kay Granger, Higher Education Affordability and Availability Act (H.R. 464); Representative Kenny Hulsolf, Education Savings and School Excellence Act of 1999 (H.R. 7).

Expanding Eligibility for Roth IRAs

One of Congress's most important tax reforms in 1997 was establishment of Roth IRAs. These popular tax-advantaged individual savings accounts permit taxpayers to convert their pre-tax IRAs into IRAs that never again face taxes. Traditional IRAs eliminate taxation at the time they are purchased because taxpayers are permitted to use pre-tax dollars to create them; but they will pay income taxes when they cash out their IRAs. The federal government assesses income taxes on the principal and the buildup. For example, a taxpayer in the 15 percent rate bracket could have paid $300 in taxes on $2,000 if he had not created a $2,000 IRA. However, if this IRA grows to $5,053 by the time he cashes it in, he would owe $758.[10]

Roth IRAs adopt a different schedule of tax relief to correct this tax problem with tax-preferred savings accounts. Taxpayers, instead of having to pay tax on the future value of the IRA, purchase Roth IRAs out of money that already has been taxed. Thus, the taxpayer in the 15 percent bracket who purchases a Roth IRA for $2,000 in after-tax dollars will pay no further taxes on that amount or on any of the buildup.

Senator William Roth (R–DE) now proposes—in the Retirement Savings Opportunity Act of 1999, co-sponsored with Senator Max S. Baucus (D–MT)—to make Roth IRAs more accessible to more taxpayers.[11] Taxpayers with incomes over $100,000 did not have access to the original Roth IRAs. Senator Roth's new legislation would lift the income cap to $1,000,000. It also would raise the annual amount taxpayers can devote to Roth IRAs from $2,000 to $5,000, and correct a number of other deficiencies in the original Roth IRA law.

This proposed expansion in Roth IRAs is especially welcome in light of the problems workers will face if they depend solely on Social Security for their retirement income. Congress should move forward with this expansion of tax-preferred savings. It also should change current tax policy in other ways that will help low- and moderate-income workers save for their retirement.

Revenue change: $3.6 billion over ten years; effective date: January 1, 2000.

Repealing the FUTA Payroll Surtax[12]

Congress should repeal the payroll tax increase it imposed on workers in 1997. In fact, the third largest tax *increase* in the Taxpayer Relief Act of 1997 was an extension of a little-known payroll surtax in the Federal Unemployment Tax Act (FUTA) that was scheduled to expire at the end of 1998. Believing incorrectly that Congress needed to increase revenues to balance the budget, Members voted to extend the FUTA surtax through 2007 and raised the ceiling on federal trust funds. As a result, the tax burden on American workers hit an all-time high, and surplus unemployment taxes are piling up to be used for purposes completely unrelated to the unemployment system.

Revenue from the FUTA tax is designated for the administration of the Unemployment Insurance (UI) system. The current FUTA tax rate of 0.8 percent on the first $7,000 of wages has two components: a permanent tax rate of 0.6 percent and a temporary surtax of 0.2 percent. Passed in 1976 to restore depleted federal UI trust funds, the surtax was set to expire in 1987. Since 1987, it has been extended five times despite having accomplished its goal, and is now set to expire at the end of 2007.

Repeatedly extending the temporary surtax has caused federal UI trust fund balances to balloon from $4.9 billion in 1987 to $19.1 billion in 1997.

10. This example assumes an interest rate of 5 percent per year. It is important to note that $758 in taxes after 20 years is equal to $300 in taxes today. In other words, the federal government can wait 20 years to collect taxes, which it has discounted each year by 5 percent, or it can have its taxes now, without any discounting.

11. Senators William Roth and Max Baucus, Retirement Savings Opportunity Act of 1999 (S. 646), filed March 17, 1999.

12. For further details, see D. Mark Wilson, "How Congress Can Lower the Cost of American Jobs," Heritage Foundation *Backgrounder* No. 1213, August 14, 1998.

Because of last year's extension of the surtax, trust fund balances are forecast to increase sharply to $41.6 billion at the end of FY 2003. Like Social Security payroll tax revenue, FUTA surtax revenue in federal trust funds is converted into federal government bonds and spent as general revenues. The money is not set aside for the UI system.

Senators Wayne Allard (R–CO) and Michael DeWine (R–OH) have introduced legislation to repeal the FUTA surtax.[13] Senator DeWine's bill also would reform the financing of employment security programs. His proposals build on legislation advanced by Representative Clay Shaw (R–FL) in the last session of the 105th Congress. Together, these two bills would let workers and businesses keep $14.4 billion more of their hard-earned money over the next ten years—just 1.6 percent of the projected budget surplus. They also would let Congress honor the promise it made in 1993 to repeal the temporary FUTA surtax and take a small step toward lowering the tax burden on American workers.

Savings to taxpayers: $14.4 billion over ten years; effective date: January 1, 2001.

Reforming Section 125 Provisions for Flexible Spending Accounts[14]

Congress should correct a flaw in current tax policy by modifying Section 125 of the Internal Revenue Code to allow workers to roll over, tax-free, up to $500 of unused health-related savings in their flexible spending accounts (FSAs) each year. These accounts, often known as "cafeteria plans," allow workers to earmark part of their wages, before taxes, to cover out-of-pocket medical expenses. But if there are unused balances at the end of the year, this money now must be forfeited and returned to the employer.

The immediate results of allowing workers to roll over unused balances would be an increase in the direct purchasing of medical services from doctors and other providers, a change in the dynamics of the current insurance market, and an increase in personal savings for future health care needs or retirement. As more funds were saved through such rollover FSAs or cafeteria plans, and available for retirees' health care coverage, the future demands on Medicare would decline.

The change in revenue to the federal Treasury in the meantime, based on calculations by the Joint Committee on Taxation, would amount to an average revenue decrease of only $600 million per year or $5.9 billion over ten years.

Revising Section 125 of the tax code would result in immediate benefits for a significant portion of the American workforce. According to the Bureau of Labor Statistics, as of 1994, 21.7 million private-sector employees chose to take advantage of employer-provided FSAs—14.8 million employed in medium to large establishments and 6.9 million in small establishments. In addition, 50 percent of state and local government employees had FSAs.

Today, FSAs and cafeteria plans are gaining popularity in the marketplace. They have been proven to meet the needs of a diversified pool of workers. If FSA funds can be rolled over tax-free, they will become a great boon, stimulating employee savings and enhancing employee security.

Savings to taxpayers: $5.9 billion over ten years; effective date: January 1, 2001.

Providing a 30 Percent Tax Credit for the Purchase of Health Insurance

Employer payments for employees' health insurance are part of each worker's compensation, but they are excluded from a family's income and payroll taxes. Thus, workers in the 15 percent income tax bracket avoid paying both the 15 percent income tax and the 15.3 percent combined

13. Senator Wayne Allard, S. 103, and Senator Michael DeWine, The Employment Security Financing Act of 1999.
14. Additional information on reforming Section 125 rollover provisions can be found in Robert E. Moffit and William W. Beach, "Rollover Flexible Spending Accounts: More Health Choices for Americans," Heritage Foundation *Backgrounder* No. 1159, February 24, 1998.

employer and employee payroll tax on the value of employer-provided health insurance—for an effective tax break of 30.3 percent. However, workers whose employers do not offer coverage must pay with after-tax dollars for coverage they buy on their own. In addition, many employers now pay only part of the premium for their employees' health insurance, particularly for family coverage, leaving the workers to pay the rest of the cost with after-tax dollars. The effect is that those who can least afford health insurance receive little or no tax relief to help them purchase coverage. Not surprisingly, most of today's 40 million uninsured Americans are workers or dependents of workers who are employed in lower-wage jobs or by small businesses.

At a minimum, all Americans should be provided with approximately equal tax treatment for their health insurance expenses. The simplest way to do this is to provide a 30 percent refundable tax credit for premiums paid directly by individuals and families for their health insurance (either through a plan they purchase on their own or payments they make for employer-sponsored coverage). The tax credit also could be targeted to those most in need of help by limiting eligibility to families with incomes below $40,000 and singles with incomes below $20,000. Almost 80 percent of the uninsured are in households with incomes of less than $40,000. While this change alone would not result in coverage for all of the uninsured, it would at least provide equal tax treatment and help a portion of the uninsured to gain coverage, particularly those who currently decline their employer-sponsored coverage because of cost-sharing requirements.

Savings to taxpayers: $33.5 billion over ten years; effective date: January 1, 2000.

Reducing Marginal Tax Rates for Individuals by 10 Percent

The tax rates that individual taxpayers face have risen twice since the Tax Reform Act of 1986. In 1991, Congress added a 31 percent rate to the two low rates (15 percent and 28 percent) of 1986. Then, in 1993, Congress added two additional rates: 36 percent and 39.6 percent. Current tax law denies many taxpayers in the top rate the exemptions, deductions, and credits that are available to taxpayers with lower incomes; thus, the effective tax rate in the top rate bracket is well above 40 percent.

These new tax rates account for part of the excess revenues that Washington currently collects. Congress should use the large general fund surpluses that are forecast for fiscal years 2004 through 2009 to cut all marginal tax rates. The CBO's forecasts of general fund surpluses are sufficiently large to enable Congress to phase in a 10 percent rate reduction over five years, beginning in FY 2004.

A recent Heritage Foundation Center for Data Analysis report shows that reducing marginal income tax rates by 10 percent will boost America's economic output, create new jobs, and promote much-needed personal savings.[15] For example, a fully phased in reduction of marginal tax rates by 10 percent would:

- **Raise** inflation-adjusted gross domestic product by an average of $35.9 billion over a ten-year period;
- **Create** an additional 289,000 jobs per year; and
- **Increase** the total amount of personal savings by $39.4 billion by the tenth year after the rate reduction.

Savings for taxpayers: $315 billion over ten years; effective date: January 1, 2004.

THE NEED TO PROVIDE HIGHER DEFENSE FUNDING

The Clinton Administration has taken full advantage of the end of the Cold War to achieve budgetary savings through cuts in defense outlays well beyond those implied by America's strategic victories of the late 1980s. In fact, so excessive

15. Beach *et al.*, "The Economic and Revenue Effects of Reducing Tax Rates by 10 Percent."

have these defense cuts been that the readiness of U.S. military forces has fallen to levels not seen since the last years of the Carter Administration. With new challenges from China and North Korea, as well as unresolved military "hot spots" in the Middle East and the Balkans, the United States can ill afford to fall further behind in its core mission of protecting U.S. lives, property, and vital national interests.

Tax cuts without adequate national security leave open the distinct possibility of losing the promise of greater future prosperity to otherwise avoidable military confrontations. That is why The Heritage Foundation supports increasing outlays for defense by $246 billion over the next ten years. An adequate defense is just as compatible with the principle of limited government as is the principle of low and just taxation. Indeed, without the means to protect the United States against its adversaries, all of the benefits of achieving a society of free and responsible individuals are put at risk.

Increased defense outlays: $245.6 billion over ten years; effective date: October 1, 1999.

USING THE REMAINING SURPLUS TO CREATE PRIVATE SOCIAL SECURITY INVESTMENT ACCOUNTS

Table 1 shows that enacting these tax cuts and enhancing defense outlays makes 68 percent of the ten-year, unified budget surplus available for reforming Social Security. That amounts to $1.766 trillion—a sum sufficient, if prudently employed, to make significant headway toward a new Social Security retirement program that includes personal savings accounts (PSAs) as well as a basic retirement income guarantee.

The debate over the shape of the new Social Security retirement program turns on a number of interesting proposals, from President Bill Clinton's advocacy of using income taxes to save the system to Senator Rod Grams' (R–MN) nearly complete "privatization" of the program. Heritage analysts in the past have illustrated the fiscal dimensions of reform through a simulation of personal savings accounts equal to five percentage points of the payroll tax. The details of this illustration are contained in the Heritage publication, "A New Framework for Cutting Taxes: Reforming the Tax Code and Improving Social Security."[16]

As described in that study, a worker who chooses to create a PSA would exchange the income received from the PSA for the portion of Social Security retirement benefits associated with the amount of taxes placed in the account. The worker would, however, receive the Social Security benefits that are financed by the rest of his or her payroll taxes.

This would not affect the insurance elements of the Social Security program, such as disability and benefits for the dependents of workers who die before retirement. All Americans, regardless of whether they opened a private savings account with some of their payroll taxes, would be entitled to a minimum benefit from traditional Social Security.

A reform of this type calls for Congress to authorize diverting a portion of a worker's payroll tax into a private retirement savings account that meets certain federal requirements. Public debt would be used to make up any shortfall in trust fund receipts. The reduction in Social Security benefits would be based on the number of years in which the individual elected to place a part of the payroll tax in the private account.

Although this approach involves a significant up-front "cost" to the Treasury from the perspective of the annual unified budget accounts, it would lead to a huge reduction in the long-term unfunded liability of the Social Security trust fund. Taken together, the total liabilities of the federal government that would have to be paid by future taxpayers (specifically, the national debt plus the unfunded liabilities of Social Security) would be cut sharply under this approach. And workers could look forward to higher incomes during

16. See Beach *et al.*, "A New Framework for Cutting Taxes: Reforming the Tax Code and Improving Social Security," pp. 7–8.

retirement, thanks to the better returns that are likely to flow from their private accounts.[17]

CONCLUSION

The energetic and productive citizens of the United States created the budget surplus and now offer Congress and the President an opportunity to make much-needed changes in federal tax policy. Congress should pursue two objectives in writing this year's tax bill: cut taxes now and make changes in tax policy that lead to fundamental tax reform.

The steps outlined in this analysis would do both. Taken together, they could save taxpayers $755 billion in taxes over the next ten fiscal years.

Taxpayers no longer would face marriage penalties, onerous taxes collected when they die, taxes on their savings that prevent them from being able to save to send their children to college or to prepare for their own retirement, or taxes on medical expenses that are not covered by employer-provided health care programs. They would get back excessive taxes collected in the federal unemployment insurance program and would be able to roll over their year-end balances in health care-related flexible spending programs. Furthermore, they could see their tax rates cut by 10 percent if the economy continues to grow at the rate forecast by the Congressional Budget Office.

America's taxpayers know, as do Members of Congress, that it is not necessary to wait for fundamental tax reform before making important changes in tax policy and cutting taxes. If Congress preserves the Social Security surpluses for Social Security reform, taxpayers will support changes in the tax code that fulfill the objectives of increased fairness, greater simplicity, and a reduction in the tax burden. All that remains is for Congress to move tax policy in this direction.

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17. See William W. Beach and Gareth G. Davis, "Social Security's Rate of Return," Heritage Foundation *Center for Data Analysis Report* No. CDA98-01, January 15, 1998.