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COMPENDIUM OF STUDIES ON TAX POLICY AND THE ECONOMY

SUBMITTED TO THE

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LETTER OF TRANSMITTAL

December 22, 1998

To the Members of the Joint Economic Committee:

Transmitted hereby is a *Compendium of Studies on Tax Policy and the Economy*. It is comprised of nine Joint Economic Committee staff studies.

The views expressed in these papers are those of the authors and do not necessarily represent the views of the individual Members of the Joint Economic Committee.

Sincerely,

Jim Saxton,
Chairman.

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COMPENDIUM OF STUDIES ON TAX POLICY AND THE ECONOMY

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A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

July 1997

Executive Summary

Dr. Lawrence B. Lindsey emphasizes that tax rates tending toward maximization of Federal revenue are not the same as those conducive to economic well-being and economic growth.

His review of the key concept of Excess Burden (the net loss in economic well-being to the taxpayer form a tax) demonstrates that even when higher tax rates increase government revenue, economic offsets include reduced taxpayer well being, a shrinking tax base, and a lower economic output.

Lindsey strongly urges the Congress to recognize this explicit trade off, to change its analytic approach to taxation by taking into account the degree of burden imposed at the margin to collect an additional dollar of Federal revenue, and to consider the cost of maintaining today's high rate structure This approach, he concludes, would allow Congress to do the best job it can at maximizing economic welfare.

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REVENUE MAXIMIZING TAXATION IS NOT OPTIMAL

by Lawrence B. Lindsey[1]

I believe that Congress is taking a very appropriate look at our tax system with the intent of rebuilding it from the ground up. Ultimately, one would hope that the final product of this work will be a tax system which is less of a burden on the U.S. economy and its taxpayers and therefore more conducive to economic growth. In that regard, it is important to lay an appropriate groundwork for a proper analysis of the issues involved.

My objective is to focus on one very important and widely misunderstood aspect of the analysis of taxation: the existing confusion between "revenue maximization" and "optimal taxation." I believe that this confusion is leading tax and budget policy makers to legislate tax systems with rates which are excessive from the point of view of economic growth.

Oddly enough, I believe that many of those who were most important in pointing out two decades ago that the United States suffered from excessively high tax rates have contributed to the confusion between revenue maximization and optimality. Consider Figure 1. It depicts the Laffer Curve, named for economist Arthur Laffer. Laffer elegantly depicted an economic reality that economists since Adam Smith have recognized: that higher tax rates might not necessarily produce higher revenue. He noted that at tax rates of either zero or 100 percent, government tax collections would be non-existent. He reasoned, correctly, that at some point between these two figures, revenue would be maximized. Although Laffer certainly never claimed that the revenue maximizing rate was the best one, or the optimal one, the construction of the figure naturally leads one to think that there is something good about being at the top.

I believe Laffer's actual point was that being on the right side of that revenue maximizing point was truly foolish. Not only were taxpayers worse off on that right-hand slope, so was the government.

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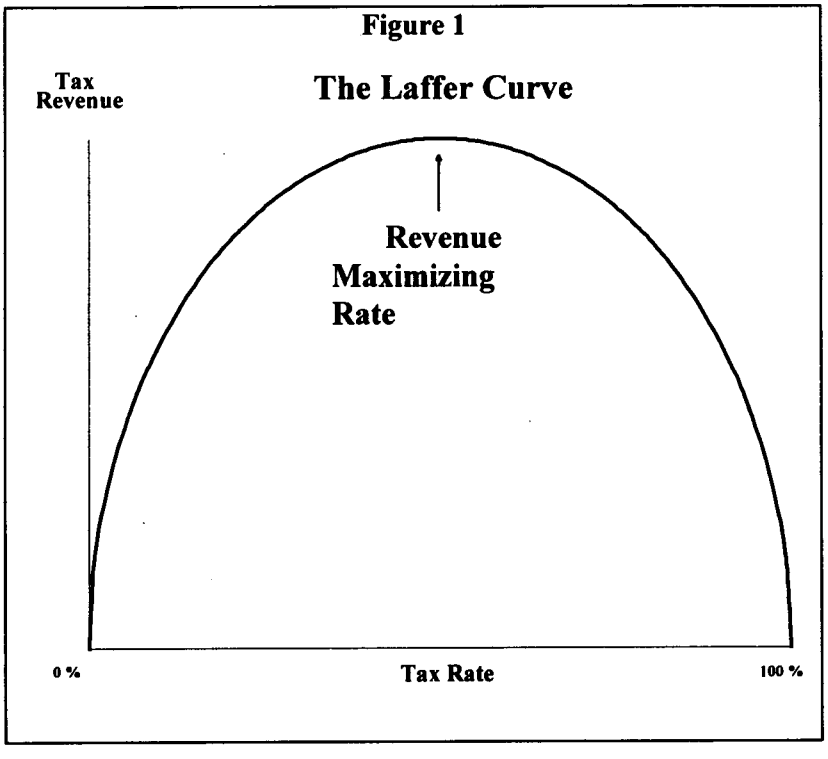
[1] The views expressed are the author's and do not necessarily reflect those of the American Enterprise Institute or any other employer past or present.

The point had real policy relevance, since with tax rates of up to 70 percent, the top portion of the U.S. tax system was clearly in that prohibitive range.

Figure 1



Some analysts who supported lower rates actively led to the confusion about the high point of the Laffer Curve being optimal. For example, Jude Wanniski argued regarding the revenue maximizing point, "It is the point at which the electorate desires to be taxed. It is the task of the statesman to determine the location of [the maximum] and follow its variations as closely as possible."[2]

On this issue, Wanniski was completely wrong. Far from being desirable, the revenue maximizing rate is actually one which any statesman would want to avoid like the plague. As I shall show, only those individuals who care only about the well-being of the Treasury

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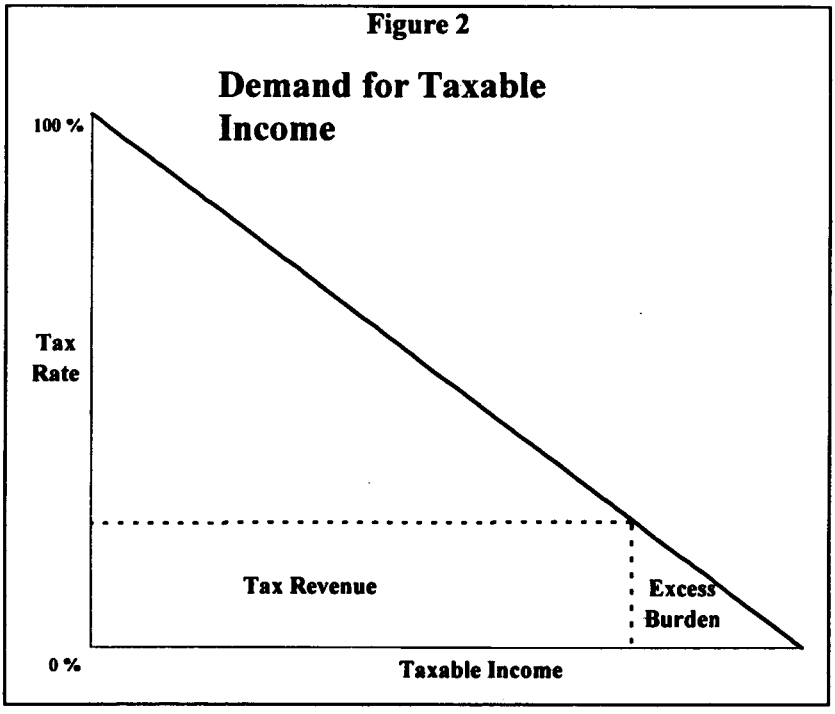
[2] Jude Wanniski, "Taxes, Revenues, and the 'Laffer Curve,'" *The Public Interest*, Winter 1978, pp. 4-5.

and do not care anything about the well-being of the taxpayer would choose the revenue maximizing point.

I wish to suggest a different way of looking at this issue and introduce the concept of the excess burden of taxation. Consider Figure 2. The figure depicts what I term the "Demand for Taxable Income." Like any demand curve in economics, it is downward sloping. That is, as the price of taxable income falls, people demand more of it. In this case, the price of taxable income is the tax rate. It is how much the taxpayer must pay the government in order to earn another dollar of taxable income. Note that at a tax rate of 100 percent, the taxpayer chooses to earn zero taxable income. At a zero tax rate, the graph depicts the amount of taxable income that a taxpayer would choose in the absence of any taxation.

Figure 2



The Demand for Taxable Income is a useful analytic tool since it helps to graphically depict two important considerations regarding tax policy. The first is tax revenue. The government sets a tax rate and the Demand for Taxable Income shows what the tax base will be at that

rate.[3] The amount of tax revenue the government collects is therefore easily shown as a rectangle--the tax rate times the tax base.

The second concept depicted by the Demand for Taxable Income is the excess burden of taxation. The excess burden is a very important concept. First, it is different from tax revenue. After all, paying taxes is a burden to the taxpayer. But, from society's point of view, it is not a net loss in economic well being. The taxpayer's loss is the government's gain.

Excess burden is the loss in the taxpayer's well being above and beyond the taxes he pays. There is no offsetting gain to the government from this loss in well being. The excess burden of the tax is indicated by the triangle to the right of the revenue rectangle. In order to understand why this is the case, we must think about what the Demand for Taxable Income means.

Like any demand curve, the Demand for Taxable Income shows how much the demander (the taxpayer) values receiving another unit of the good, in this case another dollar of taxable income. Note that this value is always less than one dollar. For example, when the tax rate is 20 percent, the taxpayer gives up all those dollars of taxable income which he values at less than 20 cents on the dollar.

Why would a taxpayer value a dollar of taxable income at less than a dollar? It is because he must give up something to get that dollar of taxable income. For example, he may have to work more, giving up leisure. Or he may have to give up a dollar of untaxed enjoyment such as a perk or fringe benefit. So, the demand curve tells us the NET value to the taxpayer of getting another dollar of income; literally this is the dollar minus how much he valued what he had to give up to get that dollar.

Therefore, a taxpayer who values his time spent going fishing instead of working at 80 cents has a net value of getting another dollar of taxable income of 20 cents. If his tax rate on that dollar is more than 20 percent, the cost of giving up his time--80 cents value in fishing plus more than 20 cents in taxes--is more than the value of earning the extra dollar, and he chooses not to earn it. If his tax rate on that dollar is less than 20 cents, on net he comes out ahead and chooses to earn. The demand curve tells us exactly the "break-even point" between earning and not earning.

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[3] This assumes that all taxable income is taxed at a single rate. Mathematically, it can be shown that a progressive rate structure would produce a lower revenue maximizing rate.

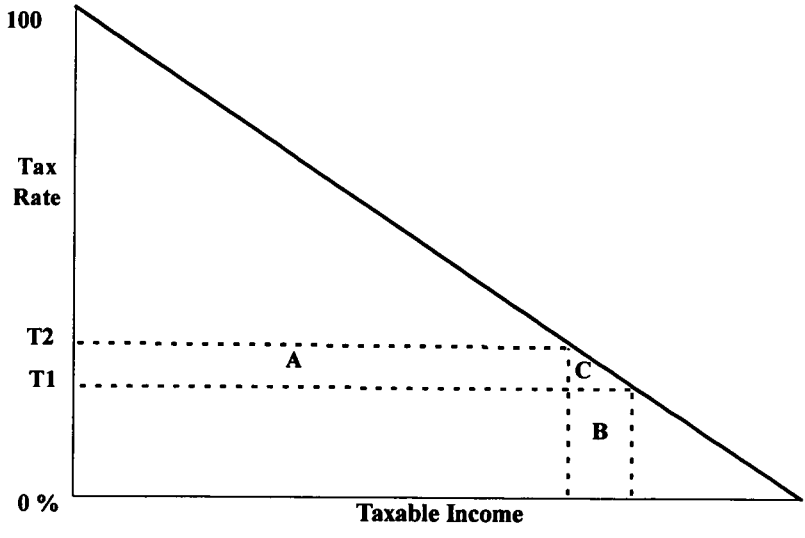
From the taxpayer's point of view, the net value to him of giving up dollars of taxable income is given by the triangle, the area under the demand curve, on dollars of taxable income not earned because of taxes. This is less than the amount the economy shrinks as a result of the tax. Generally, the economic output forgone is dollar for dollar with the process of giving up taxable income. That is because untaxed activities which also do not show up as economic activity, such as going fishing, are substituted for taxed activities.

Thus, excess burden is over and above the cost of paying taxes, but is less than the reduction in economic activity from taxes. It is the net loss in economic well being to the taxpayer from the tax.

Now, consider Figure 3 to show what happens when a tax rate is increased from rate T1 to rate T2. First, the government collects taxes at a higher rate on the new level of taxable income earned. That is depicted in the box labeled "A." Second, the government gives up some revenue which it would have collected at the old rate of T1 because the level of taxable income falls. That is depicted in the figure by the box labeled "B." So, the net increase in revenue from raising this tax is A minus B, the revenue gained from raising the rate minus the income lost from shrinking the tax base.

Figure 3

Effect of a Tax Rate Increase on Excess Burden



As drawn, this tax increase is a revenue gainer, placing it on the left-hand slope of the Laffer Curve. But does this mean that raising the rate was a good idea? That depends on how much worse off the taxpayer is. Obviously the taxpayer is worse off by rectangle "A," because that is revenue he is now paying the government. But, because the government is ahead by that box, it is not a net loss in well-being for society as a whole, only for the taxpayer. Therefore, it is not counted as an excess burden of the tax.

The **increase** in the excess burden of this tax is given by how much bigger the triangle to the right of the revenue box grew. That is graphically depicted in Figure 3 by rectangle "B" plus little triangle "C." To sum up, the government gained rectangle A and lost rectangle B. The taxpayer lost rectangles A and B and little triangle C. Whether it was a good idea or not to raise taxes depends on how much you value the government's need for revenue and how much you value the taxpayer's well being.

The concept that I would strongly urge the Congress to begin considering is what is technically called the "Marginal Excess Burden per Extra Dollar of Revenue." In terms of Figure 3, it is a comparison of areas B and C with area A minus area B. As shown in Figure 3, the marginal excess burden is larger than the extra revenue collected. This means that the net loss in social welfare was more than the gain in revenue. Stated differently, the taxpayer lost more than $2 for every $1 the government collected.

So much for the theory. Let me bring this down to a very practical application. I refer you to an editorial in the *Washington Post* on February 20, 1990.[4] In the second paragraph, the *Post* goes through an analysis very similar to the one which I have just performed. A key difference is that the discussion is about CUTTING tax rates, not RAISING them. So, we have to consider the question in reverse: What is the GAIN in taxpayer well-being--or the reduction in EXCESS BURDEN per dollar of revenue lost by the Treasury?

The editorial notes, "The Treasury would lose from the lower rate but gain from the higher volume." In this case, the *Post* is talking about area A as a loss to the Treasury and area B as a gain to the Treasury from an expansion in taxable income. The editorial goes on to talk about the Joint Committee on Taxation (JCT) estimates of the burden of the tax, citing $100 billion as the amount by which taxpayers would be better off over five years. This is the JCT estimate of areas B

[4] *Washington Post*, "Rich and Poor," February 20, 1990.

and C. It then gives an estimate of the net revenue foregone of $11 billion. This is the JCT estimate of area A minus area B.

The marginal excess burden per dollar of revenue collected in the tax change talked about in the *Post* is roughly $9 per dollar of revenue. In the case discussed, the JCT estimated that taxpayers would be made better off for every $1 that the Treasury would sacrifice in revenue. Would this have been a good idea?

Now the *Post* argued that it would not be a good idea. They argued that because these taxpayers who would have seen their burdens reduced were largely well-to-do, the government was smart to keep the rates high. In the *Post's* reasoning, it was sensible to make these taxpayers $9 worse off in order for the Treasury to collect an additional dollar in revenue. The *Post* is entitled to its opinion; after all, this is a political judgment.

I respectfully disagree with the *Post's* conclusion. If the Congress genuinely is interested in improving economic well-being and fostering economic growth, taxes which make society $9 worse off to collect an extra $1 of revenue are luxuries we simply cannot afford. But again, that is a political judgment. The more important issue is the analytic point. If Congress is going to consider how to build a better tax system, it must begin to consider this trade-off explicitly.

Note that this is going to be radically different than looking at the Laffer Curve or searching for the revenue maximizing rate. If you thought that the revenue maximizing rate was where you should head, then you would have to agree with the *Post*. After all, the Treasury did gain from keeping the rate higher. The revenue maximizing rate argument does not factor in the costs to society of collecting the revenue.

It is a mathematical point, but at the very top of the Laffer Curve, the marginal excess burden per extra dollar of revenue is infinite. Literally, by picking the revenue maximizing rate, Congress is saying that it is willing to impose ANY cost on the taxpayer in order to collect more revenue. Frankly, I do not think that is economically defensible, nor do I really believe that members of Congress would care to defend such a position in their districts.

Therefore, my recommendation is for Congress to change its analytic approach and begin to consider how much of a burden is being imposed **at the margin** for maintaining today's rather high tax rate structure. If such calculations are made the basis for analysis, Congress will by definition be doing the best job it can at maximizing

economic welfare. Any tax imposed will carry an excess burden. But isn't it smart policy to make that burden as small as possible?

About the author:

Dr. Lawrence B. Lindsey joined the American Enterprise Institute in Washington, D.C. on February 6, 1997 as a Resident Scholar and holder of the Arthur F. Burns Chair in Economics. He is also Managing Director of Economic Strategies, an economic advisory service based in New York City.

Dr. Lindsey served as a Member of the Board of Governors of the Federal Reserve System for five years from November 1991 to February 1997. Dr. Lindsey also served three years on the staff of the Council of Economic Advisers during the Reagan Administration where he was Senior Staff Economist for Tax Policy.

Optimal Capital Gains Tax Policy: Lessons From the 1970s, 1980s, and 1990s*

JIM SAXTON (R-NJ),
Chairman

Joint Economic Committee
United States Congress

June 1997

Abstract

This study analyzes data from previous changes in the capital gains tax rate and concludes that the current capital gains tax rate is too high. The study shows that a reduction in the capital gains tax would generate large revenue gains in the short run and would be roughly revenue neutral in the long run. In addition, a lower capital gains tax rate would improve the efficiency of capital markets and benefit the entire economy. Furthermore, failure to adjust capital gains for inflation results in excessively high effective capital gains tax rates, imposing an unfair burden on taxpayers even when the inflation rate is relatively low.

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OPTIMAL GAINS TAX POLICY: FROM THE 1970S, 1980S, AND 1990S[5]

James D. Gwartney[6]
Randall G. Holcombe[7]

The federal capital gains tax has been the subject of substantial debate for more than a decade. Prior to the Tax Reform Act of 1986 long-term capital gains were taxed at a lower rate than ordinary income, but since that tax reform, they have been taxed at the same rate. Advocates of capital gains tax cuts argue a lower rate would stimulate investment and benefit the economy. Those who argue against the cuts say that any stimulus would be small, that the Treasury cannot afford the revenue losses that would result from rate cuts, and that reducing the capital gains tax rate would provide an unfair benefit to upper-income taxpayers who pay most of the capital gains taxes.

A number of the major issues surrounding the capital gains tax debate can be analyzed by examining the data on capital gains taxation during the past two decades. This period is particularly interesting to an analyst because the capital gains tax rates were altered several times. In 1974 the highest marginal tax rate on capital gains was 35 percent, and a series of cuts lowered it to 20 percent by 1982. The 20 percent rate remained in effect until 1987, when it was raised to the current 28 percent level. The response to these rate changes can be used to estimate the actual effects of changes in capital gains tax rates on the tax base and the revenue derived from the tax. In turn, this information can guide us as we search for an optimal capital gains tax policy.

The analysis that follows unambiguously concludes that the current capital gains tax rate is too high. Analysis of data from previous changes in the capital gains tax rates indicates that a reduction in the capital gains tax rate from 28 percent to 20 percent will result in a substantial increase in capital gains tax revenue in the short run. In

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[5]The authors gratefully acknowledge the research assistance of Jennifer Platania.

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the long run, revenue may either increase or decrease slightly. If there are any revenue losses in the long run, they will be exceedingly small because revenue reductions due to the lower rate will be offset by revenue enhancements resulting from increased capital gains realizations. A lower capital gains tax rate will both (1) release capital resources that many investors continue to hold in order to delay or avoid a tax liability and (2) reduce an impediment to the purchase and sale of capital assets. Both of these factors will improve the efficiency of capital markets and benefit the entire economy. Furthermore, the current failure to adjust capital gains for the effects of inflation leads to exceeding high effective capital gains tax rates and imposes an unfair burden on asset owners earning only modest capital gains returns. As we will demonstrate, this is true even when the inflation rate is relatively low. The effective capital gains tax rate is *highest* for those taxpayers earning the *lowest* rates of return on their ownership of capital assets. This inverse relationship between rate of return and the effective tax rate is both unfair and inefficient. Indexing would eliminate this discriminatory element of the current system. Based on this analysis, we conclude that the capital gains tax rate should be cut substantially, and that capital gains should be indexed to adjust for the effect of inflation.

Capital Gains Tax Rates and Revenues

Straightforward economic reasoning shows that in principle tax rates could be so high that lowering them would expand the tax base sufficiently to increase the revenue derived from the tax. While there is little debate that this effect could, in theory, exist, there is a great deal of debate on how high tax rates must rise before it takes place in practice. Skeptics argue that rates would have to reach 80 percent or 90 percent before an increase in tax rates would reduce tax revenues. On the other hand, some would argue the revenue maximum rate is much lower, perhaps as low as 30 percent in the case of the personal income tax.[8]

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[8]See Feldstein (1995b) for support of the idea that tax rate decreases led to increases in revenues. Slemrod (1990) contains a number of chapters arguing both ways, showing that there is not a consensus on the issue. Even a tax rate of zero could increase tax revenues, when all effects are considered. Feldstein (1995a) argues that by exempting IRA contributions from income taxation, saving increases, which increases corporate income. Increased corporate income tax payments may more than offset the revenue losses from the zero rate in IRA contributions.

When examining the effects of tax rates on revenues, the issue can sometimes be clouded by the fact that, because of deductions and other special provisions, income from different sources can be taxed at different effective rates. Capital gains income provides a good example. The degree to which capital gains tax revenues are sensitive to rate changes has been the subject of debate among economists for decades. Feldstein, Slemrod, and Yitzhaki (1980) argued that a capital gains tax cut would increase revenues, and a decade later, Slemrod and Skobe (1990), in an environment where the rate was lower, argued that this remained true in the short run, and possibly in the long run as well. Auten and Clotfelter (1982) found no strong support for an inverse relationship between capital gains tax rates and revenues, but even this suggests that the rate is too high. At the other end of the spectrum, Auerbach (1988) suggests that after any transitory effects from rate changes are accounted for, there is no strong evidence that changes in capital gains tax rates have any effect on capital gains realizations.

The capital gains tax rate has exhibited large fluctuations since the late 1970s, providing a substantial amount of evidence that capital gains realizations are very sensitive, both in the short run and in the long run, to changes in the capital gains tax rate. Table 1 shows the maximum marginal tax rate on ordinary capital gains from 1974 to 1994, along with realized capital gains in current dollars and in constant 1992 dollars.[9] The numbers in parentheses show the amount of capital gains that was included in adjusted gross income (AGI). Prior to 1978 long-term capital gains were taxed at half the rate of ordinary income, and the rate was computed simply by dividing actual capital gains by two so that only half of long-term capital gains income was added to adjusted gross income for tax purposes. Thus, adjusted gross income excluded half of the long-term capital gains income and the top rate was 35 percent (half of the 70 percent maximum marginal personal income tax rate applicable at the time). The exclusion was upped to 60 percent in 1979, lowering the maximum effective capital gains tax rate to 28 percent (40 percent of the 70 percent top rate). In 1982 the maximum personal tax rate was lowered to 50 percent and the 60 percent exclusion was retained, lowering the maximum capital gains tax rate to 20 percent. The Tax Reform Act of 1986 treated capital gains as ordinary income, but placed a cap on the rate at 28 percent.

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[9]Depending upon the size and magnitude of other sources of income, various minimum tax provisions caused some taxpayers to confront marginal rates higher than the maximum ordinary capital gains rate during years prior to 1979.

Despite increases in ordinary income tax rates since then, the maximum capital gains tax rate has remained capped at 28 percent.

The inflation-adjusted capital gains realizations, in constant 1992 dollars, are also shown in Table 1. The impact of rate changes on the realization of capital gains is clearly observable. Legislation passed in 1978 cut the top capital gains rate from 35 percent to 33.8 percent in 1978 and 28 percent in 1979 when the rate reduction became fully effective. Capital gains realizations rose from $100.7 billion in 1977 to $112 billion in 1978, an increase of more than 11 percent. Then in 1979, the first full year of the lower rate, capital gains increased by an additional 24 percent (to $139 billion).[10] The cumulative two-year increase was 38 percent, far larger than increases in prior years. After this short-run impact, growth slowed, but capital gains realizations remained well above the levels they had exhibited under the 35 percent rate.

Although everybody does not pay the maximum effective rate, one can roughly estimate the percent change in revenue as the result of the rate reduction by multiplying the maximum effective rate by the amount of realized gains (measured in constant dollars). This implies tax collections of about $35 billion in 1977 and $39 billion in 1979, strongly suggesting that the 35 percent rate of 1977 was higher than the revenue-maximizing capital gains rate, at least in the short run.

Realized capital gains in 1981 were $127 billion, implying capital gains taxes of $36 billion, calculated the same way, indicating that even in the long run, the lower rate expanded tax revenue.

[10] In 1978 and 1981 the capital gains tax cuts were implemented in mid-year, and the rates shown in the table for those years are effective rates for the entire year.

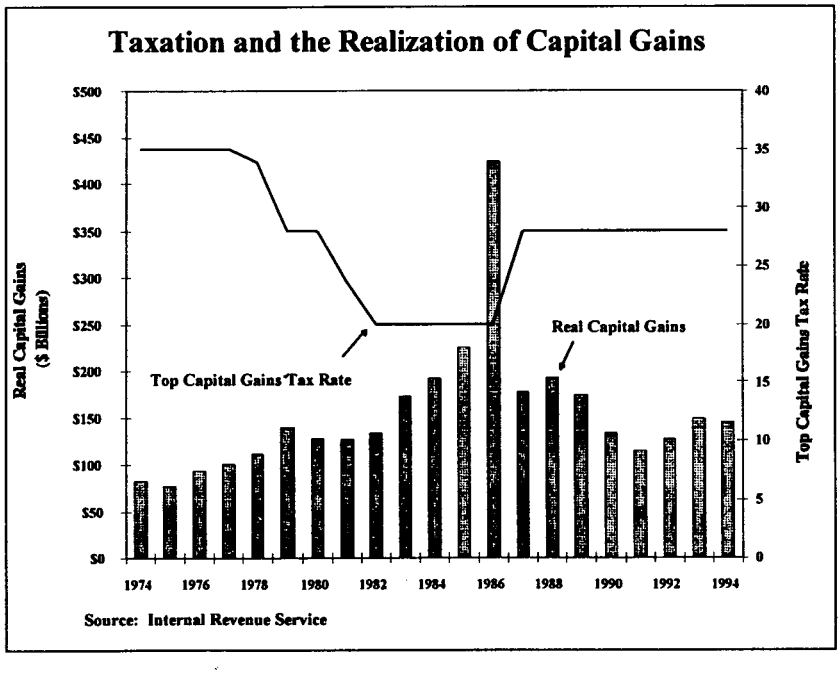
Table 1: Nominal and Real Capital Gains: 1974-1994

	Top Marginal Rate Applicable to Ordinary Capital Gains	Nominal Capital Gains (amount included in AGI is in parentheses)[a] (billions of dollars)		Real Capital Gains (amount included in AGI is in parentheses) (billions of dollars)	
1974	35.0	$30.8	(15.4)	$83.2	(41.6)
1975	35.0	30.9	(15.8)	77.3	(39.5)
1976	35.0	39.5	(20.2)	93.4	(47.8)
1977	35.0	45.4	(23.4)	100.7	(51.9)
1978	33.8	50.5	(26.2)	112.0	(54.1)
1979	28.0	73.4	(31.3)	139.0	(59.3)
1980	28.0	75.0	(33.1)	128.2	(56.7)
1981	23.7	80.9	(34.7)	127.0	(54.5)
1982	20.0	90.1	(38.5)	133.7	(57.1)
1983	20.0	122.0	(52.4)	173.0	(74.3)
1984	20.0	140.0	(58.9)	191.5	(80.6)
1985	20.0	171.0	(72.2)	225.6	(93.5)
1986	20.0	331.0	(135.0)	424.4	(173.1)
1987	28.0	144.2		178.0	
1988	28.0	161.9		192.1	
1989	28.0	153.5		173.6	
1990	28.0	123.8		133.3	
1991	28.0	111.4		115.1	
1992	28.0	126.7		126.7	
1993	28.0	152.3		148.4	
1994	28.0	152.7		145.3	

Source: Internal Revenue Service, *Statistics of Income: Individual Income Tax Returns* (various years) and *SOI Bulletin* (various issues). The consumption expenditure component of the GDP deflator was used to convert the nominal data to real 1992 dollars.

[a]Prior to 1987, only a portion of long-term capital gain was included in AGI. During 1974-77, 50 percent of the long-term capital gains was included in AGI. That figure was reduced to 40 percent in 1979 and remained at that level through 1986.

When the rate was decreased to 20 percent in 1982, realized capital gains increased again even though the economy was in the midst of a very severe recession. For purposes of comparison, look at the average capital gains realizations in the three years following the rate reduction compared to the three years just prior to the rate cut. Measured in 1992 dollars, capital gains averaged $166 billion during the three years following the rate reduction to 20 percent, compared to $131 billion during 1979-1981. Multiplying by the effective tax rate yields collections of about $33 billion for the 20 percent rate, compared to $37 billion under the 28 percent rate. This suggests a revenue-maximizing rate of between 20 and 28 percent, but note the steep cost involved in going from a 20 percent rate to a 28 percent rate. Tax revenues are only 12 percent higher, but the tax rate is 40 percent higher. When one considers the excess burden of taxation, it is likely that even the 20 percent capital gains tax rate is higher than optimal. Furthermore, the steep recession in 1982 surely lowered capital gains realizations and reduced tax revenues from this source during the year.



The increase back to a 28 percent capital gains tax rate in 1987 gives even stronger evidence that the 28 percent tax rate is higher than the revenue-maximizing tax rate. The higher rate was instituted as a part of the Tax Reform Act of 1986, providing taxpayers with notice of the impending higher capital gains tax rate, and in 1986 capital gains realizations were $424.4 billion, which is more than twice as high as any subsequent year. Taxpayers realized their capital gains when they saw higher future rates, and have been reluctant to realize capital gains since. Despite substantial income growth in the intervening decade, capital gains realizations at the 28 percent top rate were substantially lower in the early 1990s than they were a decade earlier when the top rate was 20 percent.[11]

This graph plots both the realized capital gains in constant dollars and the top capital gains tax rate from Table 1 to help visualize the changes that took place over the time period. Note the substantial growth in capital gains realizations in the early 1980s that correspond with sharp cuts in the tax rate. When legislation passed in 1986 which increased in the capital gains rate beginning in 1987, there was a huge one-year increase in realizations, followed by an even sharper reduction.

When considering the long-run effect of capital gains tax rates on revenues, one cannot fail to be struck by the fact that, even though there was substantial income growth over that decade, the capital gains realizations were lower in the early 1990s than during the early 1980s when the capital gains tax rate was 20 percent. Compare realized capital gains in 1982, 1983 and 1984, with realized gains in 1992, 1993, and 1994. The average capital gains realization for the 1982-84 period was $166 billion. Over the next decade real GDP grew by 20.4 percent, and if capital gains realizations had kept up with income growth, they would have averaged $200 billion.[12] Yet the actual

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[11]The economy went into a recession in 1991, and as Table 1 shows, the realization of capital gains fell by approximately 14 percent during the downturn. In contrast, when the economy was in a much more severe recession in 1982, capital gains realizations increased by 5.3 percent over the previous year. This suggests that the lower rates of 1982 stimulated the realization of capital gains more than the recession deterred them.

[12]This may understate the case because 1982 was a recession year, depressing capital gains realizations in that year and making the 1982-84 total lower. The low year of the less severe recession in the early 1990s was 1991, so 1992 was a recovery year.

average for 1992, 1993, and 1994 was $140 billion. This admittedly rough calculation suggests that a lower capital gains tax rate of 20 percent would have produced about 43 percent more realized capital gains than the 28 percent rate. Applying a 20 percent rate to $200 billion would have yielded $40 billion in capital gains taxes, while the 28 percent rate applied to $140 billion would yield $39 billion. These calculations suggest that the higher capital gains tax rates mandated by the 1986 legislation yielded no additional revenue for the Treasury, and may have even reduced capital gains tax revenues.

Linear regression analysis suggests the same thing. Using the log of real capital gains realizations as the dependent variable, and the log of the capital gains tax rate as an independent variable, the coefficient will be the elasticity of capital gains realizations with respect to the capital gains tax rate. Table 2 presents the results of two regressions. The additional independent variables are the growth rate of GDP, to account for the fact that capital gains realizations are pro-cyclical (thus they will increase when the rate of growth is higher), the log of real GDP, included to capture the effect of long-term income growth on realized capital gains, and two dummy variables for the years 1986 and 1987. These are included because after the Tax Reform Act of 1986, the owners of assets with unrealized capital gains knew that they could realize the gains in 1986 and pay a 20 percent capital gains rate, after which the rate would increase to 28 percent.

The first regression equation shown in Table 2 is run without the GDP level variable, and shows an elasticity of -1.11. All of the variables except for the 1987 dummy are significant at the .05 level or better, and that dummy is significant at the .10 level. The second regression includes the level of GDP, and gives similar results, with an elasticity of -0.94. **Like our earlier calculations, regression analysis indicates that, within the range of capital gains tax rates imposed during 1974-1994, the changes in the capital gains tax rates were almost exactly offset by changes in the tax base, leaving revenues unaffected.**

These results unambiguously point to the desirability of lowering the capital gains tax rate. Reducing the rate to 20 percent, the lower limit of the past 20 years, would not have an adverse effect on revenues. In the short run, the lower rate would increase revenues as people find it worthwhile to realize capital gains that they were previously holding unrealized to avoid the tax. In the long run, there would be little impact on the stream of revenue derived from the taxation of capital gains. Most important, however, the lower tax rate would reduce the excess burden of the tax, which would encourage

capital market transactions and enhance the performance of the economy.

Table 2: Taxation and Realization of Real Capital Gains: Regression Analysis of 1974-1994 Data

Independent Variables	Dependent Variable: Log of Real Capital Gains in 1992 dollars (T-ratios in parentheses)	
	(1)	(2)
Top Marginal Capital Gains Rate (log)	-1.11	-0.94
	(5.54)	(5.91)
Growth of Real GDP	0.038	0.035
	(2.37)	(2.88)
Real GDP in 1992 dollars (log)	—	0.64
		(3.58)
Dummy: 1986	0.80	0.81
	(4.37)	(5.81)
Dummy: 1987	0.31	0.24
	(1.79)	(1.80)
Constant	8.45	6.86
	(12.70)	(10.19)
R^2	.80	.89
n	21	21

THE REVENUE-MAXIMIZING TAX RATE VERSUS THE OPTIMAL TAX RATE

It is vitally important to distinguish between the revenue-maximizing tax rate and the optimal tax rate. The revenue-maximum rate is the rate that will raise the most tax revenue for the government. The optimal tax rate weighs the economic cost of the higher rate against the benefits of more revenue. At the optimal rate, the marginal benefits derived from the revenue generated by a little higher rate are just equal to the marginal cost in the form of loss of productive economic activity squeezed out by the rate increase. Thus, the optimal rate is the rate that is best for the economy. Even though the difference between these two rates is relatively simple, ambiguity

in this area is often a source of confusion. Therefore, the topic deserves some elaboration.

As any tax rate is increased, it has an increasingly larger disincentive effect on the tax base. At low rates, a tax will have a modest effect on economic activity, but at higher rates, the tax discourages more and more of the taxed activity. At some point the disincentive effect reduces the tax base so much that further increases in the tax rate will lower tax revenues because the shrinkage of the tax base will more than offset the rate increase. As rates are increased and the revenue-maximizing point approached, rate increases will add less and less to tax revenue, but they will impose larger and larger costs on the economy. Such rate increases are highly inefficient because even though they raise only a little more revenue, they squeeze out lots of economically advantageous activities. In the polar case at the revenue-maximum point, productive activity is reduced (this is why the tax base shrinks) even though the rate increase yields no additional revenue.

When examining the capital gains tax, capital transactions enhance the efficiency of the economy by allocating capital assets to their highest valued uses. In the absence of taxes, if another individual could make more productive use of a capital asset than its current owner, exchange between the two parties would be profitable. Exchanges of this type enhance the operation of the economy because they move the ownership of assets toward those individuals able to use capital assets most productively. The capital gains tax discourages these capital transactions because the current owner can keep the asset without any tax liability, but if the asset is sold, the capital gains tax must then be paid. Thus, it inhibits capital movements in the economy and reduces the productivity of the economy by discouraging the movement of capital toward its highest valued use. Lower capital gains taxes would reduce this inefficiency.

In the range near the revenue-maximizing tax rate, lower tax rates lead to substantial efficiency gains with little or no loss of revenue. At the optimal rate, the marginal benefits derived from the additional tax revenue will just equal the marginal cost imposed on the economy as a result of the higher rate. At the revenue-maximizing rate, however, the marginal benefit is zero (because a rate increase does not generate any additional revenue), but there is a substantial marginal cost (because the rate increase eliminates a large number of beneficial-activities.)

Clearly, the optimal tax rate is always less than the revenue-maximizing rate, because at the revenue-maximizing tax rate, a

small increase in the tax rate eliminates productive activities without raising any additional revenue. In contrast with the optimal rate, the revenue-maximum rate is highly inefficient. Thus, the optimal tax rate will be well below that rate. While this point reflects standard economic analysis widely accepted by almost all economists, it has been almost universally ignored in the policy debate. The implications for capital gains taxation are straightforward: If the revenue-maximum rate is no higher than 20 percent as we estimate, the optimal capital gains rate must be significantly lower, probably 15 percent or less.[13]

INCOME TAXES AND ADJUSTED GROSS INCOME

Not surprisingly, most capital gains taxes are paid by people in upper-income brackets. At least, they are in the upper-income brackets during the year a major capital gain is realized. Thus, it is worthwhile to break down taxpayers by income group to get a better idea of the effect of tax rates on the base income level. Table 3 presents some statistics on adjusted gross income (AGI) and income taxes paid by the bottom 50 percent and the bottom 75 percent of taxpayers, while Table 4 presents the same data for taxpayers in the upper 1 percent and upper 5 percent.

The column labeled MTR in Initial Bracket shows the lowest marginal income tax rate. Note that the rate remains relatively constant throughout the period, especially when viewed in terms of the income a taxpayer gets to keep after taxes. The highest initial rate during 1980-1994 was 15 percent, meaning a taxpayer gets to keep 85 cents out of every dollar, and the lowest was 11 percent, meaning that a taxpayer gets to keep 89 cents out of every dollar earned. Compared to the highest initial rate, the lowest initial rate provides only a 5 percent increase in after-tax income. Given the small differences, the rate changes in the lower brackets are likely to exert only a minor impact on the tax base. Of course, because the AGI data in Table 3 includes most taxpayers, a substantial share of the income listed in the table will be taxed at marginal rates higher than the minimum. Thus, the rate changes during the period will have provided many middle income taxpayers with a slightly greater change in after-tax earnings. Nonetheless, it is clear that the incentive effects accompanying the rate changes will be relatively small for most lower and middle income taxpayers.

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[13]While a rate reduction to 15 percent or less would lower the current rate substantially, Hall and Rabushka (1985) make a persuasive case for eliminating capital gains taxes entirely.

Table 3: Changes in the Real AGI and Real Taxes Paid by the Bottom 50 Percent and Bottom 75 Percent of Taxpayers Following Reductions in Marginal Tax Rates (1980-85 and 1985-90) and Increases in Marginal Tax Rates (1990-1994)

	MTR in Initial Bracket	Real AGI (billions of 1992 dollars)		Real Income Taxes Paid (billions of 1992 dollars)	
		Bottom 50%	Bottom 75%	Bottom 50%	Bottom 75%
1980	14.00	$491.6	$1,203.8	$30.2	$115.0
1981	12.75	499.0	1,218.4	33.1	123.0
1985	11.00	533.8	1,299.6	30.5	110.3
1986	11.00	539.2	1,325.6	30.4	112.8
1990	15.00	558.3	1,407.0	28.0	110.6
1991	15.00	549.7	1,385.7	25.4	105.2
1994	15.00	561.1	1,408.3	24.3	104.1
		Annual Rate of Change			
1980-1985		1.7%	1.5%	0.1%	-0.8%
1985-1990		0.9	1.6	-1.7	-0.8
1990-1994		0.1	0.0	-3.5	-1.5
1990-1991		-1.5	-1.5	-9.3	-4.9

Source: Internal Revenue Service, *Statistics of Income: SOI Bulletin* (various issues). The personal consumption expenditure component of the GDP deflator was used to convert the nominal data to real 1992 dollars.

Table 3 shows a relatively slow growth of income for lower and middle income recipients during the 1980s, followed by virtually no growth in the 1990s. Note that there was a slight increase in the growth of AGI (from 1.5 percent to 1.6 percent) for the bottom 75 percent of income earners in the second half of the 1980s when compared to the first half. The average annual growth of AGI for the bottom 50 percent, however, declined from 1.7 percent in the first half of the 1980s to 0.9 percent during the latter half of the decade. Both groups showed virtually no growth in AGI between 1990 and 1994.

Real income taxes paid show a slight decline for the period for taxpayers in the bottom 50 percent and 75 percent of income earners.

Table 3 shows that the rate of decline is larger in the 1990s than it was in the 1980s, and that the decline has been larger for the bottom 50 percent than the bottom 75 percent. Compare these figures with the parallel statistics on taxes paid by the upper 1 percent and upper 5 percent of taxpayers, shown in Table 4. The taxes paid by the upper-income groups show a consistent upward trend. For the top 5 percent of taxpayers, real income taxes paid grew at a rate of 1.2 percent per year from 1980 to 1985, 4.5 percent from 1985 to 1990, and 3.6 percent from 1990 to 1994. The bottom 75 percent of taxpayers showed negative growth rates in real tax payments for all of these periods. These figures show that the tax reforms since 1980 not only reduced the share of total income taxes paid by most taxpayers, and increased the share paid by upper-income taxpayers; the reforms actually reduced the total amount of taxes paid by most earners, while increasing the total amount paid by those with high incomes.

As noted earlier, the incentive effects of the rate changes were substantially greater in the upper-income tax brackets. A comparison of taxes paid in Tables 3 and 4 shows that when considering overall tax payments, the effects of tax rate changes on upper-income taxpayers are very important. In 1980 the bottom 75 percent of earners paid $115 billion in personal income taxes, nearly 40 percent more than the $82.5 billion paid by the top 1 percent of earners. By 1986 the taxes paid by the top 1 percent of taxpayers exceeded those paid by the bottom 75 percent and by 1994 the top 1 percent paid 41 percent more than the bottom 75 percent of taxpayers ($146.7 billion compared to $104.1 billion). Although the marginal tax rates faced by the highest income taxpayers are now sharply lower than in 1980, their share of total tax payments has increased substantially.

The average tax rates of upper-income taxpayers have fallen along with their marginal tax rates. In 1980 the top 5 percent of income earners paid 27 percent of their incomes in income taxes, compared with 23 percent in 1994. The increases in income tax payments over this period have come because of increases in income. During the 1980s, the AGI of the top 5 percent of taxpayers grew at an average annual growth rate of 5.8 percent, and the growth rate was 8.3 percent for the upper 1 percent. In contrast, during the first half of the 1990s the growth of AGI in the upper brackets, like that for the bottom 75 percent of earners, fell to near zero.

Table 4: Marginal Tax Rates and the Growth of AGI and Taxes Paid by High Income Taxpayers

		Real AGI (in billions)		Real Income Taxes Paid (in billions)	
	Top MTR	Top 1%	Top 5%	Top 1%	Top 5%
1980	70.0	$235.3	$584.3	$82.5	$158.6
1981	70.0	233.5	584.3	79.8	157.6
1985	50.0	310.2	701.0	95.7	168.7
1986	50.0	365.6	773.7	121.1	200.3
1990	28.0	520.2	1,026.2	120.9	210.0
1991	31.0	471.4	974.7	114.7	201.7
1994	39.6	520.2	1,049.3	146.7	242.0
1980-1985		5.7%	3.7%	3.0%	1.2%
1985-1990		11.0	8.0	4.8	4.5
1980-1990		8.3	5.8	3.9	2.9
1990-1994		0.0	0.6	5.0	3.6
1990-1991		-9.4	-5.0	-5.5	-4.0

Source: Internal Revenue Service, *Statistics of Income: Individual Income Tax Returns*, (various issues). The personal consumption expenditure component of the GDP deflator was used to convert the nominal data to real 1992 dollars.

As marginal tax rates change, people adjust their economic affairs in order to minimize their tax burdens. When the top marginal tax rates plummeted during the 1980s, people had less incentive to look for ways to avoid taxes. If, for example, a tax attorney were able to develop a tax shelter at the cost of 50 cents for every dollar sheltered, this would be a good option for a taxpayer in the 70 percent tax bracket. The taxpayer would then get to keep 50 cents rather than 30 cents after taxes. But when the top marginal tax rate fell to 28 percent, the taxpayer would be better off reporting taxable income than paying for the tax shelter. A reduction in tax avoidance activities during the 1980s enhanced the reported income—particularly in the upper-income groupings—and contributed to the apparent increase in the inequality of the observed income statistics.

Between 1980 and 1985, the real income taxes paid by the upper 1 percent of earners grew at an average annual rate of 3 percent; the

growth in the taxes collected from the top 5 percent of earners was 1.2 percent. During this same time period, the top marginal tax rate fell from 70 percent to 50 percent. From 1985 to 1990 the top marginal tax rate fell from 50 percent to 28 percent, and both the top 1 percent and top 5 percent of income earners saw an increase in their rate of growth of tax payments to about 4.5 percent. Then, when the top tax bracket was increased to 31 percent in 1991 and 39.6 percent in 1993, the *growth rate* of tax collections from the upper 1 percent changed little, going from 4.8 percent to 5 percent, while the growth rate for the upper 5 percent declined from 4.5 percent to 3.6 percent. Income growth slowed also, but as noted above, this is at least partly attributable to taxpayers looking for more ways to shelter their income from taxes due to the higher rates.

The responsiveness in overall tax payments to changes in tax rates is not as apparent as it is when examining capital gains taxes. Still, one can see substantial effects in the growth of tax payments for upper-income taxpayers in Table 4. The growth rate in tax payments was 60 percent larger for the top 1 percent of earners during the 1985-1990 period, when the top marginal rate declined from 50 percent to 28 percent, than for the 1980-1985 period when the top marginal rate ranged from 50 percent to 70 percent. When tax rates went up again in the 1990-1994 period, the growth of tax revenues collected from the top 1 percent was virtually unchanged from that of the late 1980s, while growth of revenues derived from the top 5 percent of taxpayers slowed by 20 percent. These results are consistent with Feldstein (1995b), who argued that the rate changes in 1986 more than paid for themselves through rate-induced increases in the tax base.

CAPITAL GAINS AND HIGH-INCOME TAXPAYERS

The impact of changes in tax rates in the upper-income brackets is highly important because most of the revenue derived from the personal income tax is collected from these taxpayers. Thus, any effect on this small subset of taxpayers will have major effects on overall tax collections. It bears repeating that in 1994 the top 1 percent of income earners paid 41 percent more in income taxes than the bottom 75 percent of income earners. This section looks at those high-income taxpayers in more detail by separating out their capital gains income from the rest of their income.

The growth of AGI shown in Table 4 is potentially misleading because of changes in the treatment of capital gains during the period. Prior to 1987, only a fraction of capital gains income was included in AGI. For example, the maximum capital gains tax rate in 1980 was 28

percent, but this was calculated by subtracting 60 percent of capital gains from AGI, so the AGI statistics prior to 1987 exclude 60 percent of capital gains. After 1987, 100 percent of capital gains is included in AGI.

Table 5 reports both the nominal and real capital gains income of the top 1 percent and top 5 percent of taxpayers. The numbers in parentheses indicate the amount of capital gains income reported in AGI. Most capital gains taxes are paid by these upper-income taxpayers, which can be seen by comparing the capital gains realizations reported in Table 5 with total capital gains realizations presented in Table 1. Throughout most of this period, the top 1 percent of income recipients earned a little more than half of the total realized capital gains, while the top 5 percent have realized about two-thirds of the total capital gains income. These taxpayers are more likely to be sensitive to changes in tax policy. Many taxpayers may realize capital gains from the sale of a house or some other asset that is sold for reasons that are not primarily financial, whereas upper-income taxpayers are more likely to realize capital gains as a result of investment activity, where tax payments can be a crucial part of the decision.

The numbers in Table 5 illustrate the strong correlation between capital gains realizations for upper-income taxpayers and the capital gains tax rate. From 1980 to 1985, when the top capital gains tax rate fell from 28 percent to 20 percent, the average annual rate of growth in real capital gains was 19 percent for the upper 1 percent of income earners, and 15.7 percent for the upper 5 percent. Then, from 1985 to 1994, when the highest capital gains tax rate rose to 28 percent (beginning in 1987), the average annual rate of change in realized capital gains dropped to *minus* 5.3 percent for both groups.[14]

[14]Here we compare capital gains income for 1985 with that of the 1990s in order to avoid distortions emanating from the moving of capital gains forward to 1986 prior to the rate increase of 1987.

Table 5: The Capital Gains Income of the Top 1 Percent and Top 5 Percent of Earners: 1980-1994

	Nominal Capital Gains (number in parentheses is amount included in AGI)		Real Capital Gains in 1992 dollars (number in parentheses is amount included in AGI)	
	Top 1%	**Top 5%**	**Top 1%**	**Top 5%**
1980	33.5	47.5	57.3	81.2
	(14.5)	(22.2)	(24.8)	(37.9)
1981	39.1	48.7	61.4	76.5
	(16.7)	(19.5)	(26.2)	(30.6)
1985	98.3	121.7	134.5	166.5
	(41.1)	(51.1)	(56.2)	(70.5)
1986	219.1	263.1	280.9	337.3
	(92.6)	(108.3)	(118.7)	(138.8)
1990	74.7	90.8	80.4	97.7
1991	61.9	76.9	63.9	79.4
1994	86.4	107.4	82.2	102.2
	Annual Rate of Change in Real Capital Gains			
1980-1985			19.0%	15.7%
1985-1994			-5.3	-5.3

Source: Internal Revenue Service, *Statistics of Income: Individual Income Tax Returns*, (various issues). The personal consumption expenditure component of the GDP deflator was used to convert the nominal data to real 1992 dollars.

Table 6: Changes in the Real AGI (Exclusive of Capital Gains) and the Real Taxes Paid by the Top 1 percent and Top 5 Percent of Taxpayers Following Reductions in Marginal Tax Rates (1981-86 and 1986-90) and Increases in Marginal Tax Rates (1991-1994)

	Real AGI (Exclusive of Capital Gains) (billions of 1992 dollars)		Real Income Taxes paid on Non-capital Gain Income (billions of 1992 dollars)[a]	
	Top 1%	Top 5%	Top 1%	Top 5%
1980	$210.4	$546.4	$73.6	$146.6
1981	207.3	553.7	66.0	141.3
1985	254.0	630.9	70.1	138.7
1986	246.9	634.9	67.7	139.6
1990	439.8	928.5	99.5	185.4
1991	407.5	895.3	97.7	181.7
1994	438.0	947.1	124.8	216.2
	Annual Rate of Change			
1980-1986	2.7%	2.6%	-1.4%	-0.8%
1986-1990	15.5	10.0	9.6	6.8
1980-1990	7.7	5.5	3.1	2.4
1990-1994	-0.1	0.5	5.8	3.9

Source: Internal Revenue Service, *Statistics of Income: Individual Income Tax Returns*, (various issues). The personal consumption expenditure component of the GDP deflator was used to convert the nominal data to real 1992 dollars.

[a]In calculating the real taxes paid as the result of capital gain income, we assumed that the top 1 percent paid 95 percent of the top marginal tax rate applicable to capital gains during the year and that the top 5 percent paid 90 percent of the maximum capital gains rate. The tax revenues generated by capital gains income were then subtracted from the total income taxes paid.

Measured in constant dollars, the capital gains realized by both the top 1 percent and top 5 percent of income recipients in 1994 were only three-fifths (61 percent) of their 1985 level. This reduction in capital gains realizations came during a decade when rising incomes, and especially rising equity values in the stock market, should have led to sharply higher capital gains. However, the higher tax rate provided a disincentive for the realization of the capital gains.

Table 6 reports the real Adjusted Gross Income *minus capital gains income* for upper-income taxpayers. Over the entire period from 1980 to 1994 upper-income taxpayers showed exceptionally high rates of income growth, but it is interesting to note how that growth is concentrated in the years just after the Tax Reform Act of 1986 that slashed the marginal tax rates of high-income taxpayers. From 1980 to 1986 upper-income taxpayers had an average annual real income growth of about 2.6 percent, which is about 1 percent higher than the AGI growth of the bottom 50 percent and 75 percent of income earners (see Table 3). In the 1990-1994 period when these taxpayers saw higher marginal tax rates, the top 5 percent of taxpayers had an average annual income growth of only 0.5 percent, and the top 1 percent saw a slight decline, which was roughly in line with the growth rates of the bottom 75 percent of earners. The big difference came from 1986 to 1990, when the top 5 percent of income earners averaged a 10 percent growth in AGI less capital gains, and the top 1 percent had a whopping income growth (AGI less capital gains) of more than 15 percent.

The figures in Table 6 exclude capital gains income, so this income jump must have come from other sources, such as wages and salaries, interest, dividends, and perhaps other types of business income. It is unlikely that income-earning opportunities increased this substantially during 1986-1990. More likely, with lower marginal tax rates, there was a smaller payoff to sheltering income from taxes, so more AGI was reported, leading to more of a growth in reported AGI than in actual income. This provides a good illustration of the way in which tax rate cuts can lead to tax revenue increases. Note that for the top 1 percent of income earners, their AGI less capital gains increased by 78 percent from 1986 to 1990. As a result, their total taxes paid on non-capital gains income rose by an estimated 47 percent during the period. For the top 5 percent, the estimated taxes on non-capital gains income rose by 33 percent between 1986 and 1990.

Critics might argue that this was due to a broadening of the tax base that offset the lowering of the marginal tax rate these taxpayers

faced, but note that the income growth during the period was sufficient to completely offset the lowering of rates independent of any base broadening due to reductions in allowable deductions. If the 50 percent marginal tax rate from 1986 were applied to all non-capital gains income of this group, they would have paid $123 billion in taxes on this income. Applying the 28 percent tax rate to all non-capital gains income in 1990 would have yielded $123 billion also. By 1994, when the top marginal tax rate was 39.6 percent, the top 1 percent of income earners had non-capital gains AGI slightly below the level they reported in 1990. These figures suggest that the current top marginal income tax rate of 39.6 percent is close to the revenue-maximizing rate, and that the 50 percent rate that existed prior to 1987 was well above the revenue-maximizing rate.

Tables 5 and 6 illustrate that upper-income taxpayers are very sensitive to changes in tax rates. Table 6 shows that when the top marginal income tax rate was cut from 50 percent to 28 percent, there was a *huge increase* in non-capital gains income between 1986 and 1990. Table 5 illustrates that, during this same period, there was a *huge decline* in capital gains realizations as the capital gains tax rate rose from 20 percent to 28 percent. **Thus, in the late 1980s when upper-income taxpayers had their marginal rates on ordinary income reduced substantially, but at the same time had their capital gains tax rate increased substantially, their non-capital gains income rose sharply while their capital gains realizations plummeted.**

The dramatic growth of the income base, exclusive of capital gains, during 1986-1990 illustrates the responsiveness of high-income taxpayers to changes in the rate structure. Unfortunately, this growth was largely concealed by the strong negative impact of the higher capital gains rates on the income base of this same group of taxpayers. The 1986 rate reductions on ordinary income had a much larger impact on the income base in the upper tax brackets than is generally realized. Had the capital gains rate not been increased by the same legislation, the growth of income in the upper brackets and increase in taxes collected from these taxpayers would have been truly phenomenal during the late 1980s and into the 1990s. Certainly, the revenues derived from this important group of taxpayers would have been greater than those that actually occurred.

THE EFFECT OF INFLATION ON REAL CAPITAL GAINS TAX RATES

Analysis of the impact of inflation on the effective taxation of capital gains helps explain their sensitivity to rate changes. The disincentive effects of capital gains taxes are larger than they first appear. Since taxpayers are not permitted to adjust the purchase price of assets for the effects of inflation, the effective tax rate on real capital gains is higher--often substantially higher--than the statutory capital gains rate. In cases that are not particularly unusual, the effective rate can exceed 100 percent of the inflation-adjusted capital gain.

With inflation, the nominal value of capital assets increases relative to their real value. Suppose that Ann Smith purchased a plot of land for $10,000 in 1980 and sold the land for $20,000 in 1997. Since prices doubled during this period, her real capital gain is zero. Ann will not be able to buy any more goods and services with the $20,000 received from the sale of the land in 1997 than she could have purchased with the $10,000 she paid for the land in 1980. Nonetheless, Ann will be subject to a capital gains tax on the nominal gain. If she is in the 28 percent tax bracket, she will owe a $2,800 tax bill even though she reaped no real gain from the transaction!

Alternatively, suppose Ann was able to sell her land for $25,000. In this case, measured in 1997 dollars, Ann's inflation-adjusted capital gain would be $5,000 ($25,000 minus a $20,000 purchase price in terms of 1997 dollars) and her additional tax liability $4,200 (28 percent of the $15,000 nominal gain). She is liable for $4,200 in additional taxes even though her real capital gain in current dollars is only $5,000. The marginal tax rate on her real capital gain is 84 percent, not 28 percent!

As these typical examples illustrate, when assets are held a number of years, the current taxation of "phantom" capital gains leads to exceedingly high marginal tax rates even at modest rates of inflation. From the viewpoint of efficiency, these high rates are harmful because they reduce the funding available for new projects and encourage people to continue holding assets (until death or retirement) that they would otherwise like to sell.

Furthermore, the current system of capital gains taxation is extremely unfair to investors earning only modest capital gain returns.

Table 7: The Rate of Return and the Variation in the Rate of Capital Gains Taxation on an Asset Purchased Five Years Ago for $10,000 When Inflation Rate is 3 Percent

Annual Nominal Rate of Return	Nominal Value of Asset Held Five Years	Nominal Capital Gain	Tax Liability at 28% Rate	Real Capital Gain[a]	Tax Rate on Real Capital Gain[b]
(1)	(2)	(3)	(4)	(5)	(6)
4%	$12,167	$2,167	$607	$ 574	105.7%
5%	12,763	2,763	773	1,170	66.1%
8%	14,693	4,693	1,314	3,100	42.4%
15%	20,114	10,114	2,832	8,521	33.2%
25%	30,518	20,518	5,745	18,925	30.4%

[a]This is equal to the nominal sales price of the $10,000 asset after five years (column 2) minus $10,000 $(1.03)^5$. The latter expression indicates the amount of current dollars that would have the same purchasing power as the original $10,000 investment had five years ago.

[b] This is equal to the tax liability (col. 4) divided by the real capital gain (col. 5). Both are measured in the purchasing power of the dollar at the end of the five-year period.

Table 7 illustrates why this is true. Here we consider how an investor's tax liability varies with the rate of return on an asset purchased for $10,000 and held for five years when the rate of the inflation is 3 percent, the approximate current rate. The calculated tax liability assumes that the taxpayer confronts a 28 percent rate, the current top statutory rate on nominal capital gains. The first row of the table assumes that the asset appreciates at a nominal rate of 4 percent per year, so at the end of five-year period it is worth $12,167. The nominal capital gain on the asset is $2,167, and at a 28 percent tax rate the capital gains tax liability is $607. After adjusting for the 3 percent inflation, however, the real increase in the value of the asset is only $574. Put another way, the $12,167 derived from the sale of the asset

will only purchase $574 more goods and services today than $10,000 would have purchased five years ago. The $607 capital gains tax liability takes all of the real capital gain and more. In this case, the effective capital gains tax rate is 105.7 percent!

Look what happens as the nominal rate of return increases. When the taxpayer's asset appreciates at a nominal rate of 5 percent over the five-year period, the value of the asset increases to $12,763, providing a real capital gain of $1,170. The tax liability against this gain would be $773, or 66.1 percent of the real gain. If the nominal return was 8 percent, the real capital gain would be taxed at a still lower rate (42.4 percent). The effective capital gains tax rate would be 33.2 percent if the investor was able to earn an annual nominal return of 15 percent. For those investors fortunate enough to enjoy a capital appreciation of 25 percent per year, the effective capital gains tax rate falls to 30.4 percent, only slightly higher than the statutory rate.[15]

As Table 7 illustrates, the current system taxes capital gains at substantially different rates. If an investor reaps a return slightly greater than the rate of inflation, the IRS claims more than 100 percent of the capital gain. In contrast, taxpayers holding assets appreciating at annual rates of 20 percent, 25 percent, or 30 percent pay much lower rates. Worse still, if you are unfortunate enough to hold an asset that appreciates less rapidly than the inflation rate, you will be hit with additional taxes even though you do not have a real capital gain.

Even with modest rates of inflation, the current system discriminates heavily against investors who reap only a small rate of return on their capital assets. The lower the taxpayer's capital gain rate of return, the higher the rate of taxation imposed on the gain. This pattern of taxing the least fortunate investors the most is highly unfair. We do not know of any principle of taxation that would support higher tax rates for those earning lower rates of return. Yet, this is precisely what happens under the current system.

Even when the rate of inflation is low, the current tax structure often taxes capital gains at exceedingly high rates and it places the

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[15] If Table 7 were recalculated using the assumption of no inflation, the real capital gains rate for each row would be equal to the 28 percent statutory rate. The effective rates exceed the statutory rate because inflation results in the taxation of phantom capital gains. When an asset is held for five years, ten years, or longer, the tax burden accompanying these phantom gains becomes large even when the inflation rate is relatively low.

largest burden on those taxpayers receiving the lowest rates of return. The former is inefficient and the latter are highly unfair. Both of these problems would be alleviated if capital gains were indexed--that is, if taxpayers were allowed to adjust the initial purchase price of assets for the effects of inflation. As long as capital gains are taxed, the tax should be computed based on inflation-adjusted capital gains, not the nominal dollar value of the gains. Indexation would remove the bias inflation injects into the taxation of capital and it is especially desirable because it would both improve efficiency and promote fairness.

CONCLUSION AND IMPLICATIONS

How high is the revenue-maximizing tax rate? In the actual economy there are many different tax rates and many different tax bases, so it may be true that some tax rates could be cut with no loss (or even a gain) in revenue, but not others. Our analysis suggests that for ordinary income the revenue-maximizing tax rate appears to be well below 50 percent, and it may be close to the current 39.6 percent top marginal rate. For capital gains the revenue-maximizing rate is much lower, and the evidence examined here indicates that a reduction in the rate from its current 28 percent to 20 percent would not reduce tax revenues in the long run, and would produce substantially more revenues in the short run as taxpayers sold capital assets they had been holding in order to delay or avoid the accompanying tax liability.

It makes sense that the revenue-maximizing tax rate would be lower for capital gains than for ordinary income. Whereas the option for most income is either to earn it or not, in the case of capital gains, taxpayers have another alternative: they can allow their gains to continue accumulating untaxed, rather than realize them and pay the tax. This possibility of deferring the payment of capital gains taxes makes capital gains income more sensitive to the rate at which it is taxed. In turn, the greater elasticity of the capital gains income base with respect to the rate makes the revenue-maximizing capital gains tax rate lower than that for ordinary income.

The point that the revenue-maximum rate is highly inefficient cannot be stressed too much. When higher tax rates shrink the tax base so much that they raise little or no additional revenue, this means that they are eliminating a large volume of mutually advantageous trades. Production is reduced and resources are used less efficiently than would otherwise be the case. Reflection on the potential gains that continue to be locked up by the current capital gains rate structure illustrates this point. Many asset owners are continuing to hold assets that they would like to sell to others who

value them more. No doubt, the potential new owners believe they can employ the assets more effectively; this is why they are willing to pay more than the current owners value of the assets. But these mutually advantageous exchanges and the accompanying movements to more efficient uses do not occur because of the tax implications.

Clearly, the optimal tax rate is always lower than the revenue-maximizing tax rate because of the excess burden of taxation. When tax rates are close to their revenue-maximizing level, the tax rate can be reduced with relatively little reduction in revenue, but with a large reduction in the welfare cost of taxation. Estimates from several studies on the marginal excess burden of taxation suggest that it is around 25 percent of the revenue raised.[16] **Cutting the capital gains tax rate from 28 percent to 20 percent would provide a substantial efficiency gain without any significant loss in revenue. From an efficiency standpoint, however, even the 20 percent rate is too high because the size of the excess burden of taxation is very high in the range near the maximum-revenue tax rate. These findings suggest that the optimal capital gain rate is probably 15 percent or less.**

In addition to reducing the capital gains tax rate, capital gains should also be indexed. The taxation of phantom capital gains, created through inflation, leads to both (1) exceedingly high effective tax rates (in some cases the effective rate exceeds 100 percent) and (2) the imposition of the highest capital gains tax rates on those earning the lowest rates of return. This allocation of the capital gains tax burden is unfair, discriminatory, and highly inconsistent with basic principles of taxation. Indexation of capital gains would both reduce the high effective rates stemming from inflation and eliminate the differential rates imposed on capital gains. The case for indexing of capital gains is particularly strong since this modification would both promote efficiency and remove one of the most unfair elements of the current tax structure.

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[16] A pioneering study on the topic is Browning (1976). More recent estimates include Ballard, Shoven, and Whalley (1985), Stuart (1984), and Browning (1987).

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THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

June 1997

Executive Summary

There is a broad recognition that the current tax system is systematically biased against saving, investment, and work effort. One form of bias is the multiple taxation of saving and investment under various provisions of the current income tax structure. Proposals to mitigate this tax bias have been offered by the Clinton Administration as well as by Members on both sides of the political aisle. One proposal that has attracted bipartisan support in the past is the reduction of the capital gains tax rate. This paper weighs the statistical evidence on capital gains tax reduction and finds that such a change would have a positive impact on economic and employment growth. In addition, a capital gains tax reduction would partly abate the problem of taxing inflationary gains.

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THE ECONOMICS EFFECTS OF CAPITAL GAINS TAXATION

EXECUTIVE SUMMARY

Between June 1981 and December 1986, the federal government allowed taxpayers to exclude 60 percent of capital gains from taxation. However, the Tax Reform Act of 1986 eliminated this exclusion, raising the maximum capital gains tax rate from 20 to 28 percent, a 40 percent increase. The increase was largest for middle income taxpayers, whose tax rate increased from 8.7 to 15 percent, a 72 percent increase. A capital gains tax reduction would help promote economic growth, benefit taxpayers across the income spectrum, and mitigate the unfair effects of taxing inflation-generated gains.

Macroeconomic Effects. Economist Allen Sinai maintains that a capital gains tax reduction would lower the cost of capital, boost investment, and stimulate economic growth. He estimates that a capital gains tax reduction could:

- ⇒ increase real gross domestic product (GDP) by an average of $51 billion annually;
- ⇒ create 500,000 new jobs by the year 2000; and
- ⇒ increase real business spending by an average of nearly $18 billion annually.

The effects of increased investment and economic growth would reverberate throughout the entire economy in the form of higher wages and rising living standards. In addition, the United States taxes capital gains more harshly than its major international competitors. Reducing the capital gains tax rate could increase U.S. global competitiveness.

Tax Revenue. The historical evidence suggest that capital gains tax reductions tend to increase tax revenue. When capital gains tax rates were lowered in 1978 and again in 1981, revenue climbed steadily. Conversely, when the tax rate was increased in 1987, revenue began declining despite forecasters predictions it would increase. For instance, capital gains tax revenue in 1985 equaled $36.4 billion after adjusting for inflation, yet $36.2 billion was collected in 1994 under a higher tax rate. In other words, tax revenue in 1994 was slightly less

than it was in 1985 even though the economy was larger, the tax rate was higher, and the stock market was stronger in 1994.

Who Would Benefit? A recent NASDAQ Stock Market survey suggests that the notion that all investors are affluent gentlemen coupon-clippers is no longer true. The survey found that:

- ⇒ stock ownership doubled over the past seven years to 43 percent of the adult population;
- ⇒ 47 percent of all investors are women;
- ⇒ 55 percent are under the age of 50; and
- ⇒ 50 percent are not college graduates.

The survey results suggest that a capital gains tax reduction would directly benefit many Americans across the income spectrum. More importantly, a tax cut would benefit all Americans by promoting economic growth, thus boosting workers' wages and living standards.

Tax Fairness. The treatment of capital gains is generally unfair and strongly discourages saving and investment -- two activities crucial to economic growth.

- ⇒ Taxpayers must pay capital gains on illusory, inflation-generated gains. In years of high inflation, this means people may pay capital gains taxes on capital losses.
- ⇒ The effective capital gains tax rate often exceeds the statutory maximum due to various phase-out provisions in the tax code.
- ⇒ Saving is subject to three, and sometimes four, levels of taxation.

Reducing the capital gains tax rate would mitigate the problem of taxing inflationary gains and would help reduce the bias against saving and investment which prevails under the current tax code.

THE ECONOMICS EFFECTS OF CAPITAL GAINS TAXATION

There is broad recognition that the current tax system is systematically biased against saving, investment, and work effort. One form of bias is the multiple taxation of saving and investment under various provisions of the current income tax structure. Proposals to mitigate this tax bias have been offered by the Clinton Administration as well as by Members of Congress on both sides of the political aisle. One proposal that has attracted bipartisan support in the past is the reduction of the capital gains tax rate. In 1989, for example, the U.S. House of Representatives passed a capital gains tax reduction with bipartisan support, though it was not passed in the Senate. This paper weighs the statistical evidence on capital gains tax reduction and finds that such a change would have a positive impact on economic and employment growth. It would also partly abate the unfair effects of taxing inflation-generated gains.

I. BACKGROUND

A capital gain is the increase in the value of a capital asset realized over its cost basis. For example, an asset purchased for $1,000 and sold for $1,500 generates a capital gain of $500. This nominal gain is subject to the capital gains tax. Because capital gains are not adjusted for inflation, much of the tax is paid on illusory, inflation-generated gains.

The Revenue Act of 1978 allowed taxpayers to exclude 60 percent of capital gains from income taxation (a 50 percent exclusion was allowed since 1942). The Economic Recovery Tax Act of 1981 reduced the top tax rate on regular income from 70 to 50 percent, yielding a maximum effective capital gains tax rate of 20 percent (0.5 x 0.4). The 60 percent exclusion was eliminated under the Tax Reform Act of 1986, thus raising the maximum tax rate on capital gains to 28 percent, a 40 percent increase. The increase was largest for middle income taxpayers whose tax rate increased from 8.7 to 15 percent, a 72 percent increase. The 1986 Act capped the statutory rate for capital gains at 28 percent so that subsequent increases in the income tax would not raise the top capital gains tax rate. The maximum statutory rate of 28 percent remains in place, though a variety of proposals have been introduced to lower it below 20 percent.

II. MACROECONOMIC EFFECTS

Except for a brief recession in 1990-91, the U.S. economy has enjoyed a 15-year expansion that is still underway. However, the growth rates of the economic upswing that began in 1991 have been relatively low compared to other postwar expansions. As a result, American incomes and living standards have been growing more slowly.

These low growth rates can be partly attributed to counter-productive tax policies that undermine long-term growth by discouraging saving and investment. Although broad tax reform is needed to address the deficiencies in the tax code, many economists believe that reducing the capital gains tax rate is an important step in the right direction. A capital gains tax reduction would enhance incentives to save and invest by increasing the after-tax return from investment. The effects of a capital gains tax reduction should not be overstated; nonetheless, its beneficial effects on the economy would make a significant contribution to long-term growth.

Increasing Investment and Economic Growth

Economic growth depends on two factors: the quantities of available inputs, such as capital and labor, and the productivity of those inputs. Economic growth cannot occur unless the quantity of inputs increases, productivity improves, or both. Investment in capital is therefore crucial to economic growth for at least two reasons. First, by contributing to capital formation, investment increases the amount of capital available in the economy. Second, investment enhances labor productivity because capital and labor are productive complements. The critical link between investment and economic growth is a widely accepted economic principle.

Unfortunately, the level of investment in the United States compares unfavorably with that of other countries and with the United States' own history. Annual U.S. investment is only half the level it was in the 1960s and 1970s. In addition, net private domestic investment dropped from an average of 7.4 percent of gross domestic product (GDP) between 1960 and 1980 to an average of only 3.0 percent since 1991.[17] Consequently, the growth rate of the capital stock in the United States has also been declining. Figure 1 shows a clear downward trend in the growth rate of the non-residential stock of capital. This downward trend has serious implications for the economy given the strong relationship between investment and economic growth.

The diminishing growth of investment can be partly attributed to high costs of capital. The cost of capital measures the return an investment must yield before a firm or an individual is willing to undertake the investment. High capital gains tax rates lower the return on investment, thus increasing the cost of capital and depressing overall investment in the economy. Conversely, a capital gains tax

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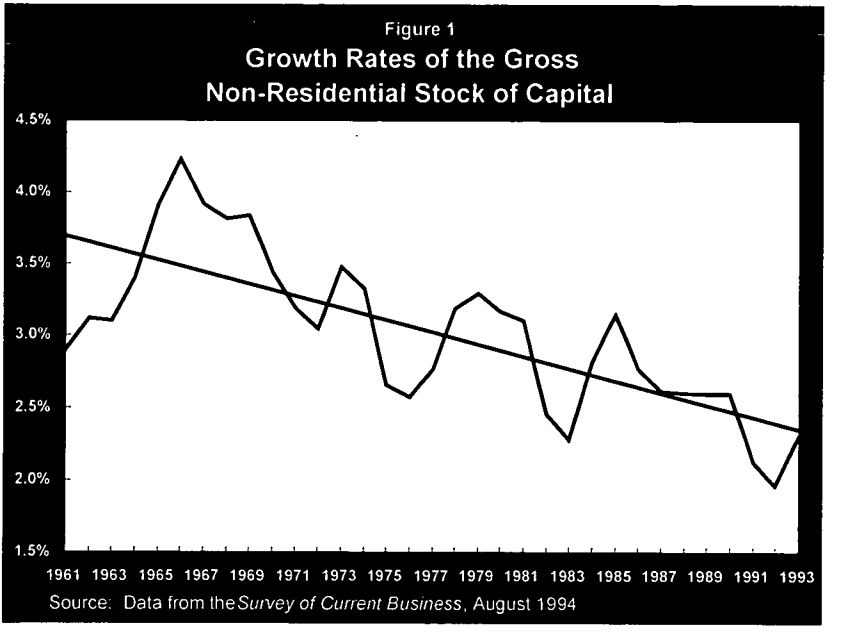
[17] Margo Thorning, "Trends in Investment and Tax Policy: Time for a Change?" *Business Economics* 30 (January 1995), p. 23.

reduction would lower the cost of capital and stimulate investment.[18] The effects of increased capital formation would reverberate throughout the economy in the form of higher wages, rising living standards, job creation, and economic growth.



Furthermore, the U.S. capital gains tax rate exceeds that of any industrialized nation except that of the United Kingdom and Australia (however, even these countries index gains for inflation, whereas the United States does not). Because the United States must compete internationally for capital, high capital gains tax rates place the United States at a disadvantage relative to its competitors. Some of the United States' major competitors, such as Germany and Hong Kong, exempt long-term gains from taxation altogether; and other countries, such as Japan, tax capital gains very lightly. As a result, these countries typically experience higher saving, investment, and productivity growth rates than the United States. The data indicate that a lower capital gains tax rate would help improve U.S. global competitiveness.

Statistical Studies

Several studies have attempted to measure the macroeconomic effects of a capital gains tax reduction. Two of the most recent studies

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[18] The cost of capital is also affected by interest rates and depreciation costs. Some of the fluctuations in Figure 3 reflect changes in investment due to fluctuations in these variables.

were conducted by DRI/McGraw-Hill and by Allen Sinai, chief global economist at Primark Decision Economics, formerly with Lehman Brothers. Both studies estimate the impact of a 50 percent capital gains exclusion for individuals and a 25 percent tax rate for corporations (the existing rate is 35 percent). The studies conclude that a capital gains reduction of this size would benefit the economy.

Allen Sinai[19]

Dr. Sinai estimates that reducing the capital gains tax rate would lower the cost of capital, thus increasing business capital spending by approximately $17.6 billion per year. The higher levels of investment and capital formation would generate increased economic activity, raising the level of real GDP by an average of $51 billion annually. The increase in entrepreneurial activity and productivity would generate close to a half million new jobs by the year 2000.

In addition, the value of the stock market would rise, leading many investors to shift their assets toward equities. This shift would raise family net worth by an average of 2.1 percent per year. Dr. Sinai estimates that the national saving rate would increase by about $44.1 billion per year, partly because of the increased income generated from additional economic activity, and partly because of the increase in personal and corporate saving which occurs when capital gains are taxed at a lower rate. The increased saving would help keep interest rates from rising in the face of increased economic activity. Dr. Sinai concludes that a "Capital gains tax reduction increases savings, capital spending and capital formation, economic growth, jobs, productivity and potential output." He notes that "The increases relative to what might have happened otherwise are definitely significant, but small to modest in magnitude."

Dr. Sinai notes that more targeted capital gains relief, such as an increase in capital gains allowed on home sales, should also stimulate economic activity, but the magnitude of the effects would be drastically reduced. He states that a capital gains reduction targeting the sale of homes would increase housing activity, "but much less benefit would accrue to savings, in general, capital formation, productivity and the maximum sustainable rate of economic growth." The major findings of Dr. Sinai's study are summarized in Table 1.

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[19] Written testimony by Allen Sinai prepared for the Senate Finance Committee, March 13, 1997.

Table 1. Allen Sinai's Estimates of the Effects of a Capital Gains Tax Reduction[1,2] Average per Year, 1997 - 2002

Real GDP		**Employment/**	
level, (in 1992		**Unemployment**	
$-billion)	$51	payroll, millions	0.356
growth, percentage		unemployment rate	-0.2
points	0.1		
		Productivity Growth	
Business Capital		percentage points	
Spending		change	0.1
Total in 1992			
$-billion)	$17.6	**S&P 500**	
		percentage change	0.8
Hourly Compensation			
percentage points		**Household Net Worth**	
change	0.1	percentage change	2.1
National Savings		**Cost of Capital**	
(in $-billion)	$44.1	pretax equity, percent	
		change	-6.8
Federal Tax Receipts[3]		composite, percent	
change from baseline		change	-2.7
OTA	$17.2		
change from baseline			
JCT	$4.5		

Source: Testimony of Allen Sinai before the Senate Finance Committee, March 13, 1997.

[1] Assumes a 50-percent exclusion of long-term capital gains for individuals and a 25 percent capital gains tax rate for corporations effective January 1, 1997.

[2] Estimates are preliminary and subject to change

[3] OTA - Office of Tax Analysis, U.S. Department of Treasury; JCT - Joint Committee on Taxation.

Estimates with unlocking and macroeconomic feedback effects. Numbers depend on estimates of unlocking effect.

DRI/McGraw-Hill[20]

The DRI study, summarized in Table 2, estimates that cutting the capital gains tax rate would lower the net cost of capital, thus raising the level of business spending by about $18 billion in 2007. Over a 10-year period, the capital stock would rise 1.2 percent above its baseline level, increasing productivity by roughly 0.4 percent. Real GDP could be 0.4 percent higher than in the baseline due to the effects of increased investment. The study notes: "The evidence suggests to almost all economists that a capital gains cut is good for the economy and roughly neutral for tax collections."

Table 2. DRI/McGraw-Hill's Estimates of the Effects of a Capital Gains Tax Reduction Total, 1998 - 2007

Real GDP (percent change from baseline)	0.4
Real Capital Spending (percent change)	1.5
Capital Stock (percent change from the baseline)	1.2
Productivity (percent change)	0.4
Net Cost of Capital (percent change)	-3.0
Total Federal Tax Receipts (in $-billion)	$7

[1] Based on 50 percent exclusion of long-term capital gains for individuals and 25 percent tax rate for corporations.

These conclusions largely conform to the findings of other studies that have analyzed the macroeconomic effects of a capital gains tax reduction. Most economists now agree that reducing the capital gains tax rate would encourage investment, boost productivity, raise living standards, and stimulate economic growth. However, some analysts argue that the macroeconomic effects of a capital gains tax reduction would be minimal unless the saving rate increases to provide additional resources for investment. It is argued that the saving rate is unlikely to increase as a consequence of a capital gains tax reduction since empirical studies have found only a weak relationship between saving rates and rates of return.

However, empirical studies which seek to measure the response of the saving rate are inadequate for two main reasons. First, saving is taxed at several levels, the capital gains tax being only one of these levels. Most studies analyze only the effects of a reduction in one level of taxation but ignore other taxes which may be rising. As a result, there are offsetting factors which are not included in the models. An example of this occurred in the 1980s when falling income tax rates

[20] DRI/McGraw-Hill, "The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks," (April 1997).

accompanied a decline in the saving rate. The 1980s, however, marked a period in which other taxes were rising. For example, the Social Security Amendments of 1983 enacted a phase-in for the taxation of Social Security benefits. Middle-income individuals who earned interest from saving could be pushed into the phase-in level, thus subjecting them to taxation. In these circumstances, this would be a disincentive to saving. In addition, rising payroll tax rates more than offset the reduction in income tax rates. The higher level of payroll taxes reduced most taxpayers' after-tax income, out of which people could save, thus dampening the saving incentives associated with the income tax reduction.[21]

The second reason that empirical studies may be flawed is that they use data from the National Income Accounts which measures saving on an income-flow basis. In other words, they measure how much of an increase in income is saved rather than consumed. Income-flow models cannot measure saving which arises from an increase in wealth. For example, the increase in the value of assets in the stock market is treated as an increase in wealth, not income. Saving which arises from increasing wealth are not captured by many models. This is an important point to note because a capital gains tax reduction is more likely to increase saving through wealth effects as opposed to income effects.

Business Creation and Entrepreneurship

Capital gains taxation further effects economic and employment growth through its impact on entrepreneurial activity and business creation. Entrepreneurship is the driving force of a market economy. It is crucial to job creation, innovation, and productivity. Entrepreneurship is affected by, among other things, the strength of the incentives that motivate entrepreneurs to undertake innovative projects and the ability of the entrepreneur to raise enough capital to finance projects. The taxation of capital gains discourages innovation, risk-taking, and capital investment, thus diminishing entrepreneurial activity in the economy.

Capital gains taxation effects entrepreneurship through its impact on venture capital, an important source of funding for entrepreneurial projects. High capital gains tax rates lower the potential return from backing innovative companies, thus restricting the amount of venture capital available to new firms. Some analysts argue that most venture capital comes from tax-exempt sources such as pension funds and

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[21] Another important reason why saving may have fallen is the 1982-83 recession which lowered individuals' incomes. It is believed that individuals reduced their saving in order to be able to maintain the same level of consumption.

foreign investment; therefore, a capital gains tax reduction would not have much effect on venture capital.

However, several studies indicate that informal venture capitalists are extremely important sources of investment and are especially critical to the formation of new companies. Professors John Freear and William Wetzel, Jr. of the University of New Hampshire found that private individuals are a crucial source of funding for new technology-based firms, accounting for 48 percent of seed capital funds. Their study states that "At the seed stage, private individuals invested more funds, in more rounds, for more firms than any other single source."[22] Formal venture capital becomes more important during later stages of development.

Another study, conducted by Coopers & Lybrand, concludes: "Creating new jobs - especially in young technology companies - requires risk capital...The risk capital invested in technology companies is provided primarily by investors subject to capital gains taxation. [Furthermore,] risk capital investors seek capital gains, not dividends."[23] The importance of informal investors to the venture capital process suggests that a capital gains tax reduction would effect the amount of venture capital available to new companies.

The taxation of capital gains may further limit the amount of entrepreneurial activity in the economy by reducing the incentives to entrepreneurship. Israel Kirzner, a professor at New York University, describes entrepreneurship as a discovery process. In other words, the entrepreneur is an innovative, resourceful, risk-taking individual who discovers otherwise overlooked opportunities. Whereas most individuals are motivated by a known set of economic incentives, such as wages or promotion potential, the entrepreneur is motivated by the potential return that may be earned from entering into a situation with *unknown* outcomes. This is why entrepreneurs are described as risk-takers: they are motivated by the uncertain return that may potentially be earned from discovering a previously unnoticed opportunity.

If the potential returns are taxed heavily, the entrepreneur's motivation is reduced. Hence, high capital gains tax rates may divert innovative, would-be entrepreneurs toward different career paths. The economy is harmed by the reduction in entrepreneurial activity, not

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[22] John Freear and William E. Wetzel, Jr., "Who Bankrolls High-Tech Entrepreneurs?" *American Council for Capital Formation Center for Policy Research,* (undated).

[23] Coopers & Lybrand, "Generating Economic Growth through Young Technology Companies," (undated).

only because business and job creation declines, but also because possible improvements to living standards are left undiscovered.[24]

III. Tax Revenue

In an attempt to estimate the revenue effects of a capital gains tax cut, the Joint Committee on Taxation (JCT) used Congressional Budget Office (CBO) estimates of capital gains realizations under the 28 percent tax rate for the 1990-95 period. The JCT concluded that a capital gains tax reduction would cost the government billions of dollars.

This JCT analysis, however, was based on grossly inaccurate data. Figure 2 illustrates the difference between actual capital gains realizations and CBO estimates. For the period 1990-94, CBO overstated capital gains realizations by $737 billion. The use of a massively overstated baseline led forecasters to overestimate the extent of revenue loss associated with a tax cut.

These substantial CBO errors occurred for two primary reasons. First, high capital gains tax rates cause realizations to decline because the penalty associated with selling assets is high. CBO did not adequately account for this behavioral response in its estimation process. Second, the CBO analysis did not account for the macroeconomic effects described in the previous section. -In other words, CBO assumed that a change in the capital gains tax rate is neutral in its effect on the economy. For these reasons, CBO massively overstated the projected levels of realization.

Historical Evidence

Historical evidence undermine the claim that capital gains tax reductions lower revenue. Figure 3 shows that, historically, taxes paid on capital gains have tended to *increase* after a reduction in the capital gains tax rate. When capital gains tax rates were lowered in 1978 and again in 1981, revenue climbed steadily despite government forecasters' claims that it would fall. Conversely, when the tax rate increase was enacted in 1987, revenue began declining, although forecasters predicted it would increase.

For instance, capital gains tax revenue equaled $36.2 billion (0.5 percent of GDP) in 1994 (the last year for which finalized IRS data are available). In contrast, $36.4 billion (0.6 percent of GDP) was collected in 1985, after adjusting for inflation. Thus, tax revenue in 1994 was slightly lower than in 1985 even though the tax rate was higher, the economy was larger, and the stock market was stronger in 1994. The historical data suggest that the government could collect more revenue if the capital gains tax rate were reduced.

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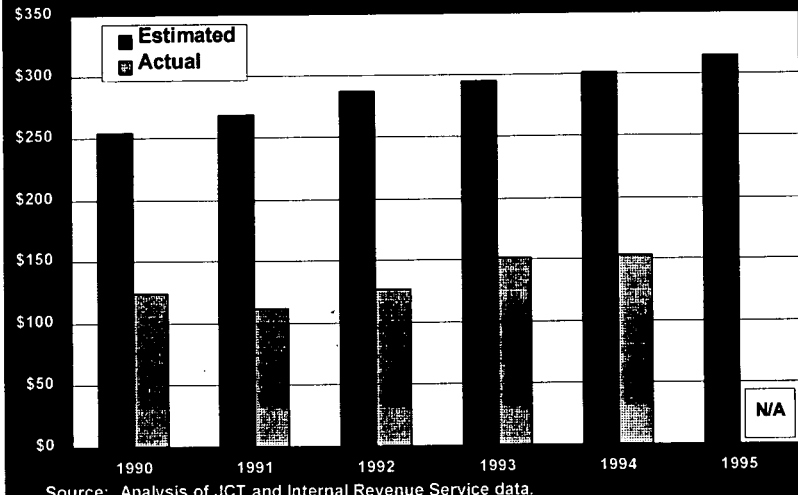
[24] Israel Kirzner, *Discovery and the Capitalist Process.* (Chicago: University of Chicago Press, 1985), pp. 93-118.

Figure 2

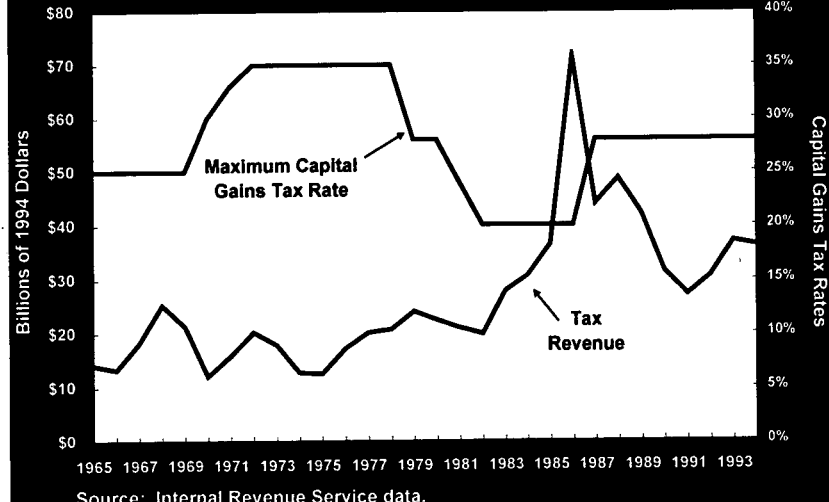
Capital Gains Realizations (in billions of dollars): CBO Estimates vs. Actual



Source: Analysis of JCT and Internal Revenue Service data.
N/A - Data not available

Figure 3

Taxes Paid on Capital Gains vs. Capital Gains Tax Rates



Source: Internal Revenue Service data.

Effects on Tax Revenue

The result that tax revenue tends to increase following a reduction in the tax rate may seem counterintuitive; however, there are many offsetting factors which must be considered. In the static analysis, tax revenue inevitably falls because the same level of realizations is being taxed at a lower rate. In addition, tax receipts may fall if taxpayers reclassify regular income as capital gains in order to take advantage of the lower rate.

On the other hand, a reduction in the capital gains tax rate creates three effects which tend to increase tax revenue. The first is the unlocking effect, which expands the tax base because realizations increase in response to the lower tax rate. The magnitude of the unlocking effect is quite controversial and will be discussed in greater detail in the next section. The second is the dynamic effect, which measures the increase in tax revenue generated from the impact of lower tax rates on economic growth. The third effect measures the increased tax revenue resulting from an increase in the value of existing assets. When capital gains tax rates are lowered, the value of existing assets necessarily increases. Tax revenue rises as owners of stock pay taxes on the higher value of their assets when realized.

The impact on tax revenue depends on the relative magnitude of each of these offsetting factors. In the past, government forecasters have used a static analysis which does not consider the macroeconomic effects or the effects of an increase in the value of assets. In general, more comprehensive studies find that a reduction in the capital gains tax rate will be revenue neutral, and may even generate small revenue gains. The DRI/McGraw-Hill study finds that the positive revenue effects outweigh the negative, and therefore federal tax revenue should increase by approximately $7 billion over 10 years. The results of the DRI study are summarized in Table 3.

Table 3. Estimated Impact of Capital Gains Tax Reduction on Federal Tax Revenue for Select Years (billions of 1997 dollars)[1]

	1998	2002	2007	1998 - 2007
Static Effect	-14	-16	-20	**-168**
Unlocking Effect[2]	15	2	2	**47**
Asset Prices	13	9	8	**95**
Income Reclassification	-2	-2	-2	**-21**
Macroeconomic Effect	0	4	11	**54**
Total	12	-3	-1	**7**

Source: DRI/McGraw-Hill, "The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks," Table 1, (April 1997).

[1] Effects of a 50 percent exclusion of capital gains for individuals and a 25 percent tax rate for corporations.

[2] DRI uses a conservative estimate of 5 percent additional unlocking over the 10-year period.

Unlocking Effect

When capital gains tax rates are high, investors avoid paying the tax by holding onto assets they would have otherwise chosen to sell. This creates a "lock-in effect," which lowers capital gains realizations by shrinking the tax base. CBO failure to adequately account for this behavioral response caused it to underestimate the extent of lock-in and overestimate capital gains realizations as shown in Figure 2 above. Economists estimate that trillions of dollars in equity are currently locked into assets because investors refuse to pay a high tax on their profits. Reducing the capital gains tax rate would unlock a portion of this capital, allowing the government to tax the increased realizations.

Although analysts agree on the existence of the unlocking effect, its magnitude and duration are controversial. Estimates of the unlocking effect depend on assumptions made about taxpayer responsiveness to changes in the tax rate. CBO estimates have found a low level of responsiveness, leading some analysts to conclude that the unlocking effect is insignificant. However, other studies have found a high degree of taxpayer responsiveness. An analysis by economists at the Office of Tax Analysis (OTA) at the U.S. Department of Treasury states that while no study can provide definitive conclusions:

> ...we find strong evidence of responsiveness to capital gains tax rates. [Our findings] show that the marginal

> tax rate on long-term gains has a significant powerful negative impact both on the proportion of taxpayers realizing gains and on the value of capital gains declared by realizers. That is, despite theoretical misgivings that many analysts have expressed, the data continue to imply that the realizations response would be sufficient to yield revenue increases from capital gains reductions.[25]

The results of various studies differ due to divergent methodologies. CBO uses an approach which estimates aggregate responsiveness, while OTA focuses on individual taxpayer behavior. Many analysts believe that the former approach understates the unlocking effect and the latter overestimates it; the true measure may be somewhere in between. The important point to note is that all studies find some evidence of unlocking, suggesting that capital gains realizations do increase when the capital gains tax rate is reduced. Furthermore, a study by economists Robert Gillingham and John Greenlees analyzed both methods and concluded: "Existing analyses do not provide conclusive evidence on the revenue effects of changes in the taxation of capital gains...The weight of the evidence from both [approaches] does not suggest, however, that a reduction in the capital gains rate from existing levels would decrease tax revenue."[26]

A study by the National Bureau of Economic Research indicates that when the unlocking effect is taken into account, the revenue-maximizing capital gains tax rate falls somewhere between 9 and 21 percent. This rate does *not* account for the increased revenue generated from the asset value and dynamic effects discussed previously.[27]

IV. Who Would Benefit?

Earlier legislation to reduce the capital gains tax rate was defeated in large part because opponents of a tax cut portrayed it as a windfall for the rich. It is obvious that affluent investors would benefit from a capital gains tax reduction, but benefits would also accrue to individuals across the income spectrum. The DRI/McGraw-Hill study notes: "Often overlooked benefits flow to all workers and middle income citizens, and the overall economy wins. The middle class will

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[25] Robert Gillingham, John S. Greenlees, and Kimberly D. Zieschang, "New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross-Section Data," *Department of Treasury OTA Papers,* (May 1989), p. 27.

[26] Robert Gillingham, and John Greenlees, "The Effect of Marginal Tax Rates on Capital Gains Revenue," *National Tax Journal* 45 (June 1992), p. 167.

[27] Testimony by Mark A. Bloomfield prepared for the Senate Finance Committee, February 15, 1995, p. 10.

benefit from greater appreciation in their pensions...Small businessmen will gain from more generous tax treatment of the gains on their enterprise. And all employees will see wage gains tied to investment-driven higher productivity."[28] DRI's research director, David Wyss, notes that "The capital gains cut helps most people and hurts no one."[29]

Furthermore, the notion that all investors are affluent gentlemen coupon-clippers is no longer true. Over the past decade, the stock market has seen a surge of middle income investors. A survey released earlier this year by the NASDAQ Stock Market found that stock ownership among Americans has doubled in the past seven years to 43 percent of the adult population. The survey also found that:[30,31]

- ⇒ 47 percent of the investors are women;
- ⇒ 55 percent are under the age of 50; and
- ⇒ 50 percent are not college graduates.

Mutual funds have become especially popular with middle income Americans as a source of investment for pension funds and as an alternative to traditional bank accounts and government securities, which generally yield lower returns. According to the survey, the proportion of American adults investing in mutual funds has tripled over the past seven years from 13 to 40 percent. Another study conducted for the mutual fund industry found that 29 percent of mutual fund shareholders have family incomes below $40,000; 38 percent have incomes between $40,000 and $75,000; and 33 percent have family incomes over $75,000.[32]

These results suggest that a capital gains tax reduction would directly benefit many Americans across the income spectrum. A stronger economy also would generate indirect benefits for individuals

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[28] DRI/McGraw-Hill, "The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks," (October 1995), p. 3.

[29] Testimony by David Wyss prepared for the House Committee on Ways and Means, March 19, 1997.

[30] Marcy Gordon, "Stock Market Looks More Like Face of America, Survey Says," *The Associated Press Business News,* February 21, 1997.

[31] The survey, conducted by Peter D. Hart Research Associates, was based on 20-minute interviews with a national sample of 1,214 investors. The margin of error is plus or minus 3.2 percentage points.

[32] The 1996 study, conducted by the Investment Company Institute, was based on telephone interviews with a randomly selected sample of 1,165 mutual fund shareholders in mid-1995. The survey data does not include individual families that only own mutual funds in 401(k) employer sponsored retirement plans.

who do not participate in the stock market. However, these indirect gains are much more difficult to quantify. Consequently, it is important that the capital gains debate is not relegated to a discussion of numbers and distributional tables.

Shortcomings of Distributional Tables

Policy makers have become heavily reliant on distributional tables which illustrate the effect of a proposed tax change on the tax liabilities and tax burdens of different income groups. As mentioned earlier, past legislation to reduce the capital gains tax rate was defeated largely on the basis of distributional analysis. Distributional tables must be interpreted with great caution.

Michael Graetz of Yale University, formerly the Deputy Assistant Secretary at the Treasury Department's Office of Tax Policy, warns that distributional tables should not guide tax policy.[33] Distributional tables are necessarily based on many assumptions and over simplifications that cannot capture the wide variety of behavioral and economic responses which occur in reality. For instance, most distributional tables only represent tax payments, but do not reflect the fact that low and middle income individuals are the major recipients of government transfer payments. Thus, the numbers overstate the true tax burden on these individuals. Consequently, the assumptions and simplifications used to construct the tables often lead to misleading results.

Graetz points out that the three government agencies responsible for constructing distributional tables (CBO, JCT, and OTA) implement divergent methodologies based on their own judgments and interpretations of the theoretical issues. The divergent methodologies produce conflicting tables which confuse the policy-making process and can significantly skew the results to bolster a particular political view. The inaccuracies are not necessarily a consequence of intent, but of the elusive nature of the impact of tax changes on the economy.

Graetz suggests that distributional analysis is best explained through words, not numbers, and heavy reliance on these imperfect tables may compromise the soundness of the affected tax legislation. Distributional tables should not be ignored -- they do contain important information when interpreted properly. However, it is extremely important to recognize that they do not relay a complete or perfectly accurate analysis.

V. Tax Fairness

Opponents of a capital gains tax reduction argue that capital gains are already subject to preferential treatment, and a further rate reduction would only motivate many taxpayers to reclassify regular income as

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[33] Michael J. Graetz, *Distributional Analysis of Tax Policy,* edited by David F. Bradford. (Washington D.C.: The AEI Press, 1995), pp. 15-78.

capital gains in order to take advantage of lower tax rates. However, there are many provisions in the tax code which discriminate against saving and investment and outweigh the preferential treatment of capital gains.

First, taxpayers purportedly benefit from a provision which allows them to defer tax payment on capital gains until the gains are realized. Whereas most interest income is taxed as it accrues, a capital gain is not taxed until the asset is sold and the gain is realized. However, the benefit of deferral is at least partially offset since the money associated with capital gains is subject to several levels of taxation: it is taxed when earned as individual income, when claimed as corporate income, when realized as a capital gain, and if held until death, it may be subject to estate taxes.

Second, many claim that capital gains are awarded preferential treatment because the tax is forgiven if the asset is held until death. This provision benefits a relatively small portion of the population since most people save to finance their retirement, to guard against unforeseen mishaps, or to achieve a desired goal such as purchasing a home or college education. These individuals save because they plan to realize their earnings during their lifetimes, and accordingly, they are unlikely to benefit from the death provision. Even those who do hold their assets until death may not escape taxation entirely if their assets become subject to the estate tax.

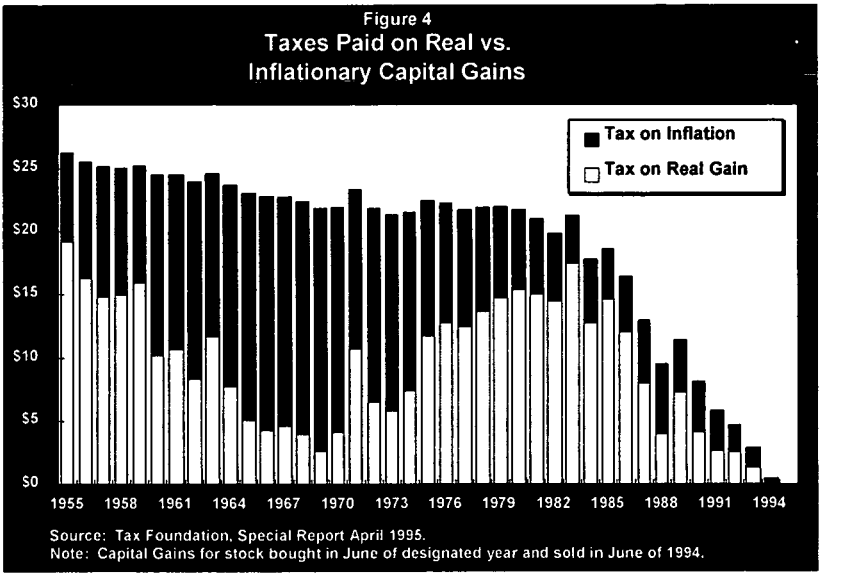
Third, capital gains are supposedly given preferential treatment since the statutory capital gains tax rate is capped at 28 percent, as opposed to regular income, which is capped at a rate of 39.6 percent. This benefit is diminished since the effective tax rate often exceeds 28 percent due to various phase-out provisions in the tax code. In addition, the realization of a capital gain may push individuals into a higher income tax bracket, thus further increasing their tax liability.

Finally, the most inequitable provision of capital gains taxation is the failure to index gains for inflation. Since capital gains are not adjusted for inflation, individuals often pay taxes on inflation-generated gains. As a result, the effective tax rate may exceed the statutory maximum. In years of particularly high inflation, the effective tax rate exceeded 100 percent; consequently, many individuals have paid capital gains taxes on capital *losses*.

Figure 4 illustrates the undue burden created by taxing inflationary gains. It shows the total tax paid on an average stock purchased in June of different years and sold in June of 1994. The bottom region of each bar reflects the portion of the tax paid on real gains, while the top region shows how much tax was paid on inflation.

The taxing of inflationary gains is unfair and counter-productive because it intensifies the lock-in effect. Many investors choose to hold onto their assets, not only to avoid paying high capital gains taxes, but

also to avoid paying taxes on illusory gains. If capital gains were indexed, much of this capital would become unlocked, allowing the government to tax the increased realizations.



Finally, it should be noted that the concern over income reclassification (classifying regular income as capital gains) is misplaced. Income reclassification would not be the consequence of lower capital gains tax rates; it is already the consequence of a complicated tax system which treats various types of income differently depending on their source and who receives them. Taxpayers already have an incentive to take advantage of tax loopholes to avoid paying high taxes on their earnings. Possibly the only solution that would eliminate tax arbitrage is the transition to a flatter, less complicated tax structure which closes loopholes and reduces individuals' ability to exploit the system.

VI. Conclusion

Saving and investment are crucial to economic growth and rising living standards. However, high costs of capital, double and triple taxation of saving, and taxation of inflationary gains discourage these activities, thus lowering economic efficiency and long-term growth prospects. While broad tax reform is needed to address the deficiencies of the existing tax code, many economists believe that reducing the capital gains tax rate is the single most effective policy measure which can be enacted immediately to promote efficiency and economic growth.

In the past, attempts to stimulate long-term economic growth through a capital gains tax reduction were thwarted by inaccurate

estimates of revenue losses and misleading distributional tables. This discussion should focus on the macroeconomic effects of cutting the capital gains tax rate rather than on the questionable distributional effects. It has been estimated that reducing the effective capital gains tax rate would add $51 billion per year to real GDP, raise productivity growth by 0.1 percentage points per year, and create a half million new jobs over the next three to four years. A capital gains tax cut would also stimulate business creation and help equalize the inequities that prevail under the current tax code.

A meaningful debate should therefore incorporate the macroeconomic effects of a capital gains tax reduction and concentrate on the positive growth effects of a tax cut. When these effects are taken into account, it becomes increasingly apparent that a capital gains tax reduction would benefit the government as well as taxpayers in all income brackets.

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EXPANDING IRA BENEFITS

A JOINT ECONOMIC COMMITTEE STUDY

Jim Saxton (R-NJ), Chairman

Joint Economic Committee
United States Congress

December 1997

Abstract

Providing new saving incentives to raise the U.S. saving rate is a primary goal for many policy makers. One of the most important saving incentives under current law is the Individual Retirement Account (IRA). IRAs offer taxpayers attractive tax benefits that encourage them to save for retirement, but restrictions on their use prevent or discourage many taxpayers from taking advantage of these benefits. Liberalizing these restrictions could substantially increase IRA participation and boost personal saving in the United States, thereby creating new incentives for financial empowerment and economic growth.

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EXPANDING IRA BENEFITS

EXECUTIVE SUMMARY

Under the current tax code, income used for consumption is taxed only once, but income used for saving is taxed at least twice. This bias discourages taxpayers from saving for future expenses. It also impedes economic growth by limiting the amount of domestic resources available for investment. Eliminating or reducing this bias through enhanced saving incentives would make the tax code fairer and more efficient.

One of the most important saving incentives under current law is the Individual Retirement Account (IRA). Expanding IRA tax benefits would generate significant gains for middle-income taxpayers while reducing the bias against saving that exists under current law. The tax laws enacted in 1997 have already made important progress in expanding IRAs. The income limits for deductible contributions have been raised; restrictions on penalty-free withdrawals have been liberalized to include college expenses and first-time homebuyer expenses; and the rules applying to uncovered spouses (spouses without employer pension plans) have been expanded. These changes will make IRA tax benefits available to the large majority of middle-income taxpayers, and they will encourage IRA participation.

However, the current $2,000 limit on IRA contributions has been in place since 1981 and should be raised. This limit does not reflect the increase in prices and wages that has taken place since 1981. It does not reflect the fact that individuals need to save more for retirement because of longer life expectancies, rising medical costs, and the deterioration in the financial status of Social Security. Finally, it does not reflect changes in the role of IRA saving that were created by the new tax laws. Raising the contribution limit would enhance the tax benefits of IRA saving, thus enhancing incentives for economic growth.

Benefits for Middle-Income Taxpayers

- Taxpayers can lower their tax liabilities for the year in which a contribution is made.
- Taxpayers can lower their tax liabilities by deferring taxes to a time when they fall into a lower tax bracket.

- Interest earned in an IRA is not taxed while it accrues. As a result, more money can be reinvested in the account each year, allowing assets to grow at a much faster rate. This benefit provides significant gains for taxpayers even if they do not qualify for tax deductible contributions based on their incomes.
- A taxpayer that makes annual contributions to their IRAs can accumulate a substantial nest egg from which they can finance important taxpayer expenses such as retirement, college expenses, and first-time homebuyer expenses among other things. Taxpayers with substantial savings are also guarded against future financial uncertainties.

Benefits for the Economy

- Raising the contribution limit would enhance IRA tax benefits and the associated saving incentives. This, in turn, would boost the level of personal saving in the United States.
- IRA saving is merely tax deferred, not tax exempt. Thus, much of the lost government revenue is recovered in the long run when distributions are made. The decline in personal tax revenue that results from eliminating the double taxation of saving is largely offset by two factors: (1) increased corporate tax revenue generated from a larger capital stock and (2) increased personal tax revenue generated from higher levels of investment earnings because of the tax deferred nature of IRA saving. Overall, IRA expansion should not adversely affect the government deficit so that the national saving rate should rise.
- A high national saving rate provides more resources for investment at a lower cost to investors. Increased investment generates productivity improvements that lead to higher wages and better living standards.
- A high national saving rate allows long-term interest rates to fall, creating an environment conducive to economic growth. It also reduces investors' reliance on foreign capital so that more of the benefits from the investment accrue to the U.S. economy.

EXPANDING IRA BENEFITS

The current tax code is biased against saving and investment—activities that are important to economic expansion and to our quality of life. This bias discourages taxpayers from saving for future expenses and unforeseen needs. It also impedes economic progress by limiting the amount of domestic resources available for investment.

Providing new saving incentives to raise the U.S. saving rate is a primary goal for many policy makers. One of the most important saving incentives under current law is the Individual Retirement Account (IRA). IRAs offer taxpayers attractive tax benefits that encourage them to save for retirement, but restrictions on their use prevent or discourage many taxpayers from taking advantage of these benefits. Liberalizing these restrictions could substantially increase IRA participation and boost personal saving in the United States, thereby creating new incentives for financial empowerment and economic growth.

I. WHAT IS WRONG WITH THE CURRENT TAX SYSTEM?

An ideal tax code would be completely neutral—it would neither encourage nor discourage any type of activity. (Of course, perfect neutrality is impossible to achieve because taxes necessarily affect individuals' decisions by distorting relative prices in the economy.) The current tax code seriously violates the principle of neutrality by favoring current consumption relative to saving (i.e., future consumption).

The disparity between the treatment of current consumption and saving occurs because the existing tax system is primarily an "income-based" system. The problem arises because the definition of income used to define the tax base generally includes both saving and the income earned from saving (i.e., interest, dividends, etc.). Thus income that is saved is taxed at two different levels. This double taxation raises the price of saving relative to the price of consumption.

For instance, consider a worker who receives a $2,000 bonus at work and is deciding between using the funds to start a saving account for graduate school or to pay for a vacation. If the worker chooses to save the bonus, the $2,000 is taxed as wage income, leaving $1,700 to deposit in the saving account (assuming a marginal tax rate of 15 percent). Any interest or dividends earned in the saving account are also taxed as income. In contrast, if the worker chooses to spend the bonus on a vacation, the $2,000 is taxed once as wage income, but any

benefit derived from the vacation is not taxed. In other words, income used for consumption is taxed only once at the time the income is earned, but income used for saving is taxed twice—once when the income is earned and again when the saving generates any earnings.

This additional burden penalizes taxpayers who save. However, saving is important to a taxpayer's quality of life and to the potential for economic growth. Saving helps taxpayers finance education, home purchases, retirement and other important expenses. It also guards taxpayers against financial uncertainties, such as unemployment or medical emergencies. Moreover, a high level of saving provides the business sector with the resources it needs to invest in human capital (such as worker education and training) and physical capital (such as plants and equipment that enhance worker productivity). Saving and investment also provide new, start-up firms with the capital they need to grow and create new jobs. In brief, saving and investment are key determinants to economic growth and productivity improvements. A larger, more productive economy generates new jobs, higher wages and better living standards.

Switching to a Consumption-Based Tax

Because saving is important to future economic prosperity, many policy makers have proposed restructuring the tax code to reduce or eliminate the bias against saving. Most tax reform proposals have one element in common: they would transform the current income-based tax system into one that is consumption based. Consumption-based taxes only tax the portion of income that is spent—they do not tax the portion of income that is saved. Thus, the main difference between the two types of taxes is that income-based systems tax the resources that people put into the economy, whereas consumption-based systems tax the resources that people take out of the economy. Murray Weidenbaum of Washington University in St. Louis notes: "Under a consumption-based tax, the basic way to cut taxes—legally—is for individuals and taxpayers to save more and for companies to invest more. To minimize tax liability under the existing tax structure, taxpayers have to earn less."[34]

Numerous studies have found that switching to a consumption-based tax would boost private saving and long-term economic growth. For instance, Eric Engen of the Federal Reserve Board and William Gale of the Brookings Institution found that moving from the existing

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[34] Murray L. Weidenbaum, "True Tax Reform: Encouraging Saving and Investment," *Business Horizons*, May 1995, Volume 38, No. 4.

system to a flat-rate consumption tax would raise the long-term saving rate by one-half percentage points and increase gross domestic product (GDP) by 1 to 2 percent in the long run.[35] Although these numbers are small in magnitude, they would make a significant contribution to future living standards.

The existing tax system is not a pure income-based system because it contains some provisions to shelter saving from taxation. One of these is the IRA. Contributions to an IRA are deducted from income and then taxed when the proceeds are withdrawn from the account and spent. Thus, the portion of income that taxpayers save in an IRA is taxed only once. IRA expansion would, therefore, be a simple way to begin the transformation toward a fairer, more efficient consumption-based tax. Expanding IRAs would not require a major overhaul of the current tax code and could, therefore, be implemented immediately, laying the foundation for broad-based reform in the future.

II. How IRAs Work

IRAs are available to all individuals with earned income and to their spouses, but different individuals receive different tax benefits depending on their situation. If neither spouse is an active participant of an employer sponsored retirement plan, then each spouse can establish an IRA and contribute $2,000 to the IRA annually. The contribution is deducted from taxable income, and the interest earned in the account is not taxed while it accrues.

When funds are withdrawn from the IRA, the entire amount of the withdrawal is subject to income tax. If funds are withdrawn before the individual reaches the age of 59 ½, the distribution is subject to a 10 percent penalty. Premature withdrawals are allowed without penalty in the case of the individual's death or disability, to pay for medical expenses that exceed 7.5 percent of adjusted gross income (AGI), or to purchase health insurance while unemployed. In addition, distributions are not penalized if they are withdrawn in the form of a lifetime annuity. Minimum distributions are required each year when the individual reaches the age of 70 ½, and contributions are not allowed after this age.

If either spouse is an "active participant" of an employer plan, the couple still can make fully tax deductible contributions to their IRAs as

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[35] Eric M. Engen and William G. Gale, "Consumption Taxes and Saving: The Role of Uncertainty in Tax Reform," *The American Economic Review*, May 1997, 87: 114-155.

long as their combined AGI does not exceed $40,000 ($25,000 for single filers). Partial deductions are allowed for taxpayers with AGI between $40,000 and $50,000 ($25,000 and $35,000 for single filers). Couples who do not qualify for tax deductible contributions based on their incomes can still benefit from IRAs because their savings accumulate on a tax deferred basis.[36] The benefit of tax deferral is quite substantial and is discussed later.

Expanding IRAs

Recent changes in the tax laws have liberalized the restrictions on IRA participation. The Taxpayer Relief Act of 1997 gradually doubles the income limits at which fully deductible contributions are allowed. For couples filing jointly, the income limit will increase from $40,000 to $80,000 with a phase-out range of $80,000 to $100,000. For single tax filers, the income limit will increase from $25,000 to $50,000 with a phase-out range of $50,000 to $60,000. In addition, a spouse who is *not* an active participant of an employer plan will be allowed to make a fully tax deductible contribution to an IRA even if his or her spouse *is* a participant of an employer plan provided that their joint AGI does not exceed $150,000 (phase-out range of $150,000 to $160,000). Finally, the 10 percent penalty on early withdrawals will not apply if the proceeds are used to finance higher education expenses or "first-time" homebuyer expenses.[37,38] A more detailed outline of the new IRA provisions is contained in the Appendix.

The new legislation has made important progress in the expansion of IRAs. Increasing the income limits and changing spousal rules will make deductible contributions available to a large majority of middle-income taxpayers; liberalizing the restrictions on early withdrawals will encourage IRA participation. However, the contribution limit of $2,000 is too low and cannot allow taxpayers the opportunity to increase their saving significantly. The maximum contribution must be

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[36] For individuals who make non-deductible contributions, only the earnings generated by the savings are taxed upon withdrawal because the principle is taxed at the time the contribution is made.

[37] Penalty-free withdrawals for first-time homebuyer expenses are subject to a $10,000 lifetime cap. A "first-time" homebuyer is defined as someone who has not had a property interest in a principle residence for at least two years.

[38] The new tax laws also created two new types of IRAs: Roth IRAs and Education IRAs. Contributions to these accounts are not tax deductible, but the proceeds are not subject to income tax when withdrawn as long as certain conditions are met. The benefits discussed throughout this paper mainly apply to traditional tax deductible IRAs.

raised in order to provide new incentives for financial empowerment and economic growth.

In February 1997, Congressmen Jim Saxton (R-NJ), Richard Armey (R-TX) and Tom DeLay (R-TX) introduced H.R. 891, a bill that would gradually increase the maximum deductible contribution from $2,000 per year to $7,000 per year.[39] Raising the contribution level to this amount would generate significant benefits for middle-income taxpayerss and for the economy.

III. Benefits for Middle-Income Taxpayers

IRAs were established in 1974 to encourage individuals to save for retirement if they were not covered by employer sponsored retirement plans. In 1981, IRA participation was expanded to include all workers regardless of their participation in an employer pension plan. The Tax Reform Act of 1986 limited IRA participation so that workers with employer plans could make tax-deductible contributions only if they met certain income limits. As a result, most of the tax benefits from IRAs are now directed toward low- and middle-income taxpayers who otherwise might not save without the appropriate incentives. IRAs provide several important tax benefits that would be augmented if the maximum contribution were increased above $2,000.

Tax Deductible Contributions. Individuals who qualify for tax deductible contributions can lower their tax liabilities for the year in which a contribution is made. If a married couple invests the maximum amount of $2,000 each, they would lower their taxable income by $4,000. This would result in a tax cut of up to $600 for taxpayers in the 15 percent tax bracket and $1,120 for taxpayers in the 28 percent tax bracket. If the maximum contribution were increased, the savings would be much higher. For instance, if the contribution were raised to $7,000, as proposed in H.R. 891, a taxpayer in the 15 percent tax bracket could lower their tax bill by as much as $2,100, and a taxpayer in the 28 percent tax bracket could lower their tax bill by $3,920.

Tax Deferred Contributions. The benefit of tax deferral allows individuals to potentially lower their tax liabilities over time. Many workers often have higher incomes during their working years than during their retirement years, thus they may fall into a lower tax

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[39] The bill is also co-sponsored by Spencer Bachus (R-AL), Steve Chabot (R-OH), Jo Ann Emerson (R-MO), Mark Foley (R-FL), Martin Frost (D-TX), Dan Miller (R-FL), Christopher Smith (R-NJ), Bob Stump (R-AZ), James Talent (R-MO), and Dave Weldon (R-FL).

bracket when they retire. IRAs allow individuals to potentially lower their tax liabilities by deferring their taxes to a time when their marginal tax rates are lower. Consider an individual who contributes $60,000 to an IRA during his or her working years when he or she falls in the 28 percent tax bracket. The contributions allow the individual to defer up to $16,800 of taxes. If the individual's marginal tax rate falls to 15 percent during retirement when the funds are withdrawn, the $60,000 contributions generate a maximum tax liability of only $9,000. Deferring taxes thus allows the individual to save $7,800.

Conversely, tax liability will increase if an individual falls into a higher tax bracket when distributions are made. However, the individual can choose to make non-deductible contributions if this is believed to be the case so that the distributions are taxed at the lower marginal tax rate. Even if distributions are taxed at a higher marginal tax rate, the benefit of tax deferred saving (discussed next) often outweighs the cost associated with moving into a higher tax bracket.

Table 1.
VALUE OF TAX DEFERRED SAVING

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
IRA Balance (10% growth)	$13,431	$35,062	$69,899	$126,005
IRA Balance, after tax (28% tax bracket)	$9,670	$25,245	$50,328	$90,724
Non-Deferred Balance, After tax (28% tax bracket)	$8,913	$21,531	$39,394	$64,683
Equalizing Tax Rate	33.64%	38.59%	43.64%	48.67%

Source: Joint Economic Committee calculations.

Tax Deferred Saving. Not only are contributions to IRAs tax deferred, but income earned in an IRA, or "inside build up," is also tax deferred. In other words, the interest earned in the account is not taxed while it accrues. Therefore, more money can be reinvested in the account each year. This allows assets to grow at a much faster rate.

The benefit of tax deferred saving generates significant gains for taxpayers that will often outweigh the tax increase associated with moving into a higher tax bracket. Consider an individual who contributes $2,000 per year to a tax deductible IRA that earns 10 percent annually. Table 1 shows that the individual would accumulate $126,005 after 20 years. If the savings are withdrawn at the end of the 20th year and taxed at 28 percent, the individual would be left with $90,724. If an equivalent amount of dollars were contributed to a non-deferred account (such as a saving account at a financial institution) under the same rate assumptions, the individual would have only $64,683 after 20 years.[40] Thus, the benefit of tax deferral is worth $26,041 in this example. The income tax rate for a middle-income individual would have to increase to over 48 percent to equalize the value of the two accounts (the highest tax rate under current law is 39.6 percent).[41] This demonstrates that even if the individual is in a higher tax bracket during retirement years, the benefit of tax deferral would probably outweigh the tax increase associated with the higher tax bracket.

Tax deferred saving also makes IRAs attractive to individuals who do not qualify for tax deductible contributions. Table 2 below shows that if an individual contributes $2,000 after taxes to an IRA earning 10 percent annually, he or she would have $126,005 after 20 years. If the savings are withdrawn at the end of the 20th year, the earnings would generate a tax liability of $24,081 (only investment earnings are taxed when distributions are withdrawn), leaving the

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[40] A $2,000 contribution to a regular saving account generates a tax liability of $560, assuming a 28 percent marginal tax rate. A $2,000 contribution to an IRA generates no tax liability. In order to equalize the values of the two contributions, one must assume that the $560 tax liability generated by the former is deducted from the contribution. Thus, this example assumes $2,000 annual contributions to the IRA and $1,440 annual contributions to the saving account. In other words, $2,000 pre taxes equal $1,440 after taxes. Upon withdrawal, the entire IRA distribution is subject to income tax, but only the earnings from the saving account are taxed.

[41] This is a modified example from Wallace F. Helin, "Deferring Tax is Good Financial Planning," *Management Accounting (USA),* December 1994.

individual with $101,924. If after-tax contributions of $2,000 were made each year to a non-deferred account, the individual would have only $89,838 after 20 years. In this case, the benefit of tax deferred saving is worth $12,086.

This benefit would be even more valuable if the annual contribution were raised above $2,000. For instance, if an individual contributed $7,000 per year to an IRA earning 10 percent annually, he or she would have $356,733 after taxes at the end of 20 years. If the contributions were made to a non-deferred saving account, the individual would have $42,300 less.

Table 2.
VALUE OF TAX DEFERRED SAVING WHEN CONTRIBUTIONS ARE NOT TAX DEDUCTIBLE

	After 5 Years	After 10 Years	After 15 Years	After 20 Years
IRA Balance (10% growth)	$13,431	$35,062	$69,899	$126,005
IRA Balance, after tax (28% tax bracket)	$12,470	$30,845	$58,727	$101,924
Non-Deferred Balance, after tax (28% tax bracket)	$12,379	$29,904	$54,714	$89,838
Difference	$91	$941	$4,013	$12,086

Source: Joint Economic Committee calculations

Financial Independence. The personal saving rate in the United States averaged only 4.9 percent during the 1990s compared to 7.4

percent in the 1960s and 8.1 percent in the 1970s.[42] The low rate of personal saving indicates that American taxpayers are not saving enough for future expenses and unforeseen financial needs. In 1992, the median value of all assets held by taxpayers who owned assets was only $13,000[43] (excluding home equity)—hardly enough to ensure a taxpayer's financial security. Raising the limit on deductible contributions would provide taxpayers with the opportunity and incentives they need to save more.

The $2,000 ceiling on IRA contributions has been in place since 1981. This limit does not reflect changes in the economy and in the role of IRAs that have taken place. For instance, the $2,000 limit does not reflect the increase in economy-wide prices and wages. It does not reflect the fact that individuals may need more money during retirement because of longer life expectancies, rising medical costs, and the deterioration in the financial status of Social Security. Moreover, a wider variety of expenses have been given penalty-free status so that the role of IRAs has expanded beyond that of a saving vehicle for retirement only. The $2,000 limit may have been adequate in the early 1980s, but it now needs to be increased to reflect the changes that have taken place since then.

Raising the contribution limit would make IRAs an important saving vehicle for middle-income taxpayers. A taxpayer that contributes $7,000 per year to an IRA earning 8 percent annually would have $249,092 after taxes (assuming a 28 percent marginal tax rate) after 20 years. A nest egg of this size could be used to finance retirement, children's education, a home purchase, and other important expenses. It would also guard taxpayers against future financial uncertainties, such as unemployment or unforeseen medical expenses. A higher contribu-tion limit would, therefore, allow taxpayers to become financially independent and less reliant on the federal safety net.

Furthermore, since IRAs are self-directed, taxpayers have the freedom to invest their savings as they see fit. This allows them the opportunity to increase their incomes relative to what the government can provide for them through social spending programs.

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[42] Council of Economic Advisers, *Economic Report of the President*, (Washington, DC: Government Printing Office) 1997, Table B-28.

[43] Arthur B. Kennickell and Martha Starr-McCluer, "Changes in Family Finances from 1989 to 1992: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, October 1994.

Benefits for Low-Income Taxpayers

A common argument against IRA expansion is that low-income families would not benefit because they do not have enough disposable income from which they can save. However, low-income families would benefit from IRA expansion regardless of whether they participate in IRA saving. Any policy that boosts the level of saving will generate significant benefits for low-income families. A higher saving rate provides more resources for investment. A higher level of investment stimulates productivity improvements and economic growth. As mentioned earlier, a larger, more productive economy generates new jobs, higher wages and better living standards. Expanding IRA benefits would, therefore, benefit everyone in the economy, even if they do not participate in IRA saving.

IV. BENEFITS FOR THE ECONOMY

IRA expansion would benefit the economy by enhancing the incentive to save and, in turn, the incentive to invest. Investment is important to the economy because it increases the domestic stock of capital, thereby promoting productivity improvements that lead to higher wages and better living standards.

Investors have two sources of funds available to them: national saving (the sum of private and government saving) and foreign investment. If national saving falls short of investment demand, then investors must compete for scarce resources, thereby driving up the interest rate. Higher interest rates, in turn, attract foreign capital. The inflow of foreign capital allows investment to increase even if national saving is low. However, relying on foreign capital has several drawbacks. First, the profits from the investment flow overseas so that less benefit accrues to the U.S. economy. Second, the foreign borrowing has to be repaid with interest so that future generations inherit a less wealthy, more burdened economy. Third, high interest rates increase the cost of capital, thus preventing investment from increasing as much as it otherwise would. A high national saving rate is, therefore, desirable because it reduces investors' reliance on foreign capital and places downward pressure on long-term interest rates.

Would IRA Expansion Increase National Saving?

Personal Saving

There are some analysts who contend that IRA expansion would not increase personal saving. These analysts argue that expanding IRA benefits would merely encourage taxpayers to shift their existing savings into IRA investments, so that net saving would be unaffected. Although this argument may have theoretical appeal, the weight of the

evidence suggests that asset-switching does not occur to any great extent in reality.

Some of the most compelling evidence against this argument has been provided by James Poterba of MIT, Steven Venti of Dartmouth College and David Wise of Harvard University. Poterba, Venti and Wise have analyzed saving data for taxpayers who contributed to IRAs after participation rules were expanded in 1981. The data show that the increase in IRA saving far outweighed the decrease in the holdings of non-IRA assets. The data also show a low level of substitution between IRAs and other retirement plans, such as 401(k) plans. The authors conclude that the increase in IRA saving that occurred in the 1980s largely represented new saving.[44] Several other studies concur with this conclusion.

It is reasonable to believe that some degree of asset switching takes place, especially in the first two or three years in which taxpayers establish new IRAs. However, most taxpayers save very little and have not accumulated enough assets to shift into IRA investments for more than a few years.[45] As mentioned earlier, the median value of assets held by taxpayers in 1992 was only $13,000. This amount could fund IRA contributions for a married couple for only three years (and even less if IRA contribution limits are raised). Thus, asset switching is thought to be negligible beyond the transition period.

Overall, the evidence strongly suggests that expanding IRA benefits would generate new saving. However, the contribution limit needs to be raised above $2,000 in order for IRAs to have a significant impact on new saving. The studies discussed above analyze IRA contributions made in the 1980s when the maximum tax rate on income was higher than it is now. Because tax rates are lower than they were prior to 1987, the tax benefit from IRAs is smaller now than it was in the 1980s. Thus, IRA expansion in the current tax environment may not generate the same incentives as it did in 1981 unless the contribution limit is raised to enhance the tax benefits.

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[44] James Poterba, Steven Venti and David Wise, "Personal Retirement Saving Programs and Asset Accumulation: Reconciling the Evidence," *National Bureau of Economic Research*, May 1996.

[45] Martin Feldstein, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving," *National Bureau of Economic Research*, March 1992.

Government Saving

A rise in personal saving would not necessarily raise the national saving rate. Some critics admit that expanding IRAs would raise personal saving rates, but argue that IRA expansion would generate large revenue losses that would adversely affect the federal deficit (i.e., government dis-saving). Government dis-saving may offset the increase in personal saving so that national saving is unchanged.

However, the loss in government revenue is not as large as many forecasters portray. IRA savings are merely tax deferred, not tax exempt. Consequently, government revenue falls in the short run when contributions are made, but increases in the long run when distributions are withdrawn. For instance, in Table 1 above, tax deductible contributions of $40,000 are made over 20 years. These contributions generate earnings of $86,005 that are not taxed while they accrue. Overall, government revenue falls by $35,281 (126,005 x 0.28) over the 20 years that contributions are being made. However, when the funds are withdrawn after 20 years, the individual pays income taxes equal to $35,281 on the entire distribution so that the government recovers the lost revenue when the distribution is made. Some individuals may end up in lower tax brackets when distributions are made, but others will end up in higher tax brackets so that, on average, the revenue effect of expanding IRAs should be roughly neutral in the long run. Many forecasters only estimate the effect on revenue for a five-year period. Such short-term estimates are important because of their impact on current operating expenses, but they are misleading because they do not capture the large revenue gains that occur in the long term when IRA funds are withdrawn.

The real loss in revenue occurs because income saved in IRAs is taxed only once instead of twice.[46] However, this decline in revenue is offset by at least two factors. First, as shown in Tables 1 and 2, investment earnings in an IRA are not taxed while they accrue. As a result, the savings appreciate at a faster rate relative to savings in a non-deferred account with the same interest rate. When the higher level of income is withdrawn and taxed, the government collects more revenue than it otherwise would. For instance, in Table 2, the IRA generates earnings of $86,005 whereas the regular saving account

[46]Some analysts argue that IRA expansion does not reduce government revenue at all because the increase in saving is new. In other words, the income would have been consumed instead of saved without the enhanced IRA incentives. Since consumption is taxed only once, there is no loss in revenue.

generates earnings of only $61,924. Thus, the earned income in the IRA generates a higher tax liability than the earned income in the non-IRA account. As a result, IRA expansion can potentially generate revenue gains in the long run.

Second, economist Martin Feldstein notes that it is inappropriate to concentrate on the loss in personal tax revenue while ignoring the gain in corporate tax revenue.[47] An increase in private saving increases the capital stock, and the return on this additional capital increases corporate tax payments. The increase in corporate tax payments should be sufficient to offset the loss of personal income tax revenue. Dr. Feldstein concludes that:

Recognizing the important effect of IRA plans on corporate tax revenue changes previous conclusions about the revenue effects of IRA plans in fundamental ways. The revenue loss associated with IRAs is either much smaller than has generally been estimated or is actually a revenue gain, depending on time horizon and key parameter values.[48]

Overall, it is reasonable to expect that IRA expansion will not result in large revenue losses and may even generate small revenue gains in the long run. As a result, it is likely that IRA expansion will increase the national saving rate, thereby generating long-run economic gains that raise wages and living standards.

V. CONCLUSION

Saving is essential to a taxpayer's financial security and to the potential for economic growth. However, the existing tax code discourages saving by taxing the income used for saving at two or three different levels. Several proposals have been introduced to reduce or eliminate this bias in order to encourage more saving. One proposal that would enhance saving incentives is the expansion of IRAs.

Recent changes in the tax laws have made important progress in expanding IRAs. The income limits at which deductible contributions begin to phase out will gradually double; spouses without employer pension plans will be allowed to deduct their contributions even if their spouses are covered by employer plans; and penalty-free withdrawals will be allowed for first-time homebuyer and higher education expenses. These changes will make IRA benefits available to more middle-income taxpayers and encourage IRA participation. However, the current contribution limit of $2,000 is too low and does not provide

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[47] *Op. Cit.*, "The Effects of Tax-Based Saving Incentives on Government Revenue and National Saving."

[48] *Ibid.*

taxpayers with sufficient opportunities to significantly increase their savings.

Raising the maximum contribution limit above $2,000 would enhance the tax benefits of IRAs, thereby encouraging more taxpayers to save. Taxpayers that contribute to their IRAs could amass a significant amount of savings from which they could finance important expenses and unforeseen needs. Moreover, an increase in personal saving would promote economic growth and productivity improvements. Low-income taxpayers who do not participate in IRA saving would benefit from productivity-driven increases in wages and living standards.

Shahira ElbogdadyKnight
Economist

APPENDIX

CHANGES IN IRA PROVISIONS

	Existing Rules	New Rules
Maximum contribution allowable	$2,000	$2,000
Income limit for fully tax deductible contributions		
Joint tax filers	$40,000	$80,000[1]
Single tax filers	$25,000	$50,000[2]
Phase out for tax deductible contributions		
Joint tax filers	$40,000 - $50,000	$80,000 - $100,000[1]
Single tax filers	$25,000 - $35,000	$50,000 - $60,000[2]
Penalty-free withdrawals[3]	Death or disability Health insurance if Unemployed Lifetime annuity Catastrophic medical Expenses	Death or disability Health insurance if Unemployed Lifetime annuity Catastrophic medical Expenses Qualified college expenses "First-time" homebuyer expenses ($10,000 lifetime cap)
Rules applying to uncovered spouses[3]	An individual who *is not* an active participant of an employer sponsored plan cannot make a deductible IRA contribution if his or her spouse *is* an active participant of an employer plan unless their joint AGI is $40,000 or less (partial deduction allowed for AGI between $40,000 and $50,000).	An individual who *is not* an active participant of an employer sponsored plan will be allowed to make a deductible IRA contribution even if his or her spouse *is* an active participant of an employer plan as long as their joint AGI is less than $150,000 (partial deduction allowed for AGI between $150,000 and $160,000).

[1] Phase in as follows: $50,000-$60,000 in 1998: $51,000-$61,000 in 1999; $52,000-$62,000 in 2000; $53,000-$63,000 in 2001; $54,000-$64,000 in 2002; $60,000-$70,000 in 2003; $65,000-$75,000 in 2004; $70,000-$80,000 in 2005; $75,000-$85,000 in 2006; and $80,000-$100,000 in 2007 and after.

[2] Phase in as follows: $30,000-$40,000 in 1998; $31,000-$41,000 in 1999; $32,000-$42,000 in 2000; $33,000-$43,000 in 2001; $34,000-$44,000 in 2002; $40,000-$50,000 in 2003; $45,000-$55,000 in 2004; $50,000-$60,000 in 2005 and after.

[3] Changes effective in 1998

CHANGES IN IRA PROVISIONS

In addition to the changes made to traditional IRAs, two new types of IRAs have been created: Roth IRAs and Education IRAs.

Roth IRA

Beginning in 1998, taxpayers will be allowed to make an after-tax contribution of up to $2,000 per year to a Roth IRA. Contributions are *not* tax deductible, but income earned in the account accrues tax free. The key benefit of the Roth IRA is that qualified distributions are tax free. In other words, the income earned in the account is never taxed. Qualified distributions include withdrawals made: (1) after the age of 59 ½; (2) in the case of death or disability and (3) for the purpose of paying first-time homebuyer expenses. Qualified distributions must be made five years after the first contribution is made to the account. All other distributions are subject to a 10 percent early withdrawal penalty, and the earned income is subject to income tax. Penalty-free withdrawals are allowed for qualified college expenses, catastrophic medical expenses, or to purchase health insurance if unemployed. Although the 10 percent penalty is waived for these distributions, income tax still applies to the earnings. Individuals can continue contributing to a Roth IRA after reaching reach the age of 70 ½, and there are no required minimum distributions at this age. Contributions to Roth IRAs begin to phase down for single tax filers with AGI between $95,000 and $110,000 and for joint tax filers with AGI between $150,000 and $160,000. It is important to note that the total contribution between a Roth IRA and a regular IRA cannot exceed $2,000 annually. Any contribution made to either account in excess of $2,000 is subject to a 6 percent penalty.

Education IRA

Beginning in 1998, taxpayers will be allowed to make an after-tax contribution of up to $500 per year to an Education IRA for each qualifying child. This contribution can be made in addition to the $2,000 contribution to a Roth IRA or a regular IRA. Contributions are *not* tax deductible, but income earned in the account is tax free for qualified higher education expenses. All other distributions are subject to a 10 percent penalty, and earned income is subject to taxation. The contribution income limits are identical to those of the Roth IRA. Before the account's beneficiary reaches the age of 30, any funds remaining in the account must be rolled over into another Education IRA for a qualifying child, or they must be liquidated. The liquidated funds are subject to the 10 percent penalty and to income tax (to the extent of earned income).

REDUCING MARRIAGE TAXES: ISSUES AND PROPOSALS

A JOINT ECONOMIC COMMITTEE REPORT

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Chairman

Joint Economic Committee
United States Congress

May 1998

Abstract

Marital status may affect a couple's federal income tax liability. Couples who pay more taxes when they are married than they would pay if they were single are said to incur "marriage penalties." Couples who pay less taxes as a consequence of marriage are said to receive "marriage bonuses." This paper discusses the sources of marriage taxes and their economic effects. It then examines some of the proposals that have been offered to reduce marriage penalties.

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REDUCING MARRIAGE TAXES: ISSUES AND PROPOSALS

EXECUTIVE SUMMARY

Marriage penalties and bonuses occur because several provisions in the tax code treat joint tax filers differently than two single filers with the same total income. Marriage taxes most commonly arise because of variations in the size of the standard deduction and the widths of the tax brackets across different filing statuses. At low levels of income, the earned income tax credit (EITC) is the main source of marriage taxes.

Whether a particular couple receives a marriage penalty or bonus (or neither) depends primarily on their division of income. Marriage penalties are more likely to occur if a couple's income is evenly divided between husband and wife. In contrast, marriage bonuses are more likely to occur if a couple's income is largely attributable to one spouse. For a given level of income, the largest penalties are generally paid by two-earner couples with a 50-50 income split, and the largest bonuses are received by one-earner couples (100-0 income split).

Economic Effects

Joint tax filing stacks the income of the secondary earner (the lesser earning spouse) on top of the primary earner's income. As a result the secondary earner's income is often taxed at a higher marginal tax rate relative to a system of individual filing. Joint tax filing can, therefore, reduce the after-tax income of secondary earners. The reduction in after-tax income may discourage secondary earners from entering the labor force or from working as many hours as they would otherwise choose. This bias disproportionately burdens married women because they are typically the secondary earners of their households.

The distortion in labor supply created by joint filing imposes economic costs on many households (in terms of foregone income) and on the economy (in terms of lost economic output). The estimated economic cost of taxing secondary earners at relatively higher marginal tax rates outweighs the associated increase in revenue.

During the past 25 years, there has been a growing trend toward more two-earner couples with greater income equality between spouses. This trend has increased the incidence and average size of

marriage penalties. As a result, several proposals aimed at reducing marriage penalties have been introduced. All of the proposals would maintain marriage bonuses and none would eliminate all penalties for all couples.

- *Optional filing (H.R. 2456)* would allow couples the option of filing jointly, as they do now, or filing as two singles on the same tax return. Thus, couples could choose the filing status that provides them with the lower tax liability. Optional filing would eliminate the penalties arising from the standard deduction and the widths of the tax brackets.
- *Income splitting (H.R. 3104 and H.R. 3734)* would effectively increase the standard deduction and the widths of the tax brackets for joint filers to twice the amounts applicable to single filers. The proposal would, therefore, eliminate the penalties arising from the standard deduction and the widths of the tax brackets. The proposal is similar to optional filing except it makes no distinction regarding the division of income between spouses. This benefit would provide married couples with the most favorable tax treatment by treating them like two singles with a 50-50 income split.
- The *second-earner deduction (H.R. 2593)* would allow couples with two-wage earners to deduct 10 percent of the income of the lower earning spouse up to a maximum deduction of $3,000

REDUCING MARRIAGE TAXES: ISSUES AND PROPOSALS

Marital status may affect a couple's federal income tax liability. Couples who pay more taxes when they are married than they would pay if they were single are said to incur "marriage penalties." Couples who pay less taxes as a consequence of marriage are said to receive "marriage bonuses." This paper discusses the sources of marriage taxes and their economic effects. It then examines some of the proposals that have been offered to reduce marriage penalties.

SOURCES OF MARRIAGE TAXES

The federal income tax code treats married couples as a single economic unit by taxing their combined incomes on a joint return.[49] Marriage penalties and bonuses occur because many provisions in the tax code treat joint filers differently than two single filers with the same total income. The tax code contains 66 provisions that can affect a married couple's tax liability.[50]

Tax Rate Schedules

The two most common sources of marriage taxes are the standard deduction and the widths of the tax brackets. Figure 1 shows that the combined standard deduction for two individuals filing single returns is $8,500, but the standard deduction for a married couple filing a joint return is only $7,100. Thus, joint filing increases a couple's taxable income by $1,400. Two single parents filing as heads of households would increase their taxable income by $5,400 if they were to marry. (This provision does not affect couples who itemize.)

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[49] Spouses are allowed to file separately, but doing so usually results in a combined tax liability that is at least as great as their tax liability under joint filing.

[50] American Institute of Certified Public Accountants, "Marriage Penalty/ Divorce/Domestic Relations Tax Issues," February 13, 1998.

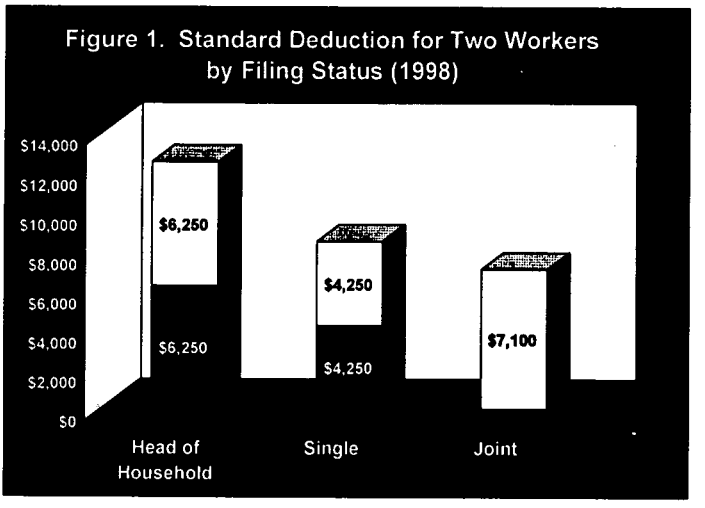

Table 1 below shows that the tax brackets for joint filers are not twice as wide as those for single filers or heads of households. As a result, more of a couple's combined income may be taxed at a higher marginal tax rate under joint filing, and in some cases, a couple's combined income may push them into a higher tax bracket.

These features of the tax code can create marriage penalties or bonuses for a particular couple depending on the division of income between spouses. Examples are provided in Appendix 1.

Table 1. Federal Income Tax Brackets, 1998

Taxable Income			
Joint	**Single**	**Head of Family**	**Marginal Tax Rate**
$0 – 42,350	$0 – 25,350	$0 – 33,950	15%
$42,350 – 102,300	$25,350 – 61,400	$33,950 – 87,700	28%
$102,300 –155,950	$61,400– 128,100	$87,700 – 142,000	31%
$155,950– 278,450	$128,100– 278,450	$142,000 – 278,450	36%
$278,450 +	$278,450 +	$278,450 +	39.6%

The Earned Income Tax Credit (EITC)

At low levels of income, marriage taxes primarily arise because of the standard deduction and the EITC, a tax credit for low-income workers. Table 2 shows that three different EITC schedules exist for households with no children, households with one child, and households with two or more children. For each schedule, the size of the credit increases over a phase-in range of income up to a maximum amount; the maximum credit is awarded over a specified range of income; the size of the credit then decreases over a phase-out range of income until it reaches zero.

Table 2. EITC Schedules, 1998

	Maximum Credit	Income Phase-In Range	Maximum Credit Range	Income Phase-Out Range
No children	$341	$0 - 4,460	$4,460 - 5,570	$5,570 - 10,028
One child	$2,271	$0 - 6,680	$6,680 - 12,260	$12,260 - 26,470
Two or more children	$3,756	$0 - 9,390	$9,390 - 12,260	$12,260 - 30,095

The EITC can affect a couple's tax liability for at least two reasons. First, the size of the credit does not depend on a family's filing status. In other words, eligibility for the credit is the same for singles, heads of households, and married couples. Thus, combining two incomes on a joint return may push a couple into the phase-out range of the EITC and reduce the size of their credit. Second, the size of the credit does not increase for households with more than two children. Combining more than two children into one family may, therefore, result in a smaller tax credit. The size of the credit may also be reduced if two unmarried individuals each bring one child to a marriage. In this case, each child brings rise to a smaller credit because the maximum credit available to households with two children

is less than twice the maximum credit available to households with one child.[51]

These features of the EITC can create large marriage penalties or bonuses for low-income couples. An example of how the EITC creates marriage penalties is provided in Appendix 1.

Means-Tested Tax Provisions

Marriage taxes can also arise because of many provisions in the tax code that provide credits, deductions, and exemptions on the basis of income. In many cases, the income limit at which a tax break phases out for joint filers is not twice as high as the income limit applicable to single filers. In such cases, a couple's combined income may disqualify them from claiming a tax break that they are eligible for as singles.

For example, the child tax credit allows taxpayers to claim a $400 tax credit in 1998 for each of their dependent children. The full credit is available to single tax filers with adjusted gross incomes (AGI) less than $75,000 and to joint tax filers with AGI less than $110,000. Consider two workers, each with one child and each earning $65,000. If both workers were single, each could claim the maximum credit. However, if the workers were married to each other, they would be ineligible for the credit because their combined income of $130,000 would exceed the income threshold for joint filers. The phase out of the credit would, therefore, create an $800 marriage penalty for the couple.

Phase-out provisions can also create marriage bonuses in some cases. For instance, a worker earning $80,000 would not qualify for the maximum child tax credit when single, but would qualify for it when married to a spouse who earns less than $30,000.

Other means-tested provisions that may affect a couple's joint tax liability include the reduction of personal exemptions and itemized deductions at high levels of income, the taxation of Social Security benefits above certain levels of income, and the phase out of deductible contributions to Individual Retirement Accounts.

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[51] Joint Committee on Taxation, *Impact on Individuals and Families of Replacing the Federal Income Tax,* Joint Committee Print JCS-8-97 (Washington, DC: Government Printing Office) 1997, pp. 37-38.

Division of Income

Whether a particular couple receives a marriage penalty or bonus (or neither) depends primarily on their division of income.[52] Marriage penalties can only occur if both spouses have earned incomes. Couples with one earner almost never pay penalties and usually receive bonuses. In general, marriage penalties are more likely to occur if a couple's income is evenly divided between husband and wife, and marriage bonuses are more likely to occur if a couple's earnings are largely attributable to one spouse. For a given level of income, the largest penalties are usually paid by two-earner couples with a 50-50 income split, and the largest bonuses are usually received by one-earner couples (100-0 income split).

It is very difficult to quantify the average size of marriage taxes or the number of couples affected by them because many assumptions must be made about each couple's financial characteristics. A recent study by the General Accounting Office (GAO) found that the current data was insufficient to make such an assessment.[53]

The Second-Earner Bias

Joint tax filing creates a "second-earner bias" in the federal income tax code. The bias occurs because the income of the secondary earner is stacked on top of the primary earner's income. As a result, the secondary earner's income may be taxed at a relatively higher marginal tax rate.

To elaborate, consider a married couple in which the husband works outside the home earning $40,000 per year, and the wife is a homemaker who earns no taxable income. If the couple claims the standard deduction and two personal exemptions, their taxable income would be $27,500, and they would fall in the 15 percent tax bracket. Their tax liability would reflect a marriage bonus of $1,834. If the wife decides to enter the labor force earning $25,000 per year, her income would be added to her husband's income to yield a combined taxable income of $52,500. The wife's additional income would push the couple into the 28 percent tax bracket and create a marriage penalty of $529.

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[52] Other factors such as level of income, number of children, and allowable deductions are also important.

[53] United States General Accounting Office, *Income Tax Treatment of Married and Single Individuals*, Report No. GAO/GGD-96-175, (Washington, DC: Government Printing Office) September 1996.

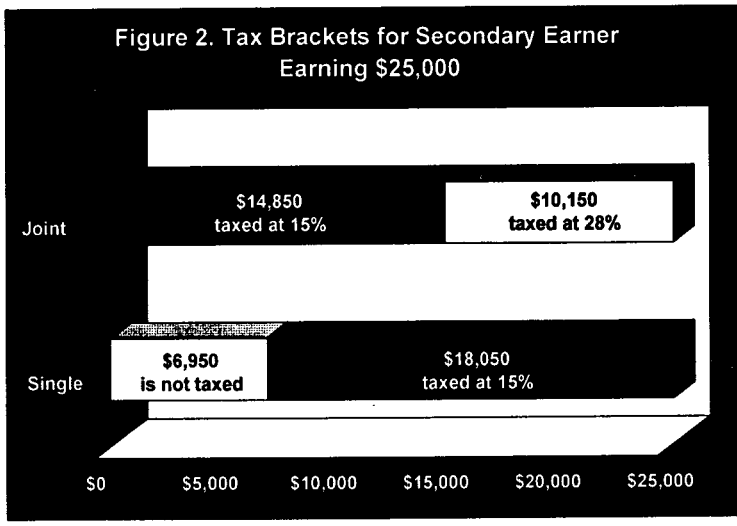

Figure 2 shows that if the wife were allowed to file a single tax return, the first $6,950 of her income would not be taxed, and the remaining $18,050 would be taxed at 15 percent. However, under joint filing, the first $14,850 of her income is taxed at 15 percent, and the remaining $10,150 is taxed at 28 percent. Thus, joint filing reduces the wife's after-tax income by $2,362 relative to single filing.

Joint tax filing essentially treats the incomes of the primary and secondary earners differently. In this example, the primary earner enters the work force at a zero percent tax rate, and the last dollar of income he earns is taxed at 15 percent. The secondary earner enters the labor force at a 15 percent tax rate, and the last dollar of income she earns is taxed at 28 percent. Even if the wife's income did not push the couple into a higher tax bracket, she still would be affected by the second-earner bias because she still could not take advantage of a zero tax bracket. Thus, more of her income would be taxed at a higher rate.

The second-earner bias is a consequence of joint tax filing and, therefore, affects all couples regardless of whether they incur marriage penalties or bonuses. However, the effect of the bias is more severe if the secondary earner's income creates a marriage penalty.

Effect on Labor Supply

Married women are typically the secondary earners of their households for at least two reasons. First, wives, on average, earn less than their husbands. Thus, their incomes are usually less essential to their families' economic well being. Second, married women tend to

move in and out of the work force, between full-time and part-time jobs, depending on their families' needs.[54] As a result, they are often less attached to the work force relative to their husbands. A great deal of research indicates that the labor supply of secondary earners is highly sensitive to marginal tax rates. Because married women are usually secondary earners, joint tax filing may distort their labor supply decisions.

Several studies have confirmed that married women are more responsive to high marginal tax rates relative to other demographic groups.[55] One study by Barry Bosworth and Gary Burtless of the Brookings Institution estimates that female labor supply increased by an average of 61 hours per year between 1981 and 1989 in response to the marginal tax rate reductions of the 1980s.[56] This gain represents a 5.4 percent increase above previous trends. The largest gains occurred among married women in high-income families.[57]

Another study by Nada Eissa of the University of California in Berkeley concludes that the labor supply of high-income married women "increased dramatically" in response to the marginal tax rate reductions of the Tax Reform Act (TRA) of 1986.[58] Eissa estimates that a 10 percent increase in the after-tax wage increased the labor supply of high-income married women by approximately 8 percent. At least half of the increase is believed to represent labor force participation.

The research suggests that once married women enter the labor force, they are less likely to exit in response to work disincentives. In

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[54] Howard V. Hayghe and Suzanne M. Bianchi, "Married Mothers' Work Patterns: the Job-Family Compromise," *Monthly Labor Review*, Vol. 117, June 1994, pp. 24-30.

[55] See for example, Michael J. Boskin and Eytan Sheshinski, "Optimal Tax Treatment of the Family: Married Couples," *Journal of Public Economics*, Vol. 20, No. 3, 1983, pp. 281-287.

[56] Barry Bosworth and Gary Burtless, "Effects of Tax Reform on Labor Supply, Investment, and Saving," *Journal of Economic Perspectives*, Vol. 6, No. 1, Winter 1992, pp. 3-25.

[57] High-income families experienced the largest reductions in marginal tax rates during the 1980s.

[58] Nada Eissa, "Taxation and the Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment," National Bureau of Economic Research Working Paper No. 5023, February 1995.

other words, high marginal tax rates may not induce women to leave the work force to the same extent that low marginal tax rates encourage them to enter. For married women already in the labor force, high marginal tax rates may have a larger impact on decisions regarding how many hours to work and the form in which compensation is taken (e.g., cash wages or non-taxable fringe benefits).

The distortions in labor supply created by the second-earner bias may impose considerable costs on the economy in terms of lost economic output and reduced efficiency. Estimates indicate that the economic cost of taxing wives at relatively higher marginal tax rates outweighs the associated increase in revenue.[59] An optimal tax system should, therefore, tax the secondary earner at a relatively lower marginal tax rate in order to maximize economic efficiency.[60]

HISTORY OF MARRIAGE TAXES[61]

When the individual income tax was established in 1913, all individuals filed their taxes separately under an individual tax schedule. As a result, the tax code was marriage neutral—individuals paid the same income tax whether they were single or married. Because the tax code was also progressive, one-earner couples often paid higher taxes than two-earner couples with identical incomes. For instance, a couple with one wage earner making $100,000 per year was taxed at a higher rate than a couple with two wage earners making $50,000 each.

Couples with the same incomes could also pay different taxes depending on their state of residence. States with community property laws allowed couples to split their incomes evenly between two tax returns regardless of who actually earned the income. The benefit of income splitting lowered the tax liabilities of married couples in community property states. In contrast, couples residing in common law states were not allowed to split their incomes for tax purposes and often paid higher taxes.

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[59] Martin Feldstein and Daniel Feenberg, "The Taxation of Two-Earner Families," National Bureau of Economic Research Working Paper No. 5155, June 1995.

[60] *Op. Cit.*, Bosworth and Sheshinski

[61] Historical discussion draws from Gregg A. Esenwein, "The Federal Income Tax and Marriage Neutrality," Congressional Research Service, January 31, 1997; and Edward McCaffery, *Taxing Women*, (Chicago: University of Chicago Press) 1997.

As the size and scope of federal income taxation grew during World War II, Congress set out to equalize the treatment of similarly situated married couples. In 1948, Congress established joint filing, thus extending the benefit of income splitting to all married couples regardless of their state of residence. The 1948 law effectively created marriage bonuses for the majority of couples.

The 1948 law was perceived by many as a singles penalty because single workers paid substantially higher taxes than one-earner couples with the same incomes. In 1969, Congress responded to the concerns of single workers by narrowing the tax brackets for joint filers, thus reducing the discrepancy in tax liabilities between singles and their married counterparts. The narrowing of the tax brackets created the marriage penalty that exists in today's laws. The creation of the EITC in 1975 increased marriage penalties for some low-income couples who reduced their EITC eligibility by marrying.

As more women entered the work force during the 1970s, more couples were subject to the marriage penalty and opposition to the 1969 tax changes grew. Congress responded by including a provision in the Economic Recovery Tax Act (ERTA) of 1981 that granted two-earner couples a tax deduction of up to $3,000. The deduction reduced the size of the marriage penalty for most couples incurring a penalty and entirely eliminated it for some. The deduction also increased the marriage bonuses received by many two-earner couples.

Five years later, the second-earner deduction was repealed in TRA 1986 and replaced with broad-based tax reform. The standard deduction for married couples was increased, and the 14 bracket tax schedule was reduced to only two tax brackets. In addition, the maximum marginal tax rate on income was lowered from 50 percent to 28 percent. TRA 1986 sharply reduced or eliminated the marriage penalty for the majority of two-earner couples. The law also reduced the severity of the second-earner bias because the flatter tax code allowed fewer opportunities to be pushed into a higher tax bracket.

The Omnibus Budget Reconciliation Act (OBRA) of 1990 created a third marginal income tax rate of 31 percent, thus slightly increasing the size of marriage taxes for high-income couples. Two years later, OBRA 1993 added two more tax brackets of 36 and 39.6 percent to the tax schedule. OBRA 1993 also expanded the size and coverage of the EITC. Together, these changes significantly increased marriage taxes for couples at the low and high ends of the income scale.

In 1995, Congress once again tried to grant tax relief to two-income families. The U.S. Senate considered a proposal to increase the standard deduction for joint filers to twice that of single filers; and the U.S. House of Representatives passed a bill that would have provided a tax credit to any couple who paid a marriage penalty. The Senate proposal was included in the Balanced Budget Act of 1995, but the entire bill was vetoed by President Clinton.

Trends among Married Couples

The federal income tax code was largely structured when one-earner couples represented the traditional family, and earnings equality between husbands and wives was rare. Thus, the large majority of married couples benefited from marriage bonuses, and relatively few were affected by the creation of marriage penalties in1969. However, changes in social attitudes, demographic patterns, and labor markets have contributed to a growth in marriage penalties.

For instance, the labor force participation rate of married women increased by 49 percent between 1970 and 1996, from 41 to 61 percent.[62] This increase led to a rise in the proportion of two-earner couples. Between 1970 and 1996, the proportion of married couple families with both spouses in the work force increased by nearly one-third, from 46 to 60 percent, and the proportion with only one spouse in the work force fell by almost 40 percent, from 36 to 22 percent.[63]

Moreover, married women's median income increased by 42 percent between 1974 and 1996, after adjusting for inflation. However, the median income of married men fell by approximately 4 percent over the same time period.[64] The relative increase in married women's incomes has led to greater earnings equality between husbands and wives. The proportion of working-aged married couples in which each spouse earned at least one-third of the couple's income doubled between 1969 and 1995, from 17 to 34 percent.[65]

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[62] U.S. Bureau of the Census, Internet, *Statistical Abstract of the United States 1997*, Table No. 631.

[63] U.S. Bureau of Labor Statistics, unpublished data.

[64] U.S. Bureau of the Census, Internet, *Current Population Survey (CPS): 1947-1996*, Table P-7.

[65] Congressional Budget Office (CBO), "For Better or for Worse: Marriage and the Federal Income Tax," (Washington, DC: Government Printing Office) June 1997, p. 38.

The trend toward more two-earner couples with greater income equality means that more married couples are potentially subject to larger penalties. As a result, several proposals to reduce or eliminate the burden on two-earner couples have been introduced.

REDUCING MARRIAGE PENALTIES

Changes in the tax laws relating to married couples have tried to balance three different principles of tax equity:

- the principle of *horizontal equity* requires couples with the same ability to pay taxes to incur the same tax liabilities;
- the principle of *marriage neutrality* requires a couple's tax liability to be the same whether they are married or single; and
- the principle of *progressivity* requires tax liability to increase as a percentage of income as income rises.

A tax system can achieve any two of these principles simultaneously, but it cannot achieve all three. The existing tax code achieves the principles of horizontal equity and progressivity, but it is not marriage neutral.

The inconsistency among the three goals of tax equity poses a difficult problem for policy makers seeking to reduce or eliminate the marriage penalty. Any proposal to alleviate the burden will necessarily entail trade-offs between different groups of taxpayers and different goals of tax policy. As a result, subjective decisions must be made regarding the proper unit of taxation, the appropriate measure of a family's ability to pay, the equitable treatment of married versus single taxpayers, and the extent to which the tax code should promote social policy goals at the expense of economic efficiency.

The Proposals

Several proposals to reduce the marriage penalty have been introduced by Members of Congress. All of the proposals would maintain marriage bonuses and none would eliminate all marriage penalties for all couples. (Marriage neutrality can only be achieved by reverting to a system of individual filing or though fundamental tax reform.) Although, the effect of any proposal depends on how revenue losses would be offset, some observations can be made about the different proposals. A summary of the proposals is provided in Table 3 at the end of this section.

Optional Filing Status

The Marriage Tax Elimination Act (H.R. 2456), introduced by Congressmen Jerry Weller (R-IL) and David McIntosh (R-IN), would

allow couples the option of filing jointly, as they do now, or filing as two singles on the same tax return.[66] Thus, couples could choose the filing status that provides them with the lower tax liability. The Joint Committee on Taxation (JCT) estimates that optional filing would reduce federal government revenue by $101 billion over five years. The legislation has been cosponsored by 236 Members in the House.

Optional filing would eliminate most marriage penalties and maintain marriage bonuses. Thus, the tax code would be marriage neutral for couples who choose to file as singles, and it would favor marriage for most other couples.

The proposal would eliminate penalties arising from the standard deduction and the widths of the tax brackets. A reduced penalty could exist for couples with children. If single, these couples could take advantage of the relatively wider tax brackets and higher standard deduction under the head of family filing status. The head of family tax schedule would not be available to married couples under the optional filing proposal.

In addition, a reduced penalty could exist for EITC-eligible couples because eligibility for the EITC would be based on joint income regardless of which tax schedule a couple chooses to use. If EITC eligibility were based on individual income, then low-income spouses would qualify for the EITC even if they were married to wealthy spouses. This would result in a redistribution of income from low- and middle-income households to high-income households. Under optional filing, the marriage penalty for EITC-eligible couples would be reduced by a maximum of $210 (reflecting the reduced penalty in the standard deduction).

Finally, a reduced penalty could exist for middle- and high-income couples because eligibility for various tax breaks would be based on joint income. As a result, the penalties arising from the phase-out provisions of the tax code would remain because a couple's combined income could push them beyond the phase-out threshold of a particular tax break.[67]

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[66] Similar bills have been introduced by John Kasich, R-OH (H.R. 2462); Sheila Jackson-Lee, D-TX (H.R. 3059); and Kay Bailey Hutchison, R-TX (S. 1314).

[67] Optional filing eliminates the penalty arising from the limitation of itemized deductions and personal exemptions.

Optional filing would only lower the tax liabilities of couples who incur marriage penalties under joint filing. The size of a couple's tax cut would equal the size of their marriage penalty (except for the exceptions noted above in which the penalty is not eliminated). Thus, for a given level of income, couples with roughly equal incomes would receive the largest tax cuts because they generally pay the largest penalties. Couples who receive marriage bonuses under current law would not be affected by the proposal—their tax liabilities would remain the same. Examples illustrating the effect of optional filing on various couples are contained in Appendix 2.

Allowing couples to choose their filing status means that couples with equal incomes may not pay the same income tax. Some observers argue that ending horizontal equity would be unfair because couples with the same total income are equally well off and, therefore, should incur the same tax liability. Others believe that income alone is not a good measure of a couple's economic well being.[68] For instance, two couples may not be equally well off if the earners in the first couple work 40 hours a week at a higher wage, and the earners in the second couple earn the same total income by working a greater number of hours at a lower wage. Thus, requiring couples with equal incomes to pay the same income tax may not necessarily satisfy the goal of horizontal equity.

Opponents of optional filing note that the proposal would increase compliance costs relative to current law. Couples would have to calculate their taxes jointly and individually to determine which provides them with the lower tax liability. Furthermore, specific rules would have to be made regarding the division of deductions for couples who choose to file individually.

Income Splitting

Two separate bills would eliminate most marriage penalties by reinstating income splitting. Although the two bills would be implemented differently, both would have the same effect on couples' tax liabilities. The first bill, titled the Marriage Protection and Fairness Act (H.R. 3104), was introduced by Congressmen Bob Riley (R-AL) and Matt Salmon (R-AZ).[69] The bill would allow each spouse to apply the single tax rate schedule to half of the couple's taxable income. The

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[68] *Op. Cit.*, CBO, p. 9.

[69] A similar bill was introduced in the Senate by Lauch Faircloth, R-NC (S. 1285).

standard deduction used to determine taxable income would be increased to twice the standard deduction for single returns. The JCT estimates that the proposal would reduce federal government revenue by $153 billion over five years. The legislation has been cosponsored by 83 Members in the House.

The second bill, titled the Marriage Tax Penalty Elimination Act of 1998 (H.R. 3734), was introduced by Congressmen Jerry Weller, David McIntosh, Bob Riley, and Wally Herger (R-CA).[70] (This bill represents a collaborative effort by the primary sponsors of the three major marriage penalty bills to support a single piece of legislation.) The proposal would increase the standard deduction and the widths of the tax brackets for joint filers to twice the applicable amounts for single filers. Revenue estimates are not yet available, but should be similar to those of H.R. 3104. The legislation has been cosponsored by 45 Members in the House.

Income splitting proposals are similar to optional filing because they adjust for differences in the tax schedules between single and joint filers. However, the proposals differ from optional filing because they make no distinction regarding the division of income between spouses. In other words, couples are treated as if each spouse earns half of their total income regardless of which spouse actually generates that income. Income splitting would, therefore, provide all couples with the most favorable tax treatment by effectively treating them like two singles with a 50-50 income split. This favorable treatment would reduce taxes for nearly all married couples. Couples with equal incomes would receive equal tax cuts, thus maintaining horizontal equity.

Moreover, income splitting would create marriage bonuses for most couples and increase bonuses for couples already receiving them, including one-earner couples. Thus, the proposals reduce marriage neutrality by heavily favoring marriage. Examples illustrating the effect of income splitting on various couples are contained in Appendix 2.

As with optional filing, income splitting would only eliminate penalties arising from the standard deduction and the widths of the tax brackets. A reduced penalty could exist for couples with children (who would otherwise file as heads of households if they were single), couples eligible for the EITC, and couples subject to the various phase-out provisions of the tax code.

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[70] A similar bill was introduced in the Senate by Kay Bailey Hutchison (S. 1999).

Opponents contend that income splitting has two primary disadvantages. First, some analysts argue that the proposals inefficiently uses scarce fiscal resources because a portion of the large revenue loss would finance bigger bonuses for couples who already receive them. Second, the establishment of income splitting in 1948 was perceived as a singles penalty because single taxpayers paid substantially higher income taxes than one-earner couples with the same total incomes. Complaints from single taxpayers led to the creation of the marriage penalty in 1969. A return to income splitting may bring about the same perceived inequities for single taxpayers who would have to bear a substantially larger share of the total tax burden (although their tax liabilities would remain the same).

Second-Earner Deduction

The Marriage Penalty Relief Act (H.R. 2593), introduced by Congressman Wally Herger and Congresswoman Barbara Kennelly (D-CT), would revive the second-earner deduction that was in the law between 1981 and 1986. Under this proposal, couples with two earners could deduct 10 percent of the income of the lesser earning spouse up to a maximum deduction of $3,000. The deduction would be available to couples whether they itemize or claim the standard deduction. The JCT estimates that the second-earner deduction would reduce federal government revenue by $45 billion over five years. The legislation has been cosponsored by 182 Members in the House.

Under the second-earner deduction, most couples incurring marriage penalties under current law would have their penalties reduced; some would have their penalties eliminated or converted into bonuses. Two-earner couples receiving bonuses under current law would receive larger bonuses. Thus, the proposal increases marriage neutrality for some couples and reduces it for others. One-earner couples would not be affected by the proposal and would continue receiving bonuses.

As with the other proposals, the second-earner deduction does not address the structural penalty in the EITC. However, it would reduce penalties for some EITC-eligible couples by reducing the income stacking problem that can potentially push a low-income couple into the 15 percent tax bracket. For instance, two single parents, each with one child and each earning $10,000, would not pay any federal income tax. However, if they married each other, their combined income would push them into the 15 percent tax bracket and generate a $315 federal income tax liability under current law. If they were allowed to

deduct $1,000, their tax liability would fall to $165, thus reducing their marriage penalty by $150. The proposal could reduce marriage penalties for some EITC-eligible couples by a maximum of $450 (reflecting the value of a $3,000 deduction at 15 percent).

A $3,000 deduction would reduce the income tax liability of a two-earner couple by a maximum of $450 to $1,188 depending on their tax bracket. Thus, the dollar value of the deduction would be more valuable at high levels of income, but this may be appropriate because the dollar value of marriage penalties increases substantially with income. The proposal would not affect the tax liabilities of one-earner couples. Examples illustrating the effect of the second-earner deduction on various couples are contained in Appendix 2.

Under a second-earner deduction, two-earner couples would pay less taxes than one-earner couples with the same total incomes. Some observers argue that this would penalize one-earner couples by increasing their share of the total tax burden (although their tax liabilities would remain the same). Others believe that two-earner couples are not as well off as one-earner couples with the same total incomes. For instance, a one-earner couple benefits from the non-earning spouse's work inside the home, the value of which is not taxed. The homemaker's non-taxed services increase the couple's economic well being. In contrast, a couple with two wage earners might have to pay for the services that a stay-at-home spouse provides, thus reducing their economic well being. In this respect, the two-earner couple is worse off and should pay less income tax.

Opponents of the proposal point to two disadvantages. First, the deduction would not eliminate any of the structural penalties in the tax code—it would merely reduce them. Second, part of the revenue loss would finance larger bonuses for couples who already receive them.

Other Proposals

Several other bills aimed at providing broad-based tax relief would also reduce the size of the marriage penalty. Some of these proposals are briefly summarized below.

- H.R. 1584 (Sam Johnson, R-TX) includes a provision that would allow couples affected by marriage penalties to claim a tax credit of up to $145 against their tax liabilities.

- H.R. 2718 (Joe Knollenberg, R-MI) would reduce marriage penalties by increasing the standard deduction for joint filers to twice that of single filers. The bill would also lower marginal tax rates for all taxpayers from 15, 28, 31, 36, and 39.6 percent to 14.25, 26.6, 29.45, 34.2, and 37.62 percent, respectively. Lowering the marginal tax rates would reduce the size of marriage penalties relative to current law by reducing the tax associated with being pushed into a higher tax bracket.
- H.R. 3151 (John Thune, R-SD) and H.R. 3175 (William "Mac" Thornberry, R-TX) would expand the 15 percent tax bracket. This would provide less opportunity for a secondary earner's income to push a couple into the 28 percent tax bracket, thus reducing marriage penalties for millions of middle-income couples. The proposal would also reduce marriage penalties at higher levels of income relative to current law because more income would be taxed at the 15 percent tax rate.

Effect On Labor Supply of Secondary Earners

Eliminating or reducing marriage penalties is likely to increase the labor supply of married women by reducing the second-earner bias. One study estimates that if marriage penalties were eliminated after the 1986 tax reforms (when penalties were less severe than they are today), the labor supply of married women would have increased by an average of 46 hours per year.[71] The effect would have been greater among married women from high-income families and married women who earned substantially less than their husbands.

Reducing marriage taxes will affect two different aspects of the labor supply decision. First, it will affect the decision of a non-working spouse to enter the labor force. Any proposal that reduces a secondary earner's *average* tax rate[72] relative to current law will increase his or her after-tax income. This incentive will encourage a non-working spouse to enter the labor force. Second, reducing marriage taxes will affect the decision of a working spouse to work more hours. Any proposal that reduces a secondary earner's *marginal* tax

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[71] Deenie Kinder Neff, "Married Women's Labor Supply and the Marriage Penalty," *Public Finance Quarterly*, Vol. 18, No. 4, October 1990, pp. 420-32.

[72] The average tax rate is defined as tax liability divided by income.

rate[73] relative to current law will increase the return to extra work. This incentive will encourage a working spouse to work more hours. The various proposals discussed above will either enhance the labor supply incentives of secondary earners or leave them unaffected. Table 6 at the end of this section summarizes the effect of the different proposals on the labor supply of secondary earners.

Optional Filing

Labor Force Participation

If a homemaker's decision to enter the labor force creates a marriage penalty under joint filing, the couple would choose to file as singles under the optional filing proposal. Single filing eliminates the second-earner bias because the income of the secondary earner is taxed separately. Thus, the non-working spouse enters the labor force at a zero tax rate instead of entering at the primary earner's higher marginal tax rate. The elimination of the second-earner bias lowers the secondary earner's average tax rate relative to current law and increases his or her after-tax income. This incentive will always encourage a non-working spouse to enter the labor force *if the couple opts for single filing.*

However, if the non-working spouse is deciding to enter the labor force at an income that is substantially lower than the primary earner's income, then the couple would likely receive a marriage bonus under joint filing. In this case, the couple would not choose to file individually because doing so would increase their combined tax liability. Thus, optional filing would not affect the labor supply decisions of the non-working spouse.

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[73] The marginal tax rate is defined as the tax rate imposed on an additional dollar of income earned.

Table 3. Summary of the Marriage Penalty Proposals

		Effect on:			
		Two-earner couples with penalties	***Two-earner couples with bonuses***	***One-earner couples with bonuses***	***EITC-eligible couples***
Optional Filing	*Marriage tax*	Reduced or eliminated	No effect	No effect	Penalty reduced by maximum of $210
	Tax liability	Reduced	No effect	No effect	Sometimes reduced
Income Splitting	*Marriage tax*	Reduced, eliminated, or converted to bonuses	Bonuses increased	Bonuses increased	Penalty reduced by maximum of $210
	Tax liability	Reduced	Reduced	Reduced	Sometimes reduced
Second-Earner Deduction	*Marriage tax*	Reduced, eliminated, or converted to bonuses	Bonuses increased	No effect	Penalty reduced by maximum of $450
	Tax liability	Reduced	Reduced	No effect	Sometimes reduced

Table. 3 (cont'd.)						
	Relative effect on goals of tax policy:			***Structural penalties eliminated***	***Relative complexity***	***5-Year revenue loss (billions)***
	Marriage neutrality	*Horizontal equity*	*Progressivity*			
Optional Filing	Increased	Decreased	Maintained	Standard deduction and widths of tax brackets	High	$101
Income Splitting	Decreased	Maintained	Maintained	Standard deduction and widths of tax brackets	Low	$153 (H.R. 3104)
Second-Earner Deduction	No net effect	Decreased	Maintained	No structural penalties eliminated, only reduced	Low	$45

Number of Hours Worked

For second-earner spouses already in the work force, optional filing may encourage more work effort in some cases. Individual filing will either lower the marginal tax rate of the secondary earner or leave it unchanged (it will never increase the secondary earner's marginal tax rate). If the marginal tax rate falls, then an additional dollar of income earned will be taxed at a lower rate. This incentive will encourage the lesser earning spouse to work more hours. If the marginal tax rate remains unchanged, optional filing will not generate any additional benefits at the margin and, therefore, will not affect the labor supply decisions of the secondary earner.

Table 4. Effect of Optional Filing on Number of Hours Worked

Income of primary earner			$75,000	$25,000
Income of secondary earner			$60,000	$40,000
	Joint filing	**Single filing**	**Joint filing**	**Single filing**
Penalty/(bonus)	$329	**$0**	$1,477	**$0**
Second earner's marginal tax rate	28%	**15%**	28%	**28%**

Note: (1) Assumes the standard deduction and two personal exemptions. (2) Marginal tax rates do not include payroll, state or local taxes.

Source: Joint Economic Committee calculations.

Table 4 provides two examples to illustrate how optional filing might affect a working spouse's decision to work more hours. In the first example, the primary earner earns $75,000 and the secondary earner earns $25,000. Joint tax filing results in a marriage penalty of $329. Thus, the couple chooses to file as singles. Single filing reduces the secondary earner's marginal tax rate from 28 percent to 15 percent. In other words, out of an additional dollar of income earned, the secondary earner keeps 72 cents under joint filing and 85 cents under single filing. The reduction in the secondary earner's marginal tax rate increases the value of his or her work at the margin and encourages

him or her to work more hours. Hence, optional filing enhances the secondary earner's labor supply incentive relative to current law.[74]

In the second example, the primary earner earns $60,000 and the secondary earners earns $40,000. Once again, the couple can lower their tax liability by filing as singles. However, in this example, using the single tax rate schedule does not lower the secondary earner's marginal tax rate. Thus, there is no additional benefit to working more hours. As a result, optional filing does not enhance the secondary earner's labor supply incentives even though the couple opts for single filing.

Overall, optional filing would affect secondary earners differently depending on each couple's income and division of income. In general, optional filing always encourages a non-working spouse to enter the labor force *if the couple opts for individual filing*. Among working spouses, optional filing encourages a secondary earner to work more hours *if the couple opts for individual filing and if individual filing lowers the secondary earner's marginal tax rate*. The proposal is more likely to increase the number of hours worked by secondary earners in high-income households. It is less likely to increase labor supply among secondary earners in low- and middle-income households unless the couple's combined taxable income is grouped around the marginal tax-rate breakpoints.

According to many analysts, allowing couples to file as singles would be economically more efficient than the current system of joint filing because it would reduce distortions in labor supply that impose economic costs on households (in terms of foregone income) and on the economy (in terms of foregone output).

Income Splitting

Labor Force Participation

Under the income splitting proposals, the higher standard deduction and wider tax brackets allow more of the secondary earner's income to be taxed at a lower rate. This will often (but not always)

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[74] Although the secondary earner's marginal tax rate may fall under single filing, the primary earner's marginal tax rate may increase, thus discouraging work effort by the primary earner. Thus, the net effect on labor supply for the couple is ambiguous in some cases. However, many studies have found that the labor supply of secondary earners is more responsive to marginal tax rates than the labor supply of primary earners. If this is the case, single filing should result in a net increase in total hours worked by the couple.

reduce a secondary earner's average tax rate relative to current law and increase his or her after-tax income. This incentive will encourage many non-working spouses to enter the labor force. Hence, the effect of income splitting is similar to that of optional filing: it will either encourage labor force participation by non-working spouses, or it will have no effect on the incentive to enter the labor force.

Table 5 below provides two examples to illustrate how income splitting might affect a homemaker's decision to enter the labor force. In the first example, the primary earner earns $40,000 per year and the non-working spouse is deciding whether to accept a job at $20,000 per year. Under current law, the secondary earner's new income generates a tax liability of $3,670. Thus, his or her average tax rate is 18 percent. Under income splitting, the secondary earner's income generates a tax liability of only $3,000. Thus, income splitting lowers the average tax rate to 15 percent and increases after-tax income by $670. This incentive encourages the non-working spouse to enter the labor force. Hence, income splitting enhances the incentive to enter the labor force relative to current law.

Table 5. Effect of Income Splitting on Labor Force Participation

Income of primary earner	$40,000	$20,000
Income of secondary earner	$40,000	$10,000

	Current law	Income splitting	Current law	Income splitting
Second earner's	$3,670	$3,000	$1,500	$1,500
Second earner's	18%	15%	15%	15%
Second earner's	$16,330	$17,000	$8,500	$8,500

Note: (1) Assumes the standard deduction and two personal exemptions. (2) Average tax rates do not include payroll, state or local taxes.
Source: Joint Economic Committee calculations

In the second example, the non-working spouse is deciding whether to accept a job at $10,000 per year. In this case, income splitting does not affect the secondary earner's average tax rate. All of the secondary earner's income is taxed at 15 percent under either

provision. Hence, income splitting does not affect the non-working spouse's decision to enter the labor force.[75, 76]

Although income splitting and optional filing have very similar effects on labor force participation, it is difficult to determine which proposal would encourage more working spouses to enter the labor force. Optional filing always encourages entry if a couple chooses to file individually, but not all couples will choose to file individually. Income splitting will encourage entry in many cases, but not all. Thus, it is difficult to determine which proposal would have the greater effect on the labor force participation of secondary earners.

Number of Hours Worked

The wider tax brackets and higher standard deduction under income splitting make it more difficult for a secondary earner's income to push the couple into a higher tax bracket. Thus, the proposals will reduce the secondary earner's marginal tax rate in some cases. This incentive will increase the return to working an additional hour and will encourage secondary earners to increase their labor supply. As with optional filing, income splitting is more likely to reduce marginal tax rates among secondary earners in high-income households. It is less likely to reduce marginal tax rates among secondary earner's in low- and middle-income family's unless the couple's taxable income is grouped around the marginal tax rate breakpoints.

Both of the income splitting proposals would be economically more efficient relative to current law because they would reduce distortions in labor supply created by the second-earner bias. The enhanced work incentives created by income splitting would reduce the

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[75] Income splitting almost always reduces a couple's average tax rate regardless of whether a second earner enters the work force. Thus, the couple receives a tax cut (or an increase in after-tax income) even if labor supply does not increase. As a result, the primary earner can work less and maintain the same standard of living. However, income splitting may also lower the primary earner's marginal tax rate, thus encouraging more work effort. Hence, the net effect on the couple's labor supply is ambiguous when the second earner does not increase his or her labor supply.

[76] Although the effect of the two income-splitting proposals on tax liabilities is the same, each proposal is implemented differently. As a result, they may have slightly different effects on labor supply incentives. For instance, H.R. 3104 can reduce the income stacking problem to a greater extent than H.R. 3734. Hence, H.R. 3104 can reduce secondary earners' average tax rates to a relatively greater extent in some cases and generate stronger work incentives.

economic costs imposed on households and the economy. (H.R. 3104 may be more efficient than H.R. 3734 because it imposes the same marginal tax rate on primary and secondary earners. In contrast, H.R. 3734 can impose a relatively higher marginal tax on secondary earners. As noted earlier, an optimal tax system would impose a lower marginal tax rate on secondary earners because they are relatively more sensitive to labor supply incentives.)

Second-Earner Deduction

The second-earner deduction permits the lesser earning spouse to deduct 10 percent of the first $30,000 of income, thus lowering the couple's taxable income by a maximum of $3,000. The deduction, therefore, reduces the marginal tax rate on the first $30,000 of income earned by the secondary earner. Hence, the proposal is likely to increase labor supply among second-earner spouses who earn less than $30,000 per year.

Table 6. Effect of Proposals on Labor Supply of Secondary Earners

		For couples receiving:		*Effect on second-earner bias*	*Economic efficiency*
		Penalties	***Bonuses***		
Optional Filing	*Participation*	Increases	No effect	Eliminates for couples who file individually	More efficient
	Hours worked	Increases or no effect	No effect		
Income Splitting	*Participation*	Increases or no effect	Increases or no effect	Reduces	More efficient
	Hours worked	Increases or no effect	Increases or no effect		
Second-Earner Deduction	*Participation*	Increases	Increases	Reduces	Slightly more efficient
	Hours worked	Increases for spouses earning less than $30,000	Increases for spouses earning less than $30,000		

For instance, consider a couple in which one spouse earns $30,000 per year, and the other is a homemaker who is deciding whether to enter the labor force at $20,000 per year. Under current law, the $20,000 of income generates a tax liability of $3,000. If a 10 percent deduction is allowed, the secondary earner can deduct $2,000 of income from taxation, thus increasing his/her after-tax income by $300. The increase in after-tax income encourages the homemaker to enter the labor force. Moreover, each additional dollar of income earned will give rise to a 10-cent deduction. Thus, the secondary earner will continue to receive an additional benefit from working more hours until his or her income reaches $30,000. However, a working spouse who earns more than $30,000 does not derive any additional benefit from working more hours and, therefore, is not affected by the deduction.

CONCLUSION

All of the marriage penalty proposals currently under consideration would maintain marriage bonuses, and none would eliminate all marriage penalties for all couples. In particular, penalties would remain for couples with children, low-income couples eligible for the EITC, and middle- and high-income couples subject to the various phase-out provisions of the tax code.

Moreover, the various proposals would affect couples differently depending on their level and division of incomes. In general, optional filing would be most favorable to couples with roughly equal incomes. At each level of income, these couples currently receive the largest marriage penalties and, therefore, would receive the largest tax cuts if they were permitted to file as singles. In contrast, income splitting would provide the greatest benefit to one-earner couples, who would have their marriage bonuses increased.

All of the proposals would be economically more efficient relative to current law because they would reduce the second-earner bias that exists under joint filing. As a result, many non-working spouses would be encouraged to enter the labor force, and many working spouses would be encouraged to work more hours. The increase in labor supply among secondary earners would reduce the economic costs imposed on households (in terms of foregone income) and on the economy (in terms of lost output). The various proposals would affect labor supply differently depending on each couple's income and income split. In general, optional filing and income splitting would enhance work incentives to the greatest extent; the second-earner

deduction would have the smallest effect on labor supply. All of the proposals would likely affect labor force participation to a greater degree than hours worked.

Shahira Elbogdady Knight
Economist

APPENDIX 1

EXAMPLES OF MARRIAGE PENALTIES AND BONUSES

The standard deduction and marginal tax rate breakpoints can create marriage bonuses for married couples with largely unequal incomes. Table A1.1 shows the tax liability of a couple earning $60,000 when all of the income is earned by one individual. If the worker is single, he/she incurs a federal income tax liability of $11,559. However, if the worker marries a spouse with no earned income, their combined tax liability falls to $7,795—a marriage bonus of $3,764.

Table A1. 1 Sources of the Marriage Bonus

	Unmarried			Married
	Worker	Non-Worker	Combined	Joint Filing
AGI	$60,000	$0	$60,000	$60,000
- Standard Deduction	(4,250)	0	(4,250)	(7,100)
- Personal Exemption	(2,700)	0	(2,700)	(5,400)
Taxable Income	53,050	0	53,050	47,500
Marginal Tax Rate	28%	0%		28%
Tax Liability	**$11,559**	**$0**	**$11,559**	**$7,795**
Marriage Penalty/(bonus)				**($3,764)**

Source: Joint Economic Committee calculations

The bonus occurs for two reasons. First, when a worker marries a spouse with no earned income, the couple's personal exemptions double and their standard deduction increases by $2,850 (see Figure A1.1). Thus, the couple reduces their taxable income by $5,550 when filing jointly. Second, under joint tax filing, the wage earner's income is subject to wider tax brackets so that less income is taxed at 28 percent and more income is taxed at 15 percent (see Figure A1.2).

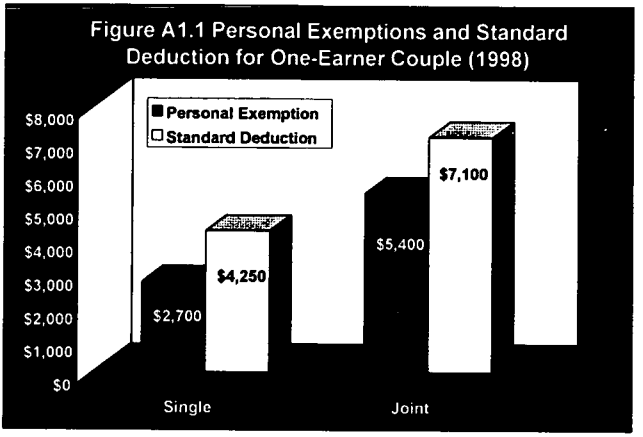
Figure A1.1 Personal Exemptions and Standard Deduction for One-Earner Couple (1998)
Personal Exemption
Standard Deduction
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
$2,700
$4,250
$5,400
$7,100
Single
Joint

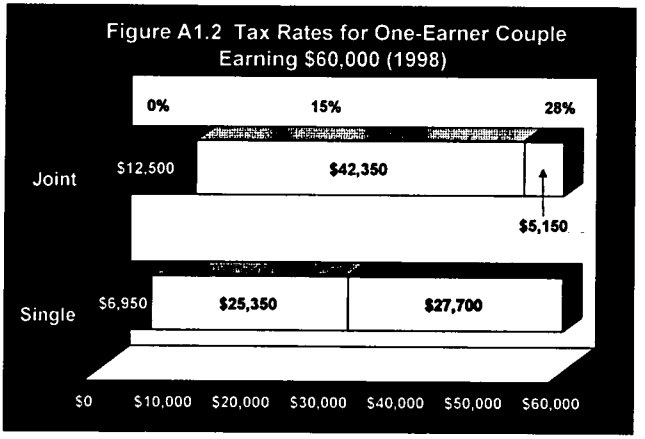
Figure A1.2 Tax Rates for One-Earner Couple Earning $60,000 (1998)
0%
15%
28%
Joint
$12,500
$42,350
$5,150
Single
$6,950
$25,350
$27,700
$0
$10,000
$20,000
$30,000
$40,000
$50,000
$60,000

The same features of the tax code can create a marriage penalty when the income is more evenly divided between husband and wife. Table A1.2 outlines the tax liability of a couple earning $60,000 when the income is divided equally between the two individuals. If the two individuals were single, they would file separate tax returns, and each would incur a federal income tax liability of $3,457.50. Their combined tax liability would be $6,915. However, if the two individuals were married, their total tax liability would be $7,795. Thus, the couple's income tax increases by $880 upon marrying.

The penalty occurs for two reasons. First, when two individuals with earned income marry each other, their personal exemptions remain the same, but their standard deduction is reduced by $1,400 (see Figure A1.3). As a result, their taxable income increases by this amount. Second, because the tax brackets for joint filers are not twice as wide as those for individual filers, some of their combined income is pushed out of the 15 percent tax bracket into the 28 percent tax bracket (see Figure A1.4).

Table A1.2 Sources of the Marriage Penalty

	Unmarried			Married
	Worker 1	Worker 2	Combined	Joint Filing
AGI	$30,000	$30,000	$60,000	$60,000
- Standard Deduction	(4,250)	(4,250)	(8,500)	(7,100)
- Personal Exemption	(2,700)	(2,700)	(5,400)	(5,400)
Taxable Income	23,050	23,050	46,100	47,500
Marginal Tax Rate	15%	15%		28%
Tax Liability	$3,457.50	$3,457.50	$6,915	$7,795
Marriage Penalty/(bonus)				$880

Source: Joint Economic Committee calculations

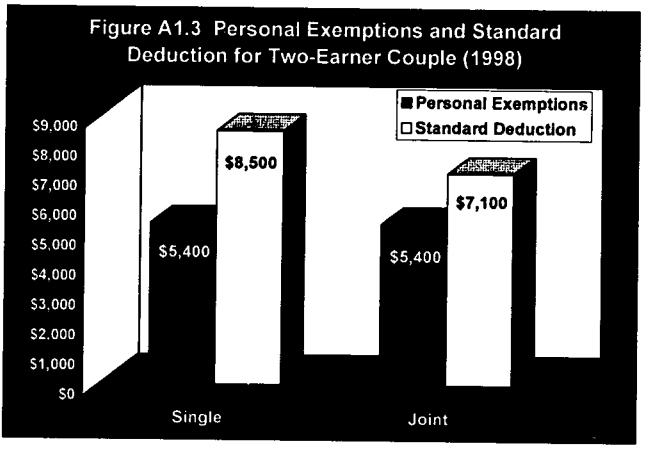
Figure A1.3 Personal Exemptions and Standard Deduction for Two-Earner Couple (1998)
Personal Exemptions
Standard Deduction
$9,000
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$2,000
$1,000
$0
$5,400
$8,500
$5,400
$7,100
Single
Joint

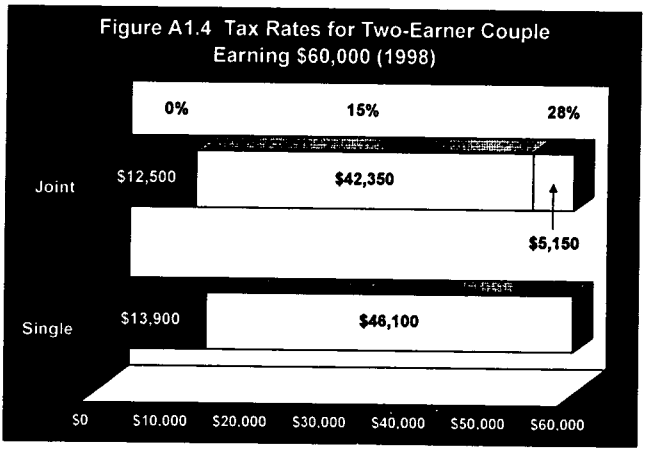
Figure A1.4 Tax Rates for Two-Earner Couple Earning $60,000 (1998)
0%
15%
28%
Joint
$12,500
$42,350
$5,150
Single
$13,900
$46,100
$0
$10,000
$20,000
$30,000
$40,000
$50,000
$60,000

Consider a couple in which each individual has one child and each earns $10,000. Table A1.3 shows that if the two individuals file as heads of households, they incur no federal income tax liability, and each receives the maximum EITC of $2,271. Their combined income tax liability is negative $4,542. If the two individuals are married, their tax liability is negative $1,811—a marriage penalty of $2,731, or 14 percent of total income.

Table A1.3 EITC as a Source of Marriage Penalties

	Unmarried			Married
	Worker 1	Worker 2	Combined	Joint Filing
AGI	$10,000	$10,000	$20,000	$20,000
- Standard Deduction	(6,250)	(6,250)	(12,500)	(7,100)
- Personal Exemption	(5,400)	(5,400)	(10,800)	(10,800)
Taxable Income	0	0	0	2,100
Marginal Tax Rate	0%	0%		15%
Federal Income Tax	0	0	0	315
Earned Income Tax Credit	-2,271	-2,271	-4,542	-2,126
Total Tax Liability	**-$2,271**	**-$2,271**	**-$4,542**	**-$1,811**
Marriage Penalty/(bonus)			**$2,731**	

Source: Joint Economic Committee calculations

The penalty occurs for three reasons. First, joint filing reduces the couple's combined standard deduction by $5,400 (see Figure A1.5). Thus, their taxable income increases by this amount and pushes them into the 15 percent tax bracket. Second, eligibility for the EITC begins to phase out at AGI $12,260 regardless of filing status. Thus, each individual qualifies for the maximum credit if single, but if married, their combined income pushes them into the phase-out range of the EITC (see Figure A1.6) and reduces the size of the credit for which they qualify. Third, when the two individuals are single with one child each, they qualify for two separate tax credits worth a combined maximum value of $4,542. However, combining their incomes and children into one family makes them eligible for only one credit worth a maximum of only $3,756.

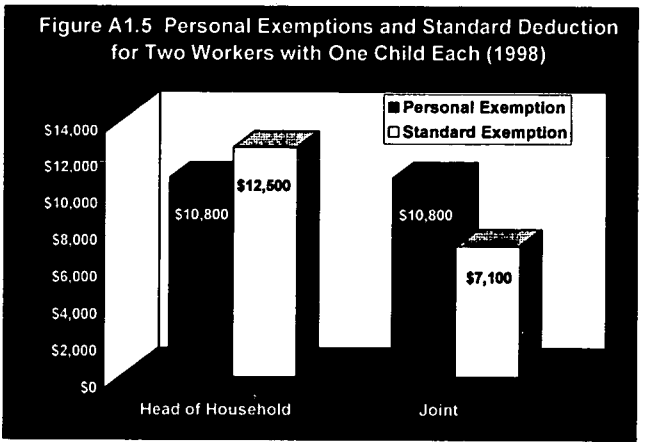
Figure A1.5 Personal Exemptions and Standard Deduction for Two Workers with One Child Each (1998)
Personal Exemption
Standard Exemption
$14,000
$12,000
$10,000
$8,000
$6,000
$4,000
$2,000
$0
$10,800
$12,500
$10,800
$7,100
Head of Household
Joint

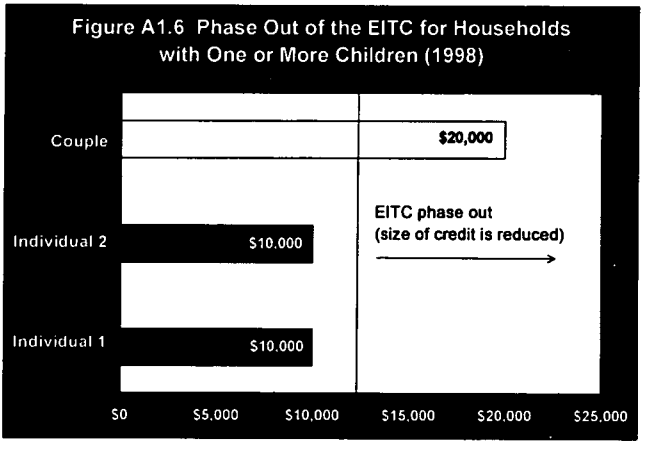
Figure A1.6 Phase Out of the EITC for Households with One or More Children (1998)
Couple
$20,000
EITC phase out
(size of credit is reduced)
Individual 2
$10,000
Individual 1
$10,000
$0
$5,000
$10,000
$15,000
$20,000
$25,000

APPENDIX 2

EFFECT OF VARIOUS PROPOSALS ON MARRIED COUPLES

The following tables illustrate how the three main marriage penalty reduction proposals would affect hypothetical low-, middle- and high-income couples depending on their division of income. The analysis does not account for behavioral changes that might occur if any of the proposals were adopted.

Table A2. Effect of Various Proposals on Tax Liability of Couple Earning $20,000

	50-50 Income Split 10,000-10,000	100-0 Income Split 20,000-0	75-25 Income Split 15,000-5,000
Current Law			
Single tax liability	-$4,542	-$182	-$3,031
Joint tax liability	-$1,811	-$1,811	-$1,811
Penalty/(bonus)	$2,731	($1,629)	$1,220
Optional Filing			
Tax liability	-$2,021	-$1,811	-$1,811
Tax cut	$210	$0	$0
Penalty/(bonus)	$2,521	($1,629)	$1,220
Income Splitting (H.R. 3104 and H.R. 3734)			
Tax liability	-$2,021	-$2,021	-$2,021
Tax cut	$210	$210	$210
Penalty/(bonus)	$2,521	($1,839)	1,010
Second-Earner Deduction			
Tax liability	-$1,961	-$1,811	-$1,886
Tax cut	$150	$0	$75
Penalty/bonus	$2,581	($1,629)	$1,145

Notes: (1) Assumes each spouse has one child for EITC calculation. (2) Calculations reflect the child tax credit that will be effective in 1998.
Source: Joint Economic Committee calculations

Table A2.2 shows that for middle-income couples, optional filing would eliminate penalties and maintain bonuses. Couples with the same income could pay different amounts of income tax. Income splitting would eliminate penalties and increase bonuses. Couples with the same income would receive equal tax cuts, thus maintaining horizontal equity. The second-earner deduction would reduce or eliminate penalties for two-earner couples. The third example shows that the deduction would increase bonuses for two-earner couples who receive them under current law. One-earner couples would not be affected by the deduction. One-earner couples would continue receiving the largest bonuses under all of the proposals.

Table A2.2 Effect of Various Proposals on Tax Liability of Couple Earning $60,000

	50-50 Income Split 30,000-30,000	100-0 Income Split 60,000-0	75-25 Income Split 45,000-15,000
Current Law			
Single tax liability	$6,915	$11,559	$8,567
Joint tax liability	$7,795	$7,795	$7,795
Penalty/(bonus)	$880	($3,764)	($772)
Optional Filing			
Tax liability	$6,915	$7,795	$7,795
Tax cut	$880	$0	$0
Penalty/(bonus)	$0	($3,764)	($772)
Income Splitting (H.R. 3104 and H.R. 3734)			
Tax liability	$6,915	$6,915	$6,915
Tax cut	$880	$880	$880
Penalty/(bonus)	$0	($4,644)	($1,652)
Second-Earner Deduction			
Tax liability	$6,955	$7,795	$7,375
Tax cut	$840	$0	$420
Penalty/bonus	$40	($3,764)	($1,192)

Note: Assumes the standard deduction and two personal exemptions
Source: Joint Economic Committee calculations

Table A2.3 shows that for high-income couples, a reduced penalty may exist because of the phase-out provisions of various tax breaks. (Certain phase-out provisions can create reduced penalties for middle-income couples as well.) In this example, income-splitting results in a reduced penalty for the couple with a 50-50 income split. The penalty arises because of the limitation of itemized deductions. (The value of itemized deductions is reduced for taxpayers with AGI more than $124,500 regardless of filing status. Thus, two individuals earning $75,000 each can take full advantage of their deductions when single, but when married to each other, they must limit their deductions because their combined income of $150,000 pushes them beyond the phase-out threshold.) Under optional filing, this particular structural penalty is eliminated, although other phase-out provisions can create penalties for some couples. The second-earner deduction reduces the tax liabilities of the two-earner couples by $930. This amount reflects the value of a $3,000 deduction at the 31 percent tax rate ($3,000 * 0.31).

Table A2.3 Effect of Various Proposals on Tax Liability of Couple Earning $150,000

	50-50 Income Split 75,000-75,000	100-0 Income Split 150,000-0	75-25 Income Split 112,500-37,500
Current Law			
Single tax liability	$26,338	$32,561	$27,183
Joint tax liability	$28,119	$28,119	$28,119
Penalty/(bonus)	$1,781	($4,442)	$936
Optional Filing			
Tax liability	$26,338	$28,119	$27,183
Tax cut	$1,781	$0	$936
Penalty/(bonus)	$0	($4,442)	$0
Income Splitting (H.R. 3104 and H.R. 3734)			
Tax liability	$26,552	$26,552	$26,552
Tax cut	$1,567	$1,567	$1,567
Penalty/(bonus)	$214	($6,009)	($631)
Second-Earner Deduction			
Tax liability	$27,189	$28,119	$27,189
Tax cut	$930	$0	$930
Penalty/bonus	$851	($4,442)	$6

Note: Assumes couples claim itemized deductions equal to 18 percent of AGI when single and when filing jointly.
Source: Joint Economic Committee calculations

THE EFFECTS OF ALLOWING AN INTEREST AND DIVIDEND EXCLUSION

Chairman Jim Saxton
(R-NJ)

Joint Economic Committee
United States Congress

February 1998

Abstract

A proposal that would allow taxpayers to exclude a low level of interest and dividend income from taxation would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers and non-savers. If signed into law, such an exclusion would interact with other initiatives, such as lower capital gains tax rates and expanded benefits for Individual Retirement Accounts, to provide new saving incentives to taxpayers across the income spectrum, thus improving the neutrality and efficiency of the U.S. tax code.

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THE EFFECTS OF ALLOWING AN INTEREST AND DIVIDEND EXCLUSION

EXECUTIVE SUMMARY

The U.S. national saving rate ranks among the lowest of the G-7 countries. Many economists have found that the low rate of saving is partially caused by tax laws that discourage saving in favor of consumption. Policies aimed at reducing this bias can promote long-term economic growth by increasing the amount of domestic resources available for investment.

One proposal that would help reduce the bias against saving would allow taxpayers to exempt from taxation the first $200 ($400 for joint tax filers) of interest or dividend income earned. Because of the low exclusion caps, such a proposal would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers and non-savers. The proposal would interact with other initiatives, such as lower capital gains tax rates and expanded benefits for Individual Retirement Accounts, to create new saving incentives for taxpayers across the income spectrum, thus improving the efficiency and neutrality of the tax code.

Saving Incentives

A $200/$400 interest and dividend exclusion would enhance saving incentives to the extent that it affects taxpayers' decisions at the margin (i.e., their decision to save an additional dollar of income.) The proposal would, therefore, enhance saving incentives among small savers and non-savers who earn less than $200/$400 of investment income. These taxpayers would earn a tax-free rate of return on an additional dollar of saving, thus encouraging them to save more.

Saving incentives for high-income taxpayers would be negligible because most wealthy households already generate more than $200/$400 of interest or dividend income. For these taxpayers, an exclusion capped at $200/$400 would not yield any additional benefits at the margin.

Tax Relief

A $200/$400 exclusion would provide tax relief to the majority of American taxpayers, but relatively more valuable benefits would

accrue to low- and middle-income households. Based on 1995 tax data:

- 57 percent of all taxpayers could have taken advantage of an interest or dividend exclusion.
- 23 percent of these taxpayers had adjusted gross incomes (AGI) between $1 and $15,000; 67 percent had AGI between $1 and $50,000.
- Because high-income taxpayers receive high levels of investment income, they would derive insignificant benefits from an exclusion capped at $200/$400. In contrast, low- to middle-income taxpayers would earn a tax-free rate of return on a substantial amount of their saving.
- Estimates by the Joint Committee on Taxation indicate that half of all taxpayers who reported taxable interest income and 35 percent of all taxpayers who reported dividend income would not have paid any taxes on that income if a $200/$400 exclusion were allowed.
- Overall, 30 million taxpayers would not have paid any taxes on their interest and dividend income.
- Low- and middle-income taxpayers would receive more valuable tax relief relative to high-income taxpayers when benefits are measured as a percentage of income.

Representative Jim Saxton (R-NJ)
Joint Economic Committee

THE EFFECTS OF ALLOWING AN INTEREST AND DIVIDEND EXCLUSION

Over the years, many economists have acknowledged that the U.S. tax code is biased against saving relative to consumption. This bias impedes long-term economic growth by lowering the level of saving in the United States. Equalizing the treatment of saving and consumption through policies that enhance saving incentives can increase the potential for long-term economic growth. The Taxpayer Relief Act of 1997 includes some provisions toward this goal, such as capital gains tax rate reductions and expanded benefits for Individual Retirement Accounts (IRA).

Another proposal that would reduce the bias against saving would allow taxpayers to exempt a specified amount of interest and dividend income from taxation. Such an exclusion would provide tax relief to the majority of American taxpayers and would enhance saving incentives for small savers. Low- and middle-income households would receive relatively more valuable benefits.

BACKGROUND

Since 1964, Section 116 of the Internal Revenue Code allowed taxpayers to exclude from adjusted gross income (AGI) the first $100 of dividend income received from domestic corporations.[77] Husbands and wives filing joint returns were each allowed a separate $100 exclusion based on dividend income earned by that spouse. The dividend exclusion was designed to provide taxpayers with some relief from the multiple taxation of saving and investment.

The Crude Oil Windfall Profit Tax Act of 1980 doubled the exclusion to $200 and expanded the coverage of Section 116 to include interest income. A $400 exclusion was available to joint tax filers regardless of which spouse earned the income.[78] The new rules were in

[77] A $50 dividend exclusion had been in the law since 1954.

[78] The expanded coverage and increased exclusion were allowed for tax years 1981 and 1982. After 1982, the law was scheduled to revert to its original text, although the rule applying to the treatment of joint returns was permanently revoked.

Table 1. Legislative History Regarding the Treatment of Interest and Dividend Income

1964	$100/$200 dividend exclusion allowed
1980	Crude Oil Windfall Profit Tax Act ▪ $200/$400 dividend *and* interest exclusion allowed for tax years 1981 and 1982
1981	Economic Recovery Tax Act ▪ $200/$400 interest exclusion repealed for tax year 1982 ▪ $100/$200 dividend exclusion reinstated ▪ 15% net interest exclusion effective for tax years after 1984 ▪ Expanded IRA benefits ▪ Top marginal tax rate reduced to 50%
1984	Deficit Reduction Act ▪ 15% net interest exclusion repealed
1986	Tax Reform Act ▪ $100/$200 dividend exclusion repealed for tax years after 1986 ▪ Restrictions on IRA eligibility instituted ▪ Tax structure reduced to 2 brackets and top marginal tax rate reduced to 28%

effect for only one year before they were repealed in the Economic Recovery Tax Act (ERTA) of 1981 in favor of more extensive saving incentives.

ERTA reinstated the $100/$200 dividend exclusion under Section 116 and established a variety of new saving incentives, including lower marginal income tax rates and expanded IRA benefits. In addition, for tax years after 1984, individuals would be allowed to exclude 15 percent of up to $3,000 of net interest income from AGI. Joint tax filers would be allowed a 15 percent exclusion of up to $6,000 of net

interest income.[79] Thus, the maximum interest exclusion for individuals and joint tax filers would be $450 and $900, respectively.

The expansion of IRA benefits significantly increased saving in IRAs, thus increasing short-term revenue losses beyond forecasters' expectations. The unexpected increase in saving and the associated reduction in short-term revenue led policy makers to repeal the 15 percent interest exclusion in 1984 before it was scheduled to take effect the following year.

In 1986, Congress enacted the Tax Reform Act (TRA). TRA permanently repealed the $100/$200 dividend exclusion provided in Section 116 and placed income restrictions on IRA participation. The revenue generated from these changes helped finance broad-based tax reform that lowered the maximum marginal tax rate on income from 50 percent to 28 percent and reduced the 15 bracket tax structure to only two tax brackets.

The saving incentives created by the TRA tax reforms were diminished by subsequent legislation. In 1991, a 31 percent tax bracket was added to the tax code, and in 1993, two more tax brackets were added, raising the maximum marginal income tax rate to 39.6 percent.

Reviving the $200/$400 interest and dividend exclusion would be an important component of a series of initiatives aimed at encouraging new saving. Because of the low exemption levels, such an exclusion would primarily benefit low- and middle-income taxpayers and would boost saving incentives for small savers. According to preliminary estimates by the Joint Committee on Taxation (JCT), the proposal would reduce federal government revenue by approximately $15 billion over five years.

TAX TREATMENT OF SAVING AND CONSUMPTION

The legislative changes affecting the taxation of interest and dividend income reflect an effort to increase saving by reducing the tax bias against saving. Under current law, income used for consumption is taxed once as personal income, but income used for saving is taxed at

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[79] Net interest income equals interest income minus interest expenses. Mortgage interest payments and interest paid in relation to business or trade was not subtracted from interest income under this approach. This definition was used to discourage arbitrage, a practice in which taxpayers can profit by borrowing money and saving an equal amount so that net saving remains unchanged.

two or three different levels—once as personal income, again as investment income, and if the saving generates a dividend or capital gain, it is taxed at a third level as corporate income.

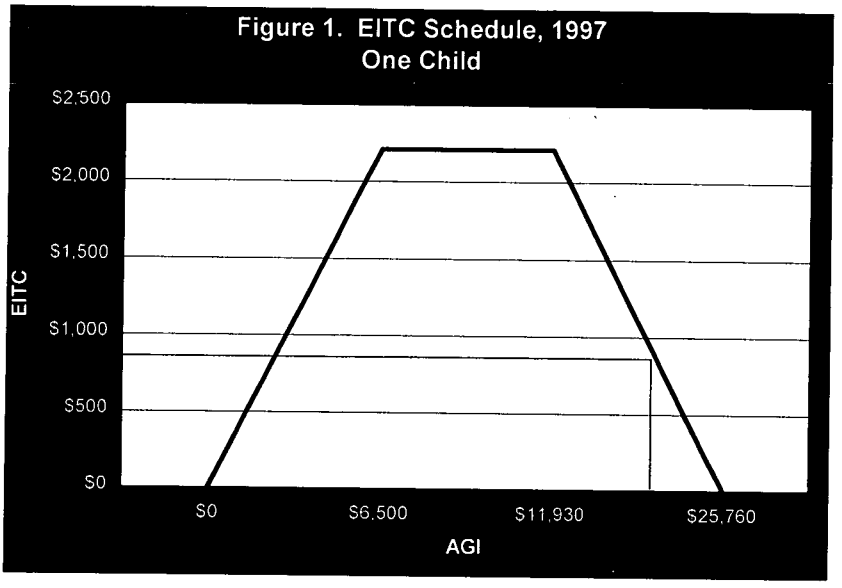
For instance, if a worker earned $30,000 in 1997, he/she would incur a federal income tax liability of $3,480, assuming the worker claims the standard deduction and one personal exemption. The worker's after-tax income would be $26,520. If the worker saves $3,000 of this after-tax income in a saving account earning 5 percent annually, the investment would yield $150 of interest income after one year. This interest income generates a further tax liability of $22.50 so that the worker keeps only 85 cents of each dollar of earnings—an after-tax rate of return of only 4.25 percent. In contrast, if the worker spends all of the income, the consumption generates no additional tax. Thus, the benefit derived from saving is taxed, but the benefit derived from spending is not taxed.

Saving Incentives and the Earned Income Tax Credit (EITC)

The additional penalty to saving is more severe for some low-income households that are eligible for the EITC, a tax credit for the working poor. Households eligible for the EITC receive a tax credit based on their AGI and number of children. The credit increases as a percentage of income up to a maximum amount; the maximum credit remains constant over a range of income; it then decreases as a percentage of income over a phase-out range until it reaches zero. Households with incomes in the phase-out range of the credit are discouraged from saving because any investment income they earn not only increases their tax liabilities, but it also reduces the size of their credits.

Consider a married couple with one child and a combined AGI of $20,000 in 1997. If the family claims the standard deduction and three personal exemptions, their tax liability would be $773. Figure 1 shows that the family would receive an offsetting credit of $920, making their total tax liability negative $147. If the family saves $1,500 of their after-tax income in a saving account earning 5 percent annually, they would earn $75 of interest income after one year. Because the family falls within the phase-out range of the EITC, they face a marginal tax rate of 31 percent—an additional dollar of income is subject to a 15 percent increase in their federal income tax and a 15.98 percent reduction in their tax credit. Thus, the $75 of interest income generates a tax liability of $23.24 so that the family keeps only 69 cents of each dollar of earnings. Taxing the family's interest income lowers their

after-tax rate of return to only 3.5 percent, thus lowering the benefit of saving for future consumption.

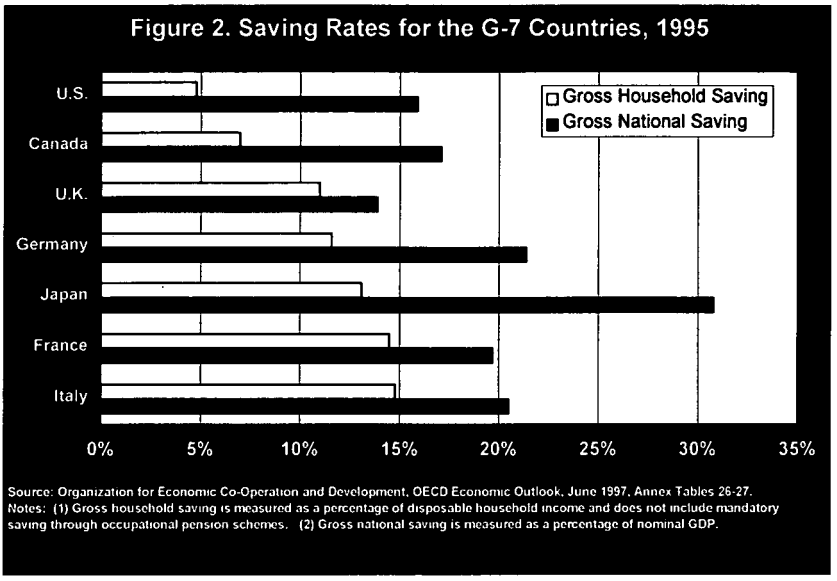


In sum, the interest rate represents the benefit of saving for future consumption. In other words, it is the relative price of current consumption. Taxing investment income artificially lowers the benefit of saving, and thus, lowers the relative price of current consumption. This distortion creates an inherent bias against saving that reduces the efficiency and neutrality of the tax code by distorting taxpayers' decisions regarding current and future consumption.

Many economists believe that the bias against saving contributes to a low national saving rate by penalizing households that save for future consumption.[80] Figure 2 below shows that U.S. saving rates compare unfavorably to those of the other G-7 countries (Group of Seven industrial democracies). In 1995, the U.S. family saving rate

[80] National saving is defined as private saving (saving done by families and businesses) and government saving (government surplus/deficit). Private business saving has remained fairly constant since 1950, but private family saving has been declining since the early 1980s, and therefore, is a concern to policy makers.

was the lowest among the G-7 countries, and the national saving rate was among the lowest, exceeding that of only the United Kingdom.



The low level of national saving limits the amount of domestic capital available for investment, thus reducing the overall level of investment in the economy.[81] Investment, in turn, is a key determinant of long-run economic growth and productivity improvements that generate new jobs, higher wages and better living standards.

EXPANSION OF SAVING INCENTIVES

A $200/$400 interest and dividend exclusion would help reduce the inequity between the treatment of saving and consumption by shielding

[81] When national saving is less than investment demand, investors must compete for scarce financial resources, thus creating upward pressure on interest rates. Higher interest rates attract foreign capital, allowing investment to rise even when domestic saving is low. However, reliance on foreign capital creates two undesirable effects: (1) profits from the investment flow overseas so that less benefit accrues to the U.S. economy, and (2) the borrowing must be repaid with interest so that future generations inherit a less wealthy, more burdened economy. In addition, higher interest rates increase the cost of capital so that the level of investment is lower than it otherwise would be.

some investment income from taxation. If the family earning $20,000 were allowed a $400 interest exclusion, none of their interest income would be taxed, allowing them to keep the $75 generated by the saving. Moreover, their marginal tax rate on saving would fall from 31 percent to zero percent so that an additional dollar saved would not be taxed. This benefit increases the after-tax rate of return on saving an additional dollar of income, thus encouraging the family to save more.

Some analysts argue that increasing the rate of return on saving has an ambiguous effect on the saving rate because of offsetting behavioral effects. Individuals may increase their saving because the relative price of saving falls (substitution effect), but they may also reduce their saving and still reach a desired target (income effect). Thus, the net effect on saving is ambiguous. However, for households that do not save at all and for households that are net borrowers, the two effects reinforce each other so that an increase in the rate of return on saving unambiguously increases saving.[82] Therefore, a low-level exclusion of interest and dividend income would most likely encourage new saving among low- to middle-income households that are typically non-savers or net borrowers. It would also make saving more attractive to small savers who generate less than $200/$400 of investment income by allowing them to earn a tax-free rate of return on an extra dollar of saving.

Saving incentives for high-income individuals, however, would be limited because of the low exclusion levels. Most wealthy households already earn more than $200/$400 of interest or dividend income. Thus, the exclusion would not lower the marginal tax rate on an additional dollar of saving, and therefore, is unlikely to encourage new saving at high levels of income.

In sum, the saving incentives created by a $200/$400 exclusion of interest and dividend income would primarily affect small savers and non-savers. If enacted, the proposal would not eliminate the double taxation of saving, but it would move the tax code in the right direction and interact with other initiatives, such as lower capital gains tax rates and expanded IRA benefits, to provide new saving incentives to taxpayers across the income spectrum. Although completely eliminating the bias against saving requires structural reform of the tax

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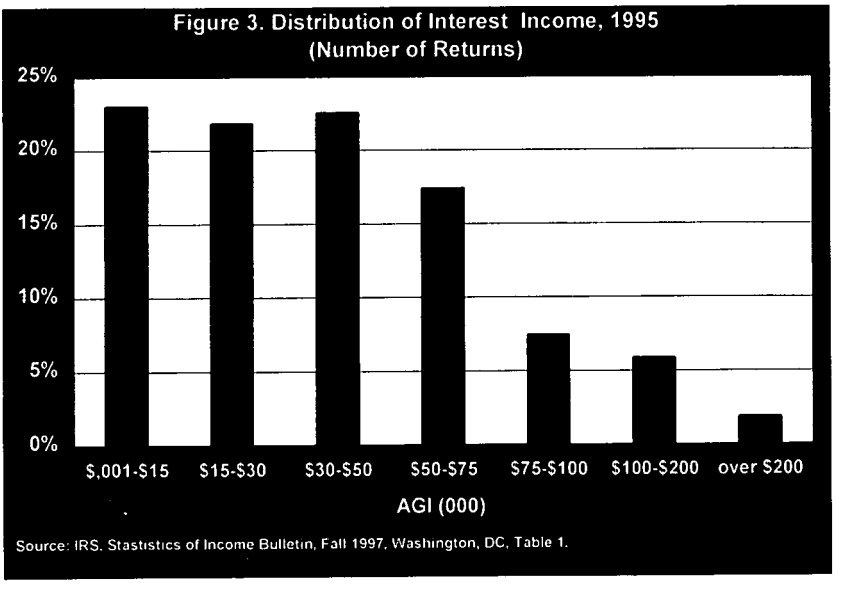
[82] M. S. Feldstein and S. C. Tsiang, "The Interest Rate, Taxation, and the Personal Savings Incentive," *The Quarterly Journal of Economics*, Volume LXXXII, No. 3, August 1968, pp. 419-434.

code, interim policies that incrementally enhance saving incentives are important because they help lay the foundation for broad-based reform, thus facilitating the transition to a more efficient and neutral tax system in the future.

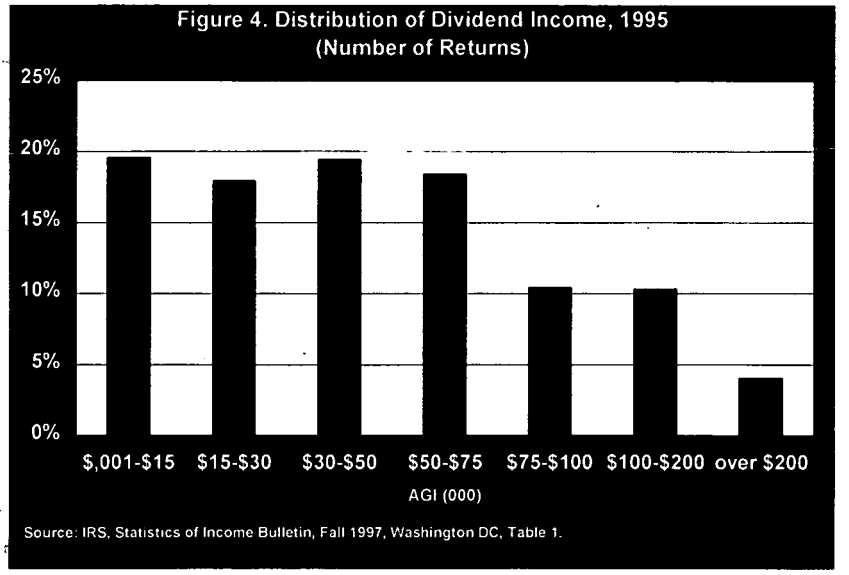
TAX RELIEF

A $200/$400 interest and dividend exclusion would provide tax relief to the majority of American taxpayers. Tax data from the Internal Revenue Service (IRS) show that 57 percent of all tax returns filed in 1995 reported taxable interest income, and 22 percent reported dividend income.[83] (Statistics for each state are contained in the Appendix.)

Figures 3 and 4 show that the majority of these tax returns were filed by low- and middle-income taxpayers. Of the 66 million returns claiming taxable interest income, 23 percent were filed by taxpayers with AGI between $1 and $15,000, and 67 percent were filed by taxpayers with AGI between $1 and $50,000. Similarly, of the 26 million returns reporting dividend income, 20 percent were filed by taxpayers with AGI between $1 and $15,000, and 57 percent were filed by those with AGI between $1 and $50,000.



[83] Statistics do not include tax returns with negative AGI, which account for 0.8 percent of all tax returns filed in 1995.



Although a majority of taxpayers could take advantage of an interest or dividend exclusion, the tax benefits would be relatively more valuable to small savers with low incomes. Figures 5 and 6 show that taxpayers with AGI more than $100,000 earned 36 percent of the total value of all taxable interest income claimed in 1995 and almost half of the total value of all dividend income claimed. Because high-income taxpayers receive high levels of investment income, they would derive insignificant benefits from an exclusion capped at $200/$400. In contrast, low- and middle-income taxpayers are generally small savers with low levels of investment income. In 1995, taxpayers with AGI between $1 and $15,000 earned 12 percent and 8 percent, respectively, of the total value of all taxable interest and dividend income claimed. The data suggest that low- and middle-income taxpayers would, therefore, earn a tax-free rate of return on a substantial amount of their savings.

Households that generate less than $200/$400 of interest and dividend income (and no capital gains) would have the double taxation of saving entirely eliminated. In 1981, the only year in which the $200/$400 exclusion was allowed, one out of four taxpayers claiming

an exclusion paid no taxes on their interest or dividend income.[84] JCT estimates indicate that half of all taxpayers reporting taxable interest income in 1995 and 35 percent of all taxpayers reporting dividend income would not have paid taxes on that income if a $200/$400 exclusion was allowed. Overall, 30 million taxpayers would not have paid taxes on their interest and dividend income.

Moreover, a $200/$400 exclusion would be relatively more valuable to low- and middle-income households when benefits are measured as a percentage of income. Table 2 shows that a $200 exclusion is worth $30 to a taxpayer in the 15 percent tax bracket and is worth $72 to a taxpayer in the 36 percent tax bracket. However, the exclusion reduces the taxable income and tax liability of the low-bracket taxpayer by 0.86 percent in this example, whereas the taxable income and tax liability of the high-bracket taxpayer are reduced by only 0.15 percent and 0.19 percent, respectively. Thus, the exclusion provides relatively more valuable tax relief at lower levels of income although the dollar value of the exclusion is greater at higher levels of income.

An interest and dividend exclusion would benefit low-income households for other reasons as well. These households are usually small savers with a low tolerance for risk and a preference for liquid assets. They often invest in interest-bearing checking or saving accounts with very low rates of return and often cannot afford the minimum deposit requirements for higher yielding bank assets. Consequently, these small savers are more likely to earn very low rates of return on their savings.[85] Taxing their interest income further reduces their rates of return and penalizes them for the tradeoff between current and future consumption. Many small savers may even earn negative rates of return over time when inflation is taken into account. An interest income exclusion would be a simple way of providing relief to these low-income taxpayers.

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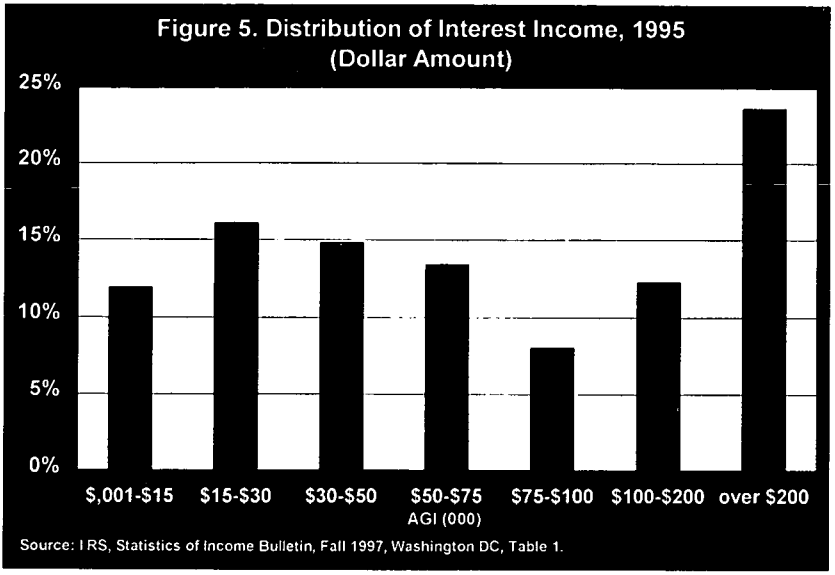
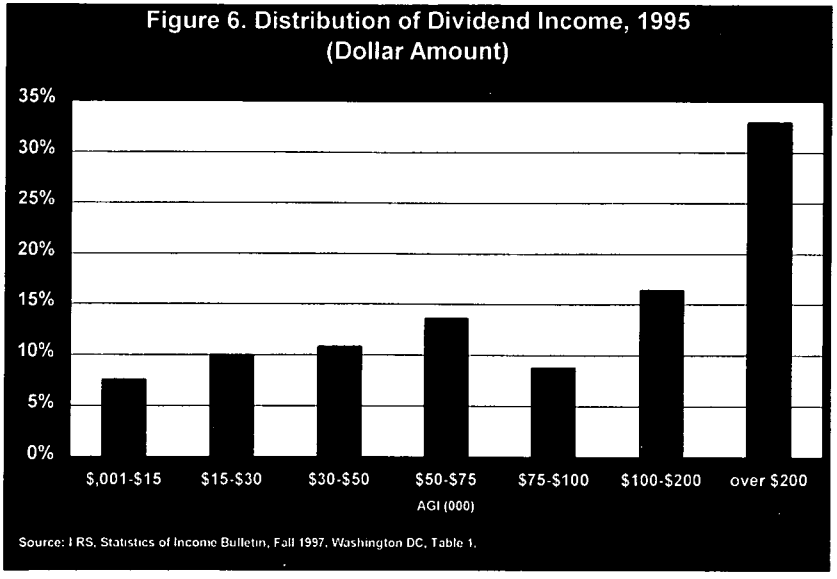
[84] Internal Revenue Service, Statistics of Income, *1981 Individual Tax Returns*, Washington, DC: Table 1.3.

[85] Prepared statement of Honorable Donald C. Ludwick for hearings before the Committee on Ways and Means, House of Representatives, *Tax Incentives for Savings*, January 29, 30, 31, 1980.





CONCLUSION

Saving rates in the United States are low compared to those of the other G-7 countries. Many economists believe that the low level of U.S. saving is partially caused by tax laws that discourage saving in favor of current consumption. Policies aimed at increasing the saving

rate through enhanced saving incentives can improve the potential for long-term economic growth.

One proposal that would help equalize the treatment of saving and consumption would allow taxpayers to exempt the first $200 of interest or dividend income from taxation ($400 for joint tax filers). A $200/$400 exclusion amount of their savings. This benefit would enhance saving incentives and encourage new saving. In addition, the tax relief provided to low- and middle-income taxpayers would be relatively more valuable than that provided to high-income taxpayers when measured as a percentage of income.

Table 2. Value of $200 Exclusion for Low- and High-Bracket Taxpayers

Marginal tax rate	15%	36%
Taxable Income		
Current law	$23,200	$135,200
$200 exclusion	$23,000	$135,000
Tax liability		
Current law	$3,480	$37,443
$200 exclusion	$3,450	$37,371
Value of $200 exclusion	$30	$72
Reduction in taxable income	0.86%	-0.15%
Reduction in tax liability	0.86%	-0.19%

The Joint Committee on Taxation estimates indicate that 50 percent of all taxpayers reporting taxable interest income in 1995 and 35 percent of all taxpayers reporting dividend income would not have paid taxes on that income if a $200/$400 exclusion were allowed. Overall, 30 million taxpayers would not have paid taxes on their interest and dividend income.

Shahira Elbogdady Knight
Economist

APPENDIX

Tax Returns Claiming Interest and Dividend Income by State, 1995

State	Interest Income		Dividend Income	
	Number	% of total	Number	% of total
Alabama	821,019	45.2%	278,911	15.3%
Alaska	180,942	49.8%	80,177	22.1%
Arizona	935,671	50.9%	396,052	21.5%
Arkansas	473,807	45.0%	178,980	17.0%
California	7,214,418	53.9%	2,826,305	21.1%
Colorado	1,066,133	59.8%	459,336	25.8%
Connecticut	1,102,097	70.5%	485,472	31.0%
Delaware	196,614	57.2%	91,687	26.7%
District of Columbia	132,226	48.7%	52,653	19.4%
Florida	3,438,200	52.5%	1,527,733	23.3%
Georgia	1,456,209	45.4%	581,689	18.2%
Hawaii	380,518	69.2%	129,732	23.6%
Idaho	276,673	55.9%	101,889	20.6%
Illinois	3,272,339	60.2%	1,357,345	25.0%
Indiana	1,517,211	57.1%	506,475	19.1%
Iowa	845,130	65.6%	330,767	25.7%
Kansas	690,177	60.8%	273,459	24.1%
Kentucky	802,381	49.8%	265,306	16.5%
Louisiana	764,935	43.4%	281,139	15.9%
Maine	349,282	62.3%	115,734	20.6%
Maryland	1,442,779	61.0%	571,438	24.1%
Massachusetts	1,933,566	67.8%	743,153	26.0%
Michigan	2,563,792	59.4%	1,026,007	23.8%
Minnesota	1,371,163	63.8%	570,525	26.6%
Mississippi	406,569	36.8%	140,773	12.7%
Missouri	1,311,362	55.2%	547,215	23.0%
Montana	243,709	62.0%	101,211	25.7%
Nebraska	482,164	62.9%	188,540	24.6%
Nevada	350,764	46.5%	137,385	18.2%
New Hampshire	369,952	65.8%	138,264	24.6%
New Jersey	2,487,427	65.4%	1,102,660	29.0%
New Mexico	352,666	47.9%	130,879	17.8%
New York	5,046,918	63.7%	1,992,886	25.2%
North Carolina	1,669,092	50.3%	623,868	18.8%
North Dakota	187,512	64.0%	65,284	22.3%
Ohio	3,016,595	57.0%	1,172,329	22.2%
Oklahoma	673,567	49.3%	231,378	16.9%
Oregon	848,219	59.4%	323,062	22.6%
Pennsylvania	3,469,903	63.5%	1,399,631	25.6%
Rhode Island	281,097	62.2%	97,003	21.5%
South Carolina	738,009	44.8%	272,148	16.5%
South Dakota	195,955	59.0%	73,221	22.0%
Tennessee	1,122,422	47.2%	367,146	15.4%
Texas	3,618,332	44.9%	1,358,818	16.9%
Utah	478,619	58.9%	142,202	17.5%
Vermont	181,415	66.3%	68,157	24.9%
Virginia	1,701,605	56.4%	743,688	24.6%
Washington	1,511,355	60.8%	587,325	23.6%
West Virginia	382,627	53.5%	123,445	17.3%
Wisconsin	1,616,125	67.7%	618,170	25.9%
Wyoming	130,720	59.3%	53,347	24.2%
Other areas	449,457	42.3%	202,030	19.0%
United States	66,551,439	56.0%	26,234,029	22.1%

Source: Internal Revenue Service, Statistics of Income Bulletin, Spring 1997, Table 2.

REFORMING K-12 EDUCATION THROUGH SAVING INCENTIVES

A JOINT ECONOMIC COMMITTEE REPORT

Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

December 1997

Abstract

The efficacy of America's educational system has become the primary concern of American voters. In response to this concern, various proposals to reform K-12 education have been introduced. This paper argues that, by empowering parents rather than bureaucracies, parental choice programs can improve educational quality and raise academic achievement within the nation's schools. Special consideration is given to proposals that promote choice through saving incentives.

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REFORMING K-12 EDUCATION THROUGH SAVING INCENTIVES

EXECUTIVE SUMMARY

The lack of progress in educational reform at the K-12 level is a serious threat to the health of the economy and to the future prosperity of American children. School reforms thus far have focused on increasing funding to public schools. Since 1983, government funding to public K-12 schools has increased by 44 percent and average per-student spending has increased by 32 percent. Total spending on public K-12 education now totals almost $300 billion, or 4 percent of gross domestic product, per year. However, the increased spending has not improved quality, suggesting that more money is not the answer to school reform.

Instead, effective school reform must address the structure of public education. Public schools monopolize the market for affordable education and, therefore, are not held accountable for their performance. Consequently, they have little incentive to improve quality or control costs because even the worst public schools are protected by the system.

Schools can be effectively reformed through parental choice programs that empower parents rather than school bureaucracies. Parental choice embodies two principles. First, any system which provides more parents with more choices will be superior to one that assigns children to certain schools based on zoning rules. Second, competition ensures that customers receive the highest quality product at the lowest price. If parents are given the financial ability to remove their children from failing schools, these schools will be forced to improve their quality if they want to remain viable. Competition essentially takes away the guarantee that classrooms will remain full regardless of a school's performance or quality.

Competition in education is not a radical policy. The market for higher education is competitive, and this competition has helped make American colleges and universities among the best in the world.

American colleges and universities among the best in the world. Private and religious schools at the K-12 level also compete for students as do pre-schools. Therefore, the lack of competition in public K-12 education is the exception.

Several proposals have been introduced in Congress that would allow parents more choices in K-12 education. One proposal with bipartisan support would allow parents to establish tax-free saving accounts to encourage them to save for their children's K-12 education. Such accounts already exist under current law for higher education. Parents who contribute to these accounts could use their savings to send their children to public, private, or religious schools. Alternatively, the savings could be used to pay for a home computer, tutor, educational therapy, college tuition, or other educational expenses.

Saving incentives can be utilized by all low- and middle-income families in all communities. Their widespread use can provide the competitive pressures needed to generate broad-based reform in the K-12 school system. In addition, low- and middle-income families can receive substantial benefits.

Data on school enrollment show that families with incomes of $35,000 or less represent 25 percent of all families with children in private schools; 66 percent of all families with children in Catholic elementary schools; and 45 percent of all families with children in Catholic high schools. These families make significant financial sacrifices to provide their children with a good education and would greatly benefit from saving incentives that ease their financial burdens. Promoting parental choice through saving incentives would not advance private and religious schools at the expense of public schools. It would simply make more options available to more parents and provide new opportunities for schoolchildren both inside and outside the public school system.

Representative Jim McCrery (R-LA)
Joint Economic Committee

REFORMING K-12 EDUCATION THROUGH SAVING INCENTIVES

In its landmark study, *A Nation at Risk*, a federal commission warned that "a rising tide of mediocrity" was deteriorating the quality of American education. Since the warning was issued in 1983, school reform at the K-12 level has been slow and ineffective. This lack of progress is a serious threat to the economy, which will accumulate lower levels of human capital, and to American children, whose future prosperity depends on the quality of their education. Accordingly, the efficacy of America's educational system has become the primary concern of American voters.[86]

In response to this concern, various proposals to reform K-12 education have been introduced. For instance, the Clinton Administration wants to establish national standards by administering national tests on a voluntary basis; some policy makers want to increase federal funding to the nation's public schools; and others want to provide parents with more control over their children's education through parental choice programs. This paper argues that, by empowering parents rather than bureaucracies, parental choice programs can improve educational quality and raise academic achievement within the nation's schools. Special consideration is given to proposals that promote choice through saving incentives.

INNOVATIONS IN SCHOOL REFORM

Several states and localities have recently established parental choice programs in response to a growing dissatisfaction with the quality of the nation's K-12 schools. Parental choice programs accomplish two goals. First, they allow parents to seek out the best schools for their children. Second, they encourage deficient schools to improve their programs and curriculums by making them accountable to parents who can leave the school if improvements are not made. Parental choice programs are thus designed to improve educational opportunities for children and to provide the impetus needed to initiate school reforms.

Choice programs vary among different states and districts. Some programs allow parents to send their children to certain public schools

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[86] Mario A. Brossard, "American Voters Focus on Worries Close to Home," *The Washington Post*, September 15, 1996.

within their districts; whereas other programs allow parents to cross district lines. More than 26 states have established charter schools—schools that are publicly financed but privately managed by teachers and parents. Charter schools are free from many state and district regulations that bind traditional public schools.

A few states and localities have adopted, or are considering, publicly funded programs that allow parents to send their children to private schools. Studies reporting success among these programs have prompted a growing number of policy makers to support similar efforts on a national level. For instance, various legislation has been introduced in the 105th Congress that would provide eligible families with grants, scholarships, vouchers, or tuition tax credits to help defray the costs of private primary and secondary educational expenses. In addition, proposals have also been introduced that would provide parents with incentives to save for their children's educational expenses.

Parental Choice Through Saving Incentives

The Taxpayer Relief Act of 1997 includes a provision that will allow parents to make a nondeductible contribution of up to $500 per year to an Education Saving Account (ESA) for each qualifying child. Savings in an ESA will accumulate tax-free and will not be taxed upon withdrawal as long as the proceeds are used to finance higher education expenses. In June 1997, Senator Paul Coverdell (R-GA) proposed an amendment to the Senate Tax Relief bill that would have allowed parents to use the proceeds of their ESAs for K-12 education as well as for higher education. The amendment was approved in the Senate with bipartisan support. However, it was eliminated from the final budget agreement when President Clinton threatened to veto the entire budget bill if it included any provision that used tax benefits to help parents send their children to private schools. Advocates of the legislation agreed to omit the amendment in order to salvage budget negotiations but reintroduced it in July as an independent bill. In October 1997, Representative Bill Archer (R-TX) introduced a similar bill that raises the allowable contribution to $2,500 per year. Mr. Archer's bill, called the Education Savings Act, passed in the House of Representatives but is currently stalled in the Senate.

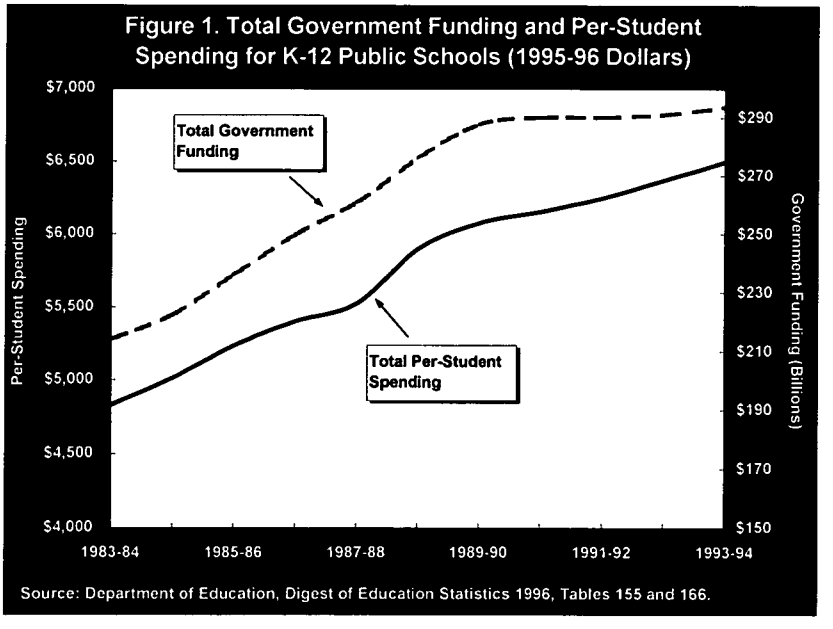
These bills differ from other choice proposals because they do not require the expenditure of public funds. They simply provide parents with incentives to save for their children's education and allow them to use their savings to finance educational expenses from kindergarten

through college. Parents could use the proceeds to pay for the cost associated with sending a child to a private school, a religious school, or a different public school. Alternatively, the funds could be used for tutoring, home schooling, purchasing a home computer, or paying for college expenses.

IMPROVING THE QUALITY OF K-12 SCHOOLS

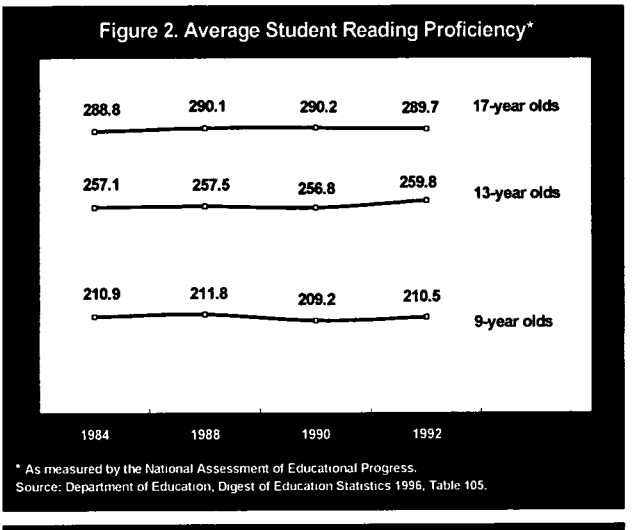
Will More Money Help?

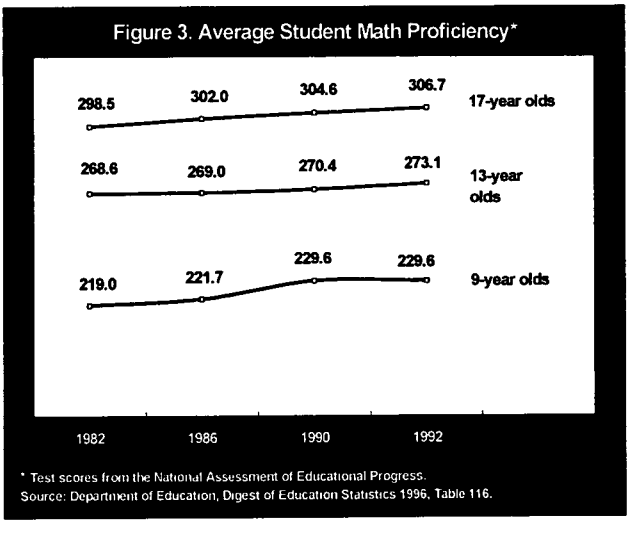
Those who defend the status quo believe that the nation's public schools simply need more money; but the historical evidence suggests that more money will not improve quality. Figure 1 shows that since 1983, when *A Nation at Risk* was released, total government funding for public K-12 education has increased by 44 percent after adjusting for inflation. The United States now spends almost $300 billion, or 4 percent of gross domestic product (GDP), on public primary and secondary education. Similarly, total spending per student has increased by 32 percent since 1983 and now averages approximate-ly $6,993 per student.



However, academic achievement has not improved significantly to match the increase in funding. Figure 2 shows that since 1984, average reading proficiency as measured by the National Assessment

of Educational Progress (NAEP) has improved by only 0.4 percent for all age groups and has actually dropped among nine-year olds. Figure 3 shows that math proficiency has improved slightly by an average of less than 3 percent for all age groups. Despite the increase in math test scores, only 20 percent of 4th, 8th and 12th grade students were rated "at or above proficient" in math by the NAEP.[87]





[87] J. A. Dossey, J. Mazzeo, K.E. Miller, and C. M. Reese, *NAEP 1996 Mathematics Report Card for the Nation and the States.* (Washington DC:

Other indicators also suggest that primary and secondary schools have not improved substantially. For instance, freshman college professors find that many high school graduates do not have high school skills. Even students who enter college with "A" and "B" averages often cannot write clearly, compute easily, or think critically.[88] Similarly, employers often hire college graduates for jobs that only require high school skills because they no longer trust the value of a high school degree.[89]

The statistics indicate that more money does not necessarily translate into a higher quality education. One reason why money may not enhance quality is because increases in government funding are not entirely spent in the classroom. They partially finance higher employee salaries, pensions, and benefits. In addition, public schools are mired by layers of bureaucracy that often prevent funding from reaching the front lines of teaching.

In addition, evidence suggests that many public schools do not use their financial resources efficiently. For instance, the financial assessor of D.C. public schools found that, over a three-year period, $50 to $60 million marked for building repairs and school supplies were used to hire as many as 700 unauthorized personnel.[90] Similarly, in New York City, an investigative commission found that millions of dollars budgeted for school supplies were disappearing through various slush funds.[91] Examples of poor money management are widespread, suggesting that schools may need to be more resourceful with their finances before an increase in government funding is justified.

Furthermore, private schools, on average, incur lower costs than public schools, yet produce better schooling outcomes. The average cost of educating a child in public schools is $6,993, compared to an

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National Center for Education Statistics, 1997).

[88] Kati Haycock, "Thinking Differently about School Reform," *Change*, January 1996.

[89] Richard J. Murnane and Frank Levy, *Teaching the New Basic Skills: Principles for Educating Children to Thrive in a Changing Economy.* (New York: Free Press, 1996).

[90] Kathleen Schalch, "D.C. School Crisis," *National Public Radio, Morning Edition*, September 2, 1997.

[91] Edward F. Stancik and Sandra Feldman, "Infestation, Not Education," *The New York Times*, June 28, 1995.

estimated $3,475[92] in private schools. School administrators argue that public schools incur higher costs because they enroll a larger percentage of students who require special education. However, according to the Center for Special Education Finance (CSEF), public schools spent a total of $19.3 billion from combined federal, state, and local sources on special education in the 1987-88 school year (the last year for which accurate data are available). This amounts to less than $500 of the average per-student cost for that academic year. In 1993-94, CSEF estimated that public schools spent a total of $32 billion on special education, or $736 per student.[93] This estimate may overstate the actual amount spent on special education, indicating that special education cannot account for the large cost differential between public and private schools.

In brief, a shortage of funding may be an obstacle to reform in some schools, but in general, there seems to be little correlation between increased government funding and higher educational quality. Since 1983, funding for public K-12 education has increased steadily as has total spending per student; but the increased spending has not significantly improved results, suggesting that more money is not the answer to school reform.

Empowering Parents

Advocates of parental choice believe that school reform is not a monetary issue. Reform must address the bureaucratic structure of educational institutions, which serves school administrators better than it serves schoolchildren. A primary problem with K-12 education is that public schools have a monopoly on affordable education. As a result, they have no incentive to improve standards, contain costs, or innovate. Most importantly, they are not held accountable to the parents and students whom they serve since there are no consequences to poor schooling outcomes. Even the worst public schools are guaranteed a steady stream of students and tax revenue because most

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[92] Tsze H. Chan, Michael Garet, and Joel D. Sherman, "Estimates of Expenditures for Private K-12 Schools," *Pelavin Research Institute, Working Paper Series for the U.S. Department of Education, National Center for Education Statistics,* May 1995.

[93] Jay Chambers, Tom Parrish, Joanne Lieberman, "What are We Spending on Special Education in the U.S.?" *Center for Special Education Finance, Office of Special Education Programs,* undated.

parents cannot afford to remove their children from failing public schools.

The late James Coleman, a sociologist from the University of Chicago, explained that private school tuition effectively acts like a protective tariff. He notes that, "Just as a protective tariff on automobiles would protect the American automobile industry from foreign competition, private school tuition,..., protects the public schools from competition by private schools."[94] He points out that protective tariffs generally oppose the public interest because they benefit producers (school bureaucracies) at the expense of consumers (students). In addition, protective tariffs generally provide the greatest benefits to the worst producers and create the greatest harm for the least well-off consumers.

Parental choice programs reduce the financial barriers to private schools, thereby creating competition among public schools. Giving parents the financial opportunity to seek out the best schools for their children provides schools with the necessary incentives to improve quality. It also motivates schools to become more resourceful with their finances and more innovative with their curriculums. Most importantly, it makes schools accountable to parents and students who can leave the school if improvements are not made. Competition essentially removes the monopolistic protection that many deficient public schools now enjoy.

Opponents of choice programs argue that competition in education is a radical policy that will hurt the nation's public schools. At a recent congressional hearing, Senator Carol Moseley-Braun (D-IL) noted that "...by definition, markets have winners and losers, and our country cannot afford any losers in a game of educational roulette."[95]

However, competition in education is not radical; and the status quo in education has already produced many "losers." Public institutions of higher education already compete for students, and this competition has helped make American colleges and universities among the best in the world. Competition also exists among the nation's private and religious schools at the K-12 level, and it exists

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[94] James Coleman, "Public Schools, Private Schools, and the Public Interest," *American Education,* Vol. 18: pp. 17-22, January/February 1982.

[95] Carol Moseley-Braun, testimony before the Committee on Education and the Workforce, September 9, 1997.

among pre-schools. The lack of competition in public K-12 education is therefore an exception, and introducing competition in this market would enhance quality as it has in other educational markets.

A study by the National Bureau of Economic Research confirmed that public schools would benefit from competition. The study presents evidence that "...increasing the potential of private schools to compete with public schools has a beneficial effect on public schooling outcomes, mostly by means that do not require higher spending."[96]

The results from existing choice programs complement these findings. John Gardner, an at-large member of the Milwaukee Public Schools Board of Directors, stated in an affidavit that Milwaukee's private school choice program "...puts effective pressure on the Milwaukee Public Schools to expand, accelerate, and improve reforms long deliberated and too-long postponed."[97]

Similarly, a public school teacher from Massachusetts, a state which implemented inter-district public school choice in 1991, notes:

> The first year of school choice was punitive to sending schools [schools which choice students left], but otherwise the whole program is going in the right direction. School choice makes each school take notice of educational improvements that nearby schools make, lest it lose students to those other schools.... School choice is improving the quality of education in Massachusetts, in my opinion.[98]

A privately financed choice program that provided vouchers to the students of Giffen Memorial School in Albany, New York also managed to generate change. After one-sixth of the school's students left, the Albany Board of Education replaced Giffen's principal, added

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[96] Caroline Minter Hoxby, "Do Private Schools Provide Competition for Public Schools?" *National Bureau of Economic Research, Working Paper #4978*, December 1994, p. 31.

[97] Cited in the written testimony of Alveda C. King prepared for a Congressional hearing before the Committee on Education and the Workforce, September 30, 1997.

[98] Massachusetts Executive Office of Education, *School Choice in Massachusetts: Why Parents Choose.* (Boston, April 1994) p. 21.

nine new teachers and two assistant principals, and pledged $125,000 for books, equipment, and teacher training.[99] An article in *The New York Times* notes that by overhauling Giffen, "...school officials seem to have inadvertently bolstered a central argument for vouchers: that they foster competition and thereby force public schools to improve."[100] Even community residents who were opposed to vouchers were pleased to "see a long-beleaguered, long-ignored school suddenly getting some much-needed attention."

A recent article in *The Washington Post* also noted that new choices in education "...have begun to send a powerful message to public schools, even prompting some of them to acknowledge a threat of competition for the first time."[101] The article cites several examples of public school districts that have initiated improvements in response to competitive pressures. For instance, Michigan public schools have lost hundreds of students to charter schools prompting them to enact new programs such as all-day kindergarten classes and student enrichment programs.

Thus parental choice would not promote private and religious schools at the expense of public schools. It would improve quality in all schools by forcing improvements and creating accountability. Existing choice programs have proven that competition does work in primary and secondary education. Schools are responding to competitive pressure by improving programs and implementing needed changes. Parental choice would therefore benefit, not only those children who leave the public school system, but also those who stay in the system.

More Choices for More Parents

Advocates of parental choice programs realize that any system which provides more parents with more choices will be superior to one that assigns children to certain schools based on zoning rules. The one-size-fits all approach to public education cannot and should not be expected to meet the needs of a diverse student body, and students would be better served if their parents had more control over their educational setting.

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[99] James Dao, "Antidote to an Exodus," *The New York Times*, September 29, 1997.

[100] *Ibid.*

[101] Rene Sanchez, "Popularity Grows for Alternatives to Public School," *The Washington Post*, October 1, 1997.

One advantage of using saving incentives to promote parental choice is that the benefits are not targeted to a specific population and can, therefore, be utilized by more families. According to the Current Population Survey, one out of four families with children in private schools have incomes under $35,000 and almost half have incomes under $50,000. The table below shows that 66 percent of families with children in Catholic elementary schools have incomes under $35,000 and 72 percent of families with children in Catholic high schools have incomes of $50,000 or less. These low- and middle-income families would benefit substantially from saving incentives that ease the burden of financing their children's education.

A family that contributed the maximum amount of $2,500 per year to an ESA that earned 8 percent annually would have $39,113 after 10 years. If the same amount of money were contributed to a regular saving account in which earnings were taxed each year, the family would only have $34,460 after taxes if they were in the 28 percent tax bracket. Thus the ESA saves the family $4,650 in taxes over this time period—an amount that could pay for two years of tuition at a four-year public university.

Income Distribution for Families with Children in Catholic Schools

Catholic High Schools, 1994-95	
Income Bracket	% Families
Under $15,000	7
$15,001-$25,000	14
$25,001-$35,000	24
$35,001-$50,000	27
Over $50,001	27
Source: Michael J. Guerra, "Dollars and Sense: Catholic High Schools and Their Finances 1994," National Catholic Educational Association, Exhibit 18.	

Catholic Elementary Schools, 1994	
Income Bracket	% Families
$0-$15,000	11.7
$15,001-$25,000	21.0
$25,001-$35,000	33.6
$35,001-$50,000	22.2
More than $50,000	11.5
Source: Robert J. Kealey, "Balance Sheet for Catholic Elementary Schools: 1995 Income and Expenses," National Catholic Educational Association, Exhibit 5.	

This tax benefit would provide relief to low- and middle-income families who are sacrificing a great deal to educate their children in private and Catholic schools. It would also provide the needed incentive to encourage other families to start saving for their children's education. In addition, since saving incentives can be utilized by all low- and middle-income families in all communities, the beneficial impact on the K-12 school system would be more consequential and widespread.

RAISING CHILDREN'S ACADEMIC ACHIEVEMENT

Private and religious schools generally produce superior schooling outcomes relative to public schools. Figures 4 and 5 show that 12th graders in Catholic and other private schools outperform their public school counterparts on achievement tests in every subject. Moreover, students in private schools are also more likely to complete high school and go onto college than are students in public schools. The average college application rate for seniors in public schools is 57.4 percent compared to 87.5 percent in private schools. For schools with at least 50 percent minority attendance, college application rates for public and private schools are 54.2 and 79.9 percent, respectively. These trends hold in inner city, suburban, and rural communities and for public and private schools with similar demographic compositions.[102] These findings suggest that parental choice in education would raise children's academic achievement by enabling more children to be educated in private school settings and by encouraging public schools to adopt effective educational approaches used in more successful schools.

Some observers argue that private schools produce better schooling results because they are more selective. Although some private schools may have rigorous admission standards, selectivity does not seem to be the key to success for Catholic schools (which serve the majority of private school students in choice programs).[103] One study by economists from the University of Maryland found that graduation and college attendance rates were the same for Catholic

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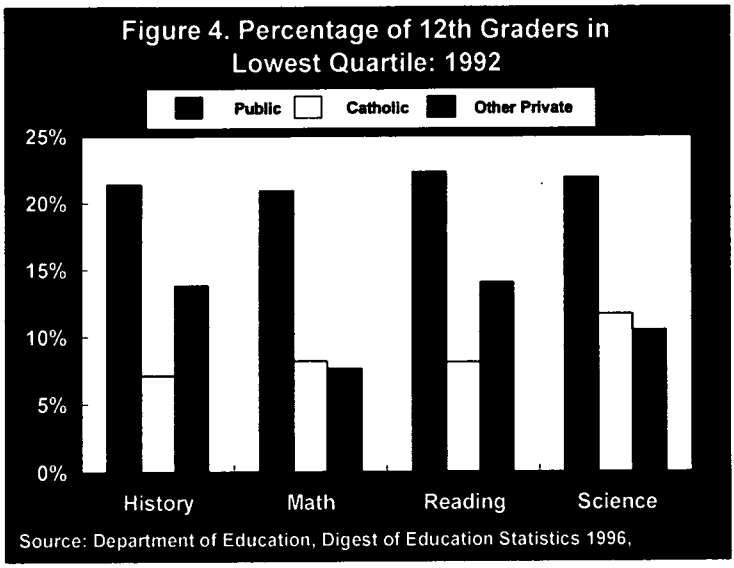
[102] *Op. Cit., Digest of Education Statistics*, Table 181.

[103] Jeanne Allen, "Nine Phoney Assertions about School Choice," *USA Today Magazine*, July 1993.

schools regardless of whether they had admission requirements.[104] In fact, Catholic schools often cater to minority and disadvantaged students, and pride themselves on their ability to raise the academic achievement of disadvantaged children who do poorly in public schools.

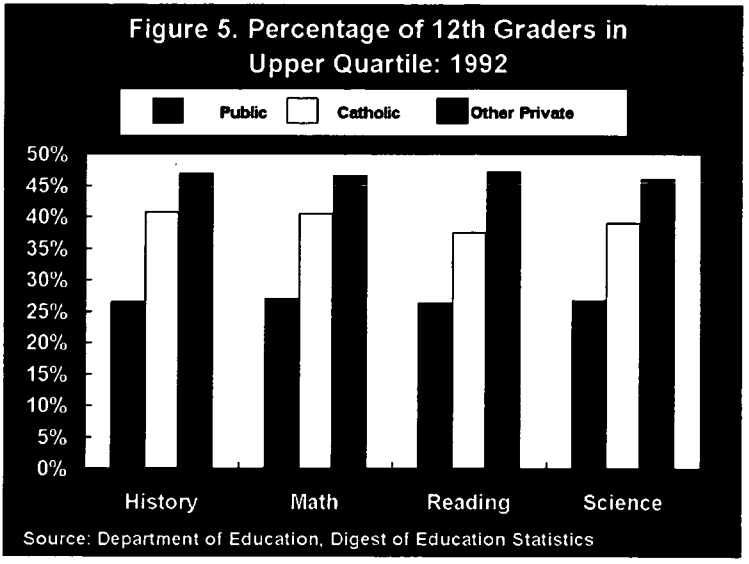
Several studies that control for selectivity bias have found that private schools (especially Catholic schools) produce better results for disadvantaged children. For instance, research conducted by James Coleman and his colleagues found that:

> Catholic schools are...more effective than public or other private schools in raising the academic achievement of subpopulations that traditionally achieve at lower levels, including blacks and Hispanics, children from families with lower levels of parental support, and children from families of lower socioeconomic status.[105]



[104] William N. Evans and Robert M. Schwab, "Finishing High School and Starting College: Do Catholic Schools Make a Difference?" *The Quarterly Journal of Economics*, CX: 942-957, November 1995.

[105] A summary of James Coleman's work is provided in: Luther B. Otto, "Public and Private High Schools: The Impact of Communities," book review, *Science*, September 11, 1987.



According to Coleman, Catholic schools are successful in educating high-risk students because they create a "functional community" in which the school, family, and student interact around common values and goals. Whereas education at any institution enhances "human capital," by endowing students with skills and knowledge that improve their economic productivity, Catholic schools provide functional relationships that enhance a student's "social capital."[106] Social capital is critical to a child's ability to learn.

Public schools, on the other hand, were designed when the goal of education was to teach a large number of students the most basic social and workplace skills, selecting only a few of the best for "thinking work."[107] A bureaucratic structure of centralized decision-making and standardized curriculums was created to carry out this goal. Regulatory obstacles make it difficult for schools to develop value-oriented communities or to be responsive to the needs of different students. Although this standardized approach works well for many students, it cannot be effective for all students.

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[106] *Ibid.*

[107] Linda Darling-Hammond, "Restructuring Schools for Student Success," *Daedalus*, September 22, 1995.

A study by the RAND Corporation concurred with this conclusion. The RAND study identified several reasons why Catholic schools are more successful in educating disadvantaged students. [108] For instance, Catholic schools focus on schooling outcomes, whereas public schools focus on delivering programs and following procedures. Catholic schools consider themselves accountable to parents and other entities who depend on their services, whereas public schools are accountable to bureaucratic superiors. Catholic schools emphasize secular ethics of honesty, reliability, fairness, and respect, whereas public schools see themselves as "transmitters of information." These traits, among others, enable Catholic schools to improve the performance of children who typically fail in public schools.

These are only a few of the studies demonstrating the positive effects of Catholic schooling on poor and minority children. The findings suggest that selectivity is not the factor behind Catholic school success and that parental choice in education can provide important opportunities that raise children's academic achievement.

ISSUES RAISED BY PARENTAL CHOICE

Funding to Public Schools

President Clinton has threatened to veto any legislation that provides parents with saving incentives to help defray the cost of private primary and secondary education. The Clinton Administration argues that such a provision would undermine public education by draining money from the public school system. However, parental choice programs do not necessarily divert money from public education.

Promoting parental choice through saving incentives does not require any expenditure of public funds, but eliminating the double taxation of saving would represent a revenue loss for the federal government. In other words, a family that decides to save $2,500 in a saving account will pay income taxes on the $2,500 when that income is earned. In addition, they will pay taxes on any interest or dividends that accrue in the saving account. However, if the money is invested in an ESA, the earnings generated by the $2,500 are not taxed so that the family is only taxed once on their savings instead of twice, thereby reducing government revenue.

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[108] Paul T. Hill, Gail E. Foster, and Tamar Gendler, *High Schools with Character.* (Santa Monica: The RAND Corporation, 1990)

Whether this loss in revenue is offset by a reduction in funding to public education depends on the language in the legislation. The Joint Committee on Taxation estimates that the Education Savings Act would reduce revenue by $2.58 billion over five years. The legislation stipulates that this cost would be offset by a $2.65 billion increase in tax revenue generated from changes in the tax law relating to employer deductions for accrued vacation pay. Consequently, the proposal will not take any money out of public schools. Moreover, since some students will leave the public school system as a result of the legislation, public schools will be left with the same amount of funding to educate fewer students. Thus it cannot reasonably be claimed that saving incentives would undermine public education by diverting funds away from public schools.

Furthermore, parental choice programs do not represent an abandonment of public schools. Not all financially empowered parents will choose to send their children to private schools. Many may use the funds to send their child to a more reputable public school or charter school. Thus saving incentives do not promote one type of school over another, they simply make more options available to more parents. The only schools that would suffer as a consequence of choice programs are those that have failed to meet the minimum quality standards already established by the public. Schools that are not adequately educating children should not be protected; they should be reformed—and the competitive pressure created by parental choice will provide the impetus necessary to initiate reform.

It is unclear why the Administration opposes public funding of private school choice at the K-12 level, but supports it at the college level. The Administration has provided $35 billion of tax benefits that will allow families to send their children to private and religious colleges, but it refuses families the same benefits for primary and secondary education. This inconsistency has led many observers to believe that the Administration's opposition is political rather than in the best interest of America's schoolchildren.

Legal Issues

Some opponents of parental choice argue that using public funds to subsidize religious schools raises a potential constitutional violation of church and state separation. It is highly unlikely that the use of saving incentives to promote choice would constitute such a violation. There are three criteria that have been established by the U.S. Supreme Court to determine the constitutionality of a law with respect to church

and state separation. [109] First, the statute must have a secular legislative purpose; second, its primary effect cannot advance or inhibit religion; and third, the law must not foster excessive government entanglement with religion.

In 1983, the Supreme Court applied this test in *Meuller v. Allen* and upheld a Minnesota law that provided parents with tax deductions for private primary and secondary school expenses.[110] Justice William Rehnquist, who delivered the opinion of the court, stated that:

> A State's decision to defray the cost of educational expenses incurred by parents—regardless of the type of schools their children attend—evidences a purpose that is both secular and understandable. An educated populace is essential to the political and economic health of any community, and a State's efforts to assist parents in meeting the rising cost of educational expenses plainly serves this secular purpose of ensuring that the State's citizenry is well educated.

It was judged that the primary effect of the law did not advance any religion since the deduction was available to parents regardless of whether their children attended religious or non-religious schools; and any benefit accruing to religious institutions was a result of parents' choices rather than government action. This precedence clearly suggests that saving incentives would also be found constitutional.

Furthermore, federal dollars are currently being used to directly subsidize religious education at the pre-school and higher education levels. Students can use federally funded Pell Grants and GI Bills to attend religious colleges and universities; they can also use government subsidized student loans to attend religious institutions of higher education; and parents can use federal day-care vouchers at religiously affiliated pre-schools. In addition, the $35 billion of tax benefits provided in the new budget bill will allow parents to send their children to religious colleges. Once again, the lack of government assistance at the K-12 level represents an exception.

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[109] Lemon v. Kurtzman, 403 U.S. 602, 91 U.S. Supreme Court 2105, 1971.

[110] Mueller v. Allen, 463 U.S. 388, 103 U.S. Supreme Court 3062, 1983.

Elitism

Some concerns have been raised that parental choice programs would create a deeply divided school system as affluent, white students would go to private schools, leaving poor and minority students behind in deteriorating public schools. This concern overlooks the fact that economic realities have already created a deeply divided public school system that barely resembles the "common" school of decades past.

Low-income families tend to live in inner cities where the quality of public schools is lowest. Because of their financial constraints, they have no choice but to send their children to these inferior schools. As a result, the majority of students in deteriorating inner-city schools come from poor, minority families. Wealthy families who live in inner-city school districts can afford to send their children to private schools or move to different neighborhoods where the public schools are more reputable. Accordingly, children of wealthy families are concentrated in private schools and in the best public schools. Thus the current system, in which only wealthy families can afford to choose, has already created a two-tiered educational system. Saving incentives, by design, would foster economic integration by allowing children to attend schools their families otherwise could not afford.

CONCLUSION

Free public education is one of the most important services provided by the government. Public schools have served the nation well and continue to provide an excellent education to the majority of children who attend them. However, it is becoming increasingly clear that many public schools are providing millions of children with a substandard education. The education crusade cannot be won without reforming these deficient primary and secondary schools.

Since 1983, government funding to public K-12 schools has increased by 44 percent and average per-student spending has increased by 32 percent. Total spending on public K-12 education now totals almost $300 billion, or four percent of GDP, per year. However, the increased spending has not improved quality, suggesting that more money is not the answer to school reform.

Instead, school reform must address the deficient bureaucratic structure of educational institutions that has lost sight of children's best interests. Public schools have a monopoly on affordable education, and therefore, are not held accountable for their performance. Consequently, they have little incentive to improve quality or control costs.

Schools can be effectively reformed through parental choice programs that empower parents rather than school bureaucracies. Parental choice embodies two principles. First, any system which provides more parents with more choices will be superior to one that assigns children to certain schools based on zoning rules. Second, competition ensures that customers receive the highest quality product at the lowest price. If parents are given the financial ability to remove their children from failing schools, these schools will be forced to improve their quality if they are to remain viable. Existing parental choice programs have managed to initiate improvements in their local public school districts.

Many policy makers support proposals that would allow parents to establish tax-free saving accounts to encourage them to save for their children's K-12 education. Tax-free saving would generate important benefits to millions of low- and middle-income families who are already sacrificing a great deal to educate their children in Catholic and other private schools. It would also benefit children in public school whose parents could use the funds to pay for computers, tutors, or other educational expenses.

Promoting parental choice through saving incentives would not promote private and religious schools at the expense of public schools. It would simply make more options available to more parents and provide new opportunities for schoolchildren both inside and outside the public school system.

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TAX POLICY AND THE FISCAL ENVIRONMENT: THE CASE FOR TAX REFORM

by

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TAX POLICY AND THE FISCAL ENVIRONMENT

I. TAX CUTS AND THE BUDGET PROCESS

Nineteen seventy-eight was a watershed year. "Stagflation"–characterized as the "major economic ill of our time"–was the dominant policy issue,[111] and tax-cutting was in vogue. The sponsors of the Kemp-Roth bill were promoting tax rate cuts, the capital gains tax-cutting Steiger Amendment became law, and California voters overwhelmingly endorsed the property tax-cutting Proposition 13.

However, since 1978, there has been a pattern of resistance to tax cut proposals. Calls to "balance the budget [first?]"–or to "pay for" tax cuts with spending reductions, offsetting tax increases, or both–became the dominant themes. A manifestation of this dynamic is the increasingly common invocation of the phrase "revenue neutrality;" the idea that tax cuts must be offset by compensatory tax increases. A corollary has been that, since 1978, every tax cut has been accompanied by a contemporaneous or lagged tax increase. This, in turn, has meant that the tax code has burgeoned, vocal special interests have been favored, multiple taxation of income has persisted, families have been discriminated against, and an anti-saving, investment and work effort bias has been built into the code. In this process, each of the commonly accepted evaluative standards for an economically sound tax code has been violated.[112] The tax code has become less fair, less efficient, and evermore complicated.

II. THE HISTORY

The Economic Recovery Tax Act (ERTA) became law on August 4, 1981. Essentially a modified version of the tax-cut proposals incorpo-

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[111]United States Congress, Joint Economic Committee. *The 1979 Joint Economic Report*, March 1979, U.S. Government Printing Office, Washington, D.C., p. (3). Stagflation is the simultaneous occurrence of rising unemployment and inflation.

[112]For more on the desirable characteristics of a tax system, see Joseph E. Stiglitz, *Economics of the Public Sector, Second Edition.* New York: W.W. Norton and Company, 1988.

rated in President Reagan's February 18, 1981, *A Program for Economic Recovery*, ERTA nevertheless contemplated:

- across-the-board marginal tax rate (MTR) reductions spread over the period October 1, 1981 through July 1, 1983,
- a reduction in the top MTR on investment income from 70 to 50 percent,
- a reduction in the maximum capital gains tax rate to 20 percent,
- marriage tax penalty relief,
- the indexation of tax rate brackets, effective in 1985,
- an increase in the maximum contribution to an individual retirement account [IRA] from $1,500 to $2,000, and
- other pro-family, pro-small business and pro-saving, investment and work effort provisions.

ERTA's passage was accompanied by growing concern about deficit spending and, implicitly, by pressure to raise taxes.[113] So great was the pressure that on September 24, 1981–less than two months after ERTA's passage–President Reagan spoke on television about the need to revise the tax code to "curtail tax abuses and enhance tax revenues."[114] The growing tax increase momentum was reflected in the *Democratic Views* incorporated in the Joint Economic Committee's March 1, 1982, *Joint Economic Report*. The Democrats' Recommendation No. 11 read, in part:

> The tax cuts scheduled to go into effect on July 1, 1982 should be deferred.... [and] indexation of the personal tax brackets to the Consumer Price Index should be repealed....[115]

While Republican Members of the Joint Economic Committee (JEC) rejected tax increases "to offset short-run increases in deficit

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[113]See, for example, "Dissent from a Keynesian and a Wall Streeter," Business Week, August 24, 1981, p. 81.

[114]The White House, Fact Sheet: Fall Budget Program, September 24, 1981.

[115]United States Congress, House of Representatives. *The 1982 Joint Economic Report*, March 1982, U.S. Government Printing Office, Washington, D.C., p. 98.

projections generated by recession"[116] the tax increase momentum was unstoppable.

Two points should be emphasized. First, the unfolding recession–which slowed revenue growth and increased the growth rate of spending–was not foreseen. In February 1982 the Congressional Budget Office (CBO)–under the direction of Alice Rivlin, a Democrat appointee–released a set of long-run economic assumptions. The trajectory of assumed nominal gross national product (GNP) growth rates comported closely with the Reagan Administration's assumptions:

Table 1. CBO and Reagan Administration Assumptions
(percent change, year to year)

	1982	1983	1984	1985	1986	1987
President's February 1982 Budget	8.1	11.5	10.2	9.7	9.2	9.0
CBO Baseline	7.5	11.9	10.4	9.7	9.4	9.1

Source: *An Analysis of the President's Budgetary Proposals for Fiscal Year 1983*, February 25, 1982, p. 38.

Clearly, neither the Administration nor CBO contemplated a recession. Neither, for that matter, did CBO assume that the Administration's revenue forecasts were overly optimistic:

Table 2. Estimated Revenue Losses Resulting from the Economic Recovery Tax Act of 1981
(by fiscal year, in $-billions)

	1981	1982	1983	1984	1985
CBO Estimates	2	39	95	148	189
Administration Estimates	*	38	92	139	171

*Less than $500 million.
Source: *An Analysis of the President's Budgetary Proposals for Fiscal Year 1983*, February 25, 1982, p. 4.

[116] *Ibid.*, p. 221

These data make it clear that the Administration did not assume that massive revenue feedback effects would result from its tax rate reduction. No "rosy revenue scenario" was evident.

The second point to be emphasized is that the 1981-82 recession was not caused by tax rate cuts; cuts which had, in any case, not yet come fully into effect. The principal cause of the recession was a restrictive monetary policy which caused M1-then the "targeted" money aggregate-to decline by 0.2 percent between April and October 1981.[117] In any case, it was the 1981-82 recession which depressed revenue growth, boosted outlays, and pushed deficits over $200 billion, and it was the prospect of higher deficits which captured policy makers' attention. The passage in 1982 of the Tax Equity and Fiscal Responsibility Act (TEFRA) was the all-but-inevitable result. Intended to increase receipts "primarily by eliminating unintended benefits and obsolete incentives, increasing taxpayer compliance, and improving collection techniques,"[118] TEFRA was estimated to raise $149.9 billion in tax revenue over four years.[119] (This contrasted with ERTA's estimated tax reduction over five years of $445.8 billion).[120] Yet pressure for tax increases driven by budget concerns continued unabated. The Deficit Reduction Act of 1984 (DEFRA) was estimated to increase taxes by $72.2 billion over five years. This was accomplished by:

- repeal of the net interest exclusion,
- an increase in, and extension of, certain excise taxes,
- restrictions on tax-exempt entity leasing,
- postponement of finance leasing rules,
- changes in the depreciation period for real property,
- modification of income averaging, and

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[117]Federal Reserve Bank of St. Louis, Monetary Trends, September 23, 1982.

[118]Office of Management and Budget, *The United States Budget in Brief, Fiscal Year 1984*, January 1983, U.S. Government Printing Office, Washington, D.C., p. 29.

[119]*Ibid.*, p. 29.

[120]Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1983*, February 1982, U.S. Government Printing Office, Washington, D.C., p. 4-10.

- revisions in the taxation of certain tax-exempt bonds.[121]

The Tax Reform Act of 1986 (TRA) was accompanied by great fanfare. The January 1987 *Economic Report of the President* is heuristic:

> The Tax Reform Act of 1986 fundamentally alters the structure of the Federal income tax. It broadens the personal and corporate income tax bases and substantially lowers tax rates. These changes will significantly alter private incentives and, accordingly, will influence the economy's performance through three principal channels:
>
> - lower marginal tax rates on personal income,
> - more uniform tax rates on income from alternative capital investments, [but]
> - a somewhat higher overall marginal tax rate on capital income will modestly reduce the economy's long-run capital intensity.[122]

The *Economic Report* concluded by asserting that "The Tax Reform Act of 1986 is perhaps the most important reform of the Federal income tax since its inception in 1913."[123] But, the *Report* adds: "To preserve the gains of tax reform, ... deficit reduction should be accomplished PRIMARILY through additional spending restraint"[124] [emphasis added].

The essential point is that, while passage of TRA was motivated by concern

> ... that many taxpayers found the prior-law tax system unfair and overly complex.... [and]

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[121]Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1986*, February 1985, U.S. Government Printing Office, Washington, D.C., pp. 4-5 and 4-6.

[122]Council of Economic Advisers, *Economic Report of the President*, January 1987, U. S. Government Printing Office, Washington, D.C., p. 79.

[123]*Ibid.*, p. 96

[124]*Ibid.*, p. 96.

> that a number of features of the prior law tax system resulted in excessive interference in labor, investment, and consumption decisions....[125]

the budget deficit affected the structure of the reform. While fairness, efficiency and simplicity were the goals, revenue neutrality–paying for tax cuts with compensatory tax increases–was the ultimate policy constraint. Consider that, on the one hand, TRA:

- reduced 15 tax brackets and tax rates to two brackets and two rates (15 and 28 percent),
- increased the standard deduction,
- increased the personal exemption,
- reduced corporate income tax rates,
- extended the Research and Experimentation Credit, and
- allowed for the deductibility of self-employed individuals' health insurance costs.

At the same time, TRA:

- repealed the two-earner deduction,
- repealed income averaging,
- limited medical deductions,
- taxed unemployment compensation benefits,
- limited the exclusion for scholarship and fellowship income,
- reduced the amount of the earned income tax credit for individuals with earned income between $6,920 and $15,432,
- repealed the State and local sales tax deduction,
- repealed the Capital Gains Exclusion for individuals and established a maximum capital gains tax rate of 28 percent,
- limited miscellaneous itemized deductions,
- limited Individual Retirement Account [IRA] deductibility,
- limited consumer interest deductions,
- limited the deductibility of passive losses,
- repealed the Investment Tax Credit,

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[125] Staff. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, May 1987, Commerce Clearing House, Chicago, Illinois, p. 6.

- modified the Accelerated Cost Recovery System of Depreciation,
- increased the Alternative Minimum Tax (AMT) tax rate and phased out the exemption amount above certain income thresholds,
- limited the deductibility of investment interest,
- repealed the dividend exclusion for individuals,
- limited the deduction for business meals and entertainment,
- limited the issuance of tax-exempt bonds, and
- limited to $7,000 the amount an employee can exclude from his adjusted gross income under a qualified cash or deferred arrangement with his employer. Moreover, the amount an employee may exclude from his taxable income by his [her] own contribution to a tax-sheltered annuity was limited to $9,500 per year.[126]

The net effect of these tax cuts and tax increases was estimated to be a tax cut of $1.2 billion spread over five years.[127] This *de minimis* tax cut reflected both a desire to "broaden" the tax base and to avoid increasing the federal budget deficit.[128]

Many of the TRA's provisions did, in principle, enhance the tax code's fairness, simplicity and efficiency. It must be said, however, that having institutionalized a 15 and a 28 percent tax rate, TRA "implicitly creat[ed] a marginal tax rate of 33 percent in the affected income range."[129] This "third tax rate" was rarely invoked when TRA was discussed. Indeed, the 28 percent tax rate was frequently, and misleadingly, characterized as the "top" tax rate–presumably because the 15 and 28 percent rates are statutory.

The *Fiscal 1992 Budget* made precisely this distinction in its discussion of the individual income tax provisions codified in the Omnibus Budget Reconciliation Act of 1990 (OBRA-90).[130] OBRA-90

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[126]Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1988, Supplement*, January 1987, U.S. Government Printing Office, Washington, D.C., pp. 4-6 to 4-11.

[127]*Ibid.*, p. 45

[128]Joint Committee on Taxation, *op. cit.*, p. 7.

[129]*Budget, Fiscal Year 1988, Supplement*, p. 4-6.

[130]Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1992*, January 1991, U.S. Government Printing Office, Washington, D.C., p. 3-4.

is significant both because it is cited as violating President Bush's "Read my lips, No new taxes" assertion, and because it began the process of systematic tax rate increases. Whereas TRA's statutory tax rates were 15 and 28 percent, OBRA-90 added a third, statutory 31 percent rate.[131]

OBRA-90 did not, however, merely institutionalize a new, higher, statutory tax rate. It also:

- limited itemized deductions,
- phased out personal exemptions as adjusted gross income exceeded threshold amounts, and
- increased, extended, modified or imposed new excise taxes–including an excise tax on "certain luxury goods."[132]

Whatever else can be said about OBRA-90's tax provisions, it is clear that they do not "simplify" the tax code. The changes are not consistent with standards of efficiency or fairness. It is also clear that the force which animated its discussion and passage was concern regarding the Unified Budget deficit. As *The New York Times* observed, less than two weeks before OBRA-90's passage,

> The measure would raise taxes by more than $140 billion over the next five years, the core of an overall plan to reduce the Federal deficit by $40 billion this year and by a total of $500 billion over five years.[133]

Indeed, in February 1991, the Office of Management and Budget (OMB) estimated that OBRA-90 would raise taxes by $192.8 billion over the 1991-96 period.[134] Clearly, "revenue enhancement" and "budget balancing" had once again driven tax policy. Any appeal to efficiency, simplicity or even "revenue neutrality" was absent. "Deficit reducing" tax increases were the motivating force behind OBRA-90's tax

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[131]Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1992*, January 1991, U.S. Government Printing Office, Washington, D.C., p. 3-4.

[132]*Budget, Fiscal Year 1992*, pp. 3-4 and 3-5.

[133]David Rosenbaum, "Leaders Reach a Tax Deal and Predict Its Approval: Bush Awaits Final Details," *New York Times*, October 25, 1990.

[134] *Budget, Fiscal Year 1992*, p. 3-3.

provisions. However, contrary to predictions, the budget deficit soon climbed to record levels because of the business cycle downturn.

Sadly, the budget was once again to drive the formulation of tax policy. The Omnibus Budget Reconciliation Act of 1993 (OBRA-93) invokes both the budget deficit and "fairness"[135] to justify the institutionalization of a new, statutory marginal tax rate of 36 percent,[136] and a 10 percent "surtax on higher-income taxpayers." The surtax is "computed by applying a 39.6 percent rate to taxable income in excess of the applicable threshold."[137] The 36 percent statutory rate, the 10 percent surtax, an increase in the alternative minimum tax, a permanent extension of the limitation on itemized deductions, and a phase out of personal exemptions were estimated to raise taxes by $124 billion over five years.[138] In addition, OBRA-93 was intended to raise taxes in the following amounts:

- $29 billion from repeal of the $135,000 limit on income subject to the Medicare wage tax,
- $16 billion from reducing the deductible portion of business meals and entertainment,
- $14 billion from raising the top marginal corporate income tax rate from 34 to 35 percent,
- $32 billion from extending the 1990 tax increase of 2.5 cents per gallon on transportation fuels, and adding a permanent increase of 4.3 cents per gallon on motor fuels, and
- $18 billion as a result of increasing the taxable portion of Social Security benefits from 50 percent to 85 percent for the 13 percent of beneficiaries with the highest total incomes.[139]

All of this in the name of "deficit reduction" and "fairness!"

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[135]Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1995*, February 1994, U.S. Government Printing Office, Washington, D.C., pp. 55-56.

[136]Conference Report, *Omnibus Budget Reconciliation Act of 1993*, August 4, 1993, U.S. Government Printing Office, Washington, D.C., p. 571.

[137]*Ibid.*, p. 572.

[138]*Budget, Fiscal Year 1995*, p. 56.

[139]*Ibid.*, p. 56.

The pattern which emerges from this post-1981 tax policy retrospective is clear: Efforts to reduce tax rates and to make the tax code fairer, simpler, and more efficient have been systematically compromised by budgetary concerns. Lower tax rates have been "paid for" by raising taxes in other ways. More important, OBRA-90 and OBRA-93 both raised statutory and "implicit" tax rates and, among other things, further limited deductions and exemptions.

Clearly, fairness, efficiency, and simplicity have been sacrificed in the interest of "revenue neutrality" and/or "revenue enhancement."

III. The Status of the Budget Deficit

It is clear that budgetary concerns have been the primary force behind post-1981 tax policy. But it is equally clear that this must change, especially since budgetary conditions have changed.

Between fiscal 1981 and fiscal 1990, the year before the calendar 1991 recession, federal revenues grew at an annual rate of 6.22 percent, while outlays grew at a 7.1 percent rate. In contrast, between fiscal 1992 and fiscal 1997 the growth rate of revenues rose to 7.67 percent, while the growth rate of outlays fell to 3.0 percent.[140] The acceleration of revenue growth and the deceleration of outlay growth reflect both the post-1991 business cycle expansion and spending restraint. The result is that, in nominal terms, the deficit fell from a post-1981 high of $290.4 billion in fiscal 1992 to $22.6 billion in fiscal 1997.[141] At the time President Clinton's fiscal 1998 budget was submitted, February 6, 1997, OMB estimated the fiscal 1997 budget deficit to be $125.6 billion, with a surplus of $17.0 billion emerging in fiscal 2002.[142]

The tendency to underestimate federal revenue growth and to overestimate the growth of federal spending has not been confined to OMB. For example, in January 1995, the Congressional Budget Office

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[140]Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1998, Historical Tables*, February 1997, U.S. Government Printing Office, Washington, D.C., pp. 23-24. Note: These data include both on- and off-budget receipts and outlays.

[141]Council of Economic Advisers, Economic Indicators, December 1997, U.S. Government Printing Office, Washington, D.C., p. 32. Again, these data include both on- and off-budget receipts and outlays.

[142]*Historical Tables: Budget of the United States Government*, Fiscal Year 1998, p. 20.

projected an increase in the total deficit from $136 billion in fiscal 1996 to $250 billion in fiscal 2002.[143]

It is against this backdrop that congressional tax and spending decisions have been shaped. Arguably, these erroneous deficit forecasts contributed to the congressional focus on "revenue neutrality." That said, it is clear that the fiscal decision environment has changed. The federal deficit is in decline, both in absolute terms, and as a percent of gross domestic product [GDP]. These declining–some might say "plunging"–deficits suggest that lawmakers can now concentrate on the formulation of a tax policy based on economic principles rather than upon budgetary concerns.

IV. Where Should We Go From Here?

In 1988, a few years before he became Chairman of President Clinton's Council of Economic Advisers, Joseph Stiglitz, wrote that

> With tax rates at the levels they have been in recent years, tax considerations are often of primary concern; one may be better off by allocating one's effort to reducing one's taxes than by designing better projects or producing more.[144]

As we have seen, OBRA-90 and OBRA-93 made matters worse. Limitations on itemized deductions, lower personal exemptions, new excise taxes and other "revenue enhancements" accompanied the higher statutory tax rates and the surtax on higher-income taxpayers. Moreover, no steps were taken to address the multiple taxation of personal saving and investment. Small wonder that federal tax receipts rose from 19.67 percent of GDP in 1990 to 20.78 percent in 1996.[145] This occurred at the same time that state and local tax receipts rose from 12.69 percent of GDP in 1990 to 13.8 percent in 1996.[146]

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[143]The total deficit is the sum of the on-budget deficit (surplus) plus the off-budget deficit (surplus). See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1996-2000*, January 1995.

[144]Stiglitz, *Economics of the Public Sector, Second Edition*, p. 391.

[145]Patrick Fleenor (ed.) Facts and Figures on Government Finance, 31st Edition, Tax Foundation, Washington, D.C., 1997, p. 5.

[146]*Ibid.* p. 5.

Bluntly stated, concern with budgetary rather than sound economic principles has resulted in a growing tax burden and the institutionalization of a tax code which, to paraphrase Stiglitz, is transparently–and increasingly–inefficient. In addition, the growing tax burden both reduces disposable income and erodes economic freedom; notably, the freedom to choose goods and services which would otherwise be affordable. As Stiglitz emphasized in 1988, the code reduces incentives to invest, to produce more and, he might have added, to save.

A tax code which distorts incentives is, under any circumstances, undesirable. Given demographic and other trends, it is intolerable for the United States. Writing in 1997 as Chairman of President Clinton's Council of Economic Advisers, Stiglitz observed that the aging of the U.S. population "should produce a dramatic increase in dissavers relative to savers, substantially reducing national saving."[147] He added that, "Given the already low U.S. saving rate, this prediction ... is a source of concern."[148]

It is time, in short, to address the inherent inefficiencies which have been built into the tax code. The need to save more is an undeniable fact, as is the need to underwrite faster economic growth with more investment, work effort and productivity growth.

The determinants of U.S. economic growth are well understood. The secular or long-term growth rate of the economy depends upon the growth rates of physical capital, labor and productivity[149] Tax policy should be shaped with this and the following propositions in mind:

- saving is a sine qua non for investment;

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[147]*Economic Report of the President*, 1997, p. 95.

[148]*Ibid.*, p. 96.

[149]See, for example, "Energy and Productivity Growth," Prepared Statement of Dale W. Jorgenson, Hearings before the Joint Economic Committee, Congress of the United States, May 28 and May 29, 1980, U.S. Government Printing Office, Washington, D.C., 1980, p. 47. This conception of the determinants of economic growth is consistent with the neoclassical model of aggregate production and distribution. The model allows for both "neutral" and "biased" technological change. See, for example, C. E. Ferguson, *The Neoclassical Theory of Production and Distribution.* Cambridge: Cambridge University Press, 1969, esp. Chapters 11 and 12.

- the growth of the labor input is hindered by a decline in the growth rate of the civilian labor force,[150] and by a steadily increasing payroll tax. Whatever else is said about it, the payroll tax is a tax on labor;
- it follows that faster economic growth will be increasingly reliant upon the growth rates of physical capital and of productivity; Yet
- multiple taxation and high marginal tax rates discourage work effort, saving and investment–in both nonhuman and human capital. This, in turn, reduces productivity growth.[151]

These considerations suggest that attention must be paid to the inefficiencies inherent in the tax code. At the most rudimentary level, there is no economic justification for the multiple taxation of income. Income should be taxed only once. At another level, the tax wedge between the value of output that an additional unit of labor produces and the after-tax wage workers receive should be reduced. The same is true of the tax wedge between the pre-tax return on investment and the after-tax return on saving. The guiding principle is easily stated:

> In general, a tax characterized by a broad base and a low tax rate will cause less distortion of economic decision making than one with a

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[150]The growth rate of the civilian labor force slowed from 2.6 percent during the 1970-80 period to 1.4 percent between 1980 and 1996. See *Economic Report of the President,* 1997, p. 338.

[151]See Joint Committee on Taxation, *op.cit.*, p. 9. For a discussion of the effect of tax rate changes on labor supply, taxable income, and capital gains realizations, see Martin Feldstein, "Behavioral Responses to Tax Rates: Evidence from the Tax Reform Act of 1986," American Economic Association Papers and Proceedings, May 1995. For a brief discussion of the relationships among tax rates, investment and productivity growth, see *Economic Report of the President*, 1987, p. 93. Finally, for discussions of the stimulative effect on saving of IRA [and 401(k)] programs, see R. Glenn Hubbard and Jonathan S. Skinner, "Assessing the Effectiveness of Saving Incentives," Journal of Economic Perspectives, Fall 1996. See also James M. Poterba, Steven F. Venti, and David A. Wise, "How Retirement Programs Increase Saving," Journal of Economic Perspectives, Fall 1996.

> narrower base and higher rates that raises a similar amount of revenue.[152]

Attention to this efficiency standard, and to the elimination of multiple taxation of income, will both enable the economy to grow faster and expand economic freedom.

"Efficiency" is not, however, the only economic standard by which to assess tax policy. "Fairness" and "simplicity" are equally important.[153] Fundamental tax reform must take into account each of these standards. Fortunately, the relationships among the standards are symbiotic. While efficiency implies low tax rates and a broad tax base, "fairness" contemplates impartial treatment of taxpayers.[154] For its part, "simplicity" is irreconcilable with the proliferation of arcane tax code provisions.

Lower tax rates and a broader tax base are reconcilable with fairness and simplicity. Simply stated, lower tax rates and a broader tax base are consonant with a systematic effort to eliminate preferential tax code provisions and, *pari passu*, to institutionalize a simpler tax code. The essential point is, however, that more than faster economic growth is at stake. As President Clinton's Council of Economic Advisers has observed, "... the perceived fairness ... of a tax system is also key to its acceptance by the public...."[155] Unfortunately, there is growing evidence that the tax code–and fiscal policy generally–is perceived to be unfair.[156] This perceived unfairness does not simply erode the public's propensity toward tax compliance; it is corrosive of the moral authority of government. If *The Wall Street Journal* is correct, that "... democracy is a

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[152]Council of Economic Advisers, *Economic Report of the President,* February 1996, p. 85.

[153] *Ibid.*, p. 84.

[154]For a discussion of fairness or justice as impartiality see John Rawls, *A Theory of Justice*, Cambridge, MA: The Belknap Press of Harvard University Press, 1971, esp. pp. 11-17. See also Daniel M. Hausman and Michael S. McPherson,"Taking Ethics Seriously: Economics and Contemporary Moral Philosophy," Journal of Economic Literature, June 1993, pp. 671-731.

[155]*Economic Report of the President*, 1996, p. 84.

[156]See, for example, Joe Klein, "Stalking the Radical Middle," Newsweek, September 25, 1995, and George Melloan, "Maybe the Beltway Just Doesn't Get It," *The Wall Street Journal*, February 5, 1996.

compact of trust between the people and their leaders,"[157] then a tax code perceived as unfair and needlessly complex is itself a threat to democracy.

V. A MENU OF REFORM OPTIONS

Efficiency, fairness and simplicity are the economic standards which should guide the formulation of tax policy. The historical record shows, however, that insufficient attention has centered on these evaluative criteria. The discussion in section II demonstrates that tax code provisions have proliferated, taxpayers have not been treated impartially, and a systematic bias against saving and investment persists. Given the widely acknowledged and growing need for more saving and investment (section IV), the multiple taxation of income is not simply inefficient; it is incongruous. There is, for example, no economic justification for a tax on dividends paid out of corporate earnings which have already been taxed. Neither is there an economic justification for a death tax; a tax on assets whose associated income streams have already been taxed at least once. And, in a non-zero inflation rate environment, there is no economic justification for the taxation of illusory, inflation-driven capital gains.

As has been emphasized (section IV), the relationships among the efficiency, fairness and simplicity standards are symbiotic. Whether achieved through major or incremental tax code reform, movement in the direction of lower tax rates and a broadening of the tax base will not simply reduce distortions in economic decision-making.[158] By definition, if accompanied by a peeling away of the multiple layers of taxation, it

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[157]Editorial, "Does Character Matter?," *The Wall Street Journal, August* 7, 1996.

[158]It is well known that the magnitude of the distortion is associated with the magnitude of the marginal tax rates embedded in the tax code. It follows that "one should attempt to design tax systems with low marginal tax rates." See Joseph E. Stiglitz, *Economics of the Public Sector, Second Edition*, New York: W. W. Norton & Company, 1988, p. 607. The essential point is that inefficiencies or distortions in economic decision-making arise when taxes change the relative prices of economic activities such as consumption and saving or work effort and leisure. Other things equal, the larger the change in relative prices [for example, as a result of an increase in a marginal tax rate], the larger the resulting distortion or deadweight loss. See Stiglitz, *Economics of the Public Sector, Second Edition*, p. 441, and Harvey S. Rosen, *Public Finance, Third Edition*, Homewood, Illinois: Richard D. Irwin, Inc., 1992, p. 314.

will make the code simpler and fairer. Equally important, movement toward lower tax rates and the elimination of multiple taxation of income may both reduce the demand for preferential tax treatment and encourage tax compliance.

An efficient, fair and simple tax code is achievable. One option is the once-and-for-all institutionalization of a single tax rate which applies to all income–and that taxes all income only once. An alternative is to contemplate incremental improvements in the tax code. Examples of such improvements include:

- permanent reductions in the number and levels of income tax rates,
- increases in the Individual Retirement Account [IRA] deduction ceiling,
- increases in the eligibility limits for IRA contributions,
- allowance for penalty-free IRA withdrawals for medical care, education and other needs,
- reduction in the capital gains rate–ideally to zero,
- expansion of the capital gains exclusion for long-term investments; at minimum, the value of gains subject to capital gains taxation could be indexed,
- elimination of death taxes or, at minimum, indexation of the estate tax exemption,
- elimination of "excess distribution" and "excess accumulation" levies, and
- elimination of tax provisions designed to benefit targeted individuals, firms or industries.

The list is not exhaustive. It is merely heuristic. It is intended to be suggestive of the directions in which tax policy might be directed in an environment in which revenue growth is up, and outlay growth is down. In this environment tax policy should be shaped by explicit attention to economic evaluative criteria.

APPENDIX

About the Author: TIMOTHY P. ROTH

Dr. Timothy P. Roth is currently the A.B. Templeton Professor and Chairman of the Department of Economics and Finance at The University of Texas at El Paso.

He served as a consultant to President Reagan's Cabinet Council on Economic Policy, as Executive Director of President Reagan's Steel Advisory Committee, and as Senior Economic Advisor in the Office of former Secretary of Commerce Malcolm Baldrige. Previously he served for two years as Senior Economist for the United States Congress, Joint Economic Committee.

On March 6, 1997, Governor George W. Bush nominated Dr. Roth for membership on the Texas Growth Fund Board of Trustees. Dr. Roth's appointment was confirmed by the Texas Senate on March 26, 1997.

TREASURY DEPARTMENT'S ESTIMATES OF TAX CHANGES: A REVIEW AND ANALYSIS

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TREASURY DEPARTMENT'S ESTIMATES OF TAX CHANGES: A REVIEW AND ANALYSIS

In recent decades it has been the practice of government revenue offices to estimate the effects of a change in tax law upon various income groups. To perform this distributional analysis, households must first be assigned to particular income groups on the basis of their income levels. Taxpayers might expect that such estimates would use the same familiar income measure they use on their own tax returns. Use of an unfamiliar income measure to classify taxpayers could be misleading because it would be like comparing apples and oranges. For example, tax benefits provided to middle class taxpayers might appear as if they were diverted to upper-income taxpayers. Nonetheless, this is the effect of the methodology currently used by the U.S. Department of the Treasury.

The statistical evidence reviewed here leads to several conclusions. First, the Treasury's income statistics considerably overstate income levels for most households, make middle class taxpayers appear to be "richer" than they themselves would recognize, and thus can generate misleading results. Second, the contention that there would be a significant shift in the tax burden away from the top income earners under the congressional tax legislation is factually incorrect. Although the Treasury has failed to provide relevant information on this point, reconstruction of the Treasury tax burden tables by the Joint Economic Committee (JEC) demonstrates that the tax shares of each income group before and after the tax reduction are unchanged.

FAMILY ECONOMIC INCOME

The Treasury income concept differs greatly from the commonly used adjusted gross income (AGI) concept used by taxpayers on their tax returns. For example, the Treasury's Family Economic Income (FEI) concept adds to income imputed rental value of owner-occupied housing, fringe benefits, most non-taxable cash transfer payments, inside build-up of IRAs and pensions, and other items.[111] The central

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[159]There are few sources of information on the Treasury methodology. See James R. Nunns, "Distributional Analysis at the Office of Tax Analysis," in

problem is that when the Treasury releases a table on projected changes in tax burdens by income group, it is natural for the public to view it in the context of commonly used income tax measures. Nonetheless, when this kind of Treasury table is seen in newspapers or TV news by millions of taxpayers, they are not aware that the table is based on an income definition few have heard of and even fewer understand.

Analyzing FEI's impact on a specific income level is difficult because FEI departs so radically from other income concepts. One approach used below is to compare FEI income levels at a specific point in the income dispersion to a comparable point in other income data. For example, the income levels at the 20th, 40th, 60th, and 80th percentiles can be estimated using the Internal Revenue Service (IRS) tax return data[112] and compared with the corresponding points in the FEI data using the quintile boundaries disclosed by the Treasury. As can be seen in the table, the overstatement of income under FEI ranges from 68 to 95 percent.

Treasury Overstatement of Income

Percentile	Tax Return Data (AGI)	FEI	% Overstated
20th Percentile	$8,701	$16,950	94.80
40th Percentile	$18,363	$32,563	77.33
60th Percentile	$31,866	$54,758	71.84
80th Percentile	$55,540	$93,222	67.85

Source: U.S. Department of the Treasury and JEC calculations

and Susan Nelson, "Family Economic Income and Other Concepts Used in Analyzing Tax Reform," in *Compendium of Tax Research*, Office of Tax Analysis, U.S. Department of the Treasury, Washington, D.C., 1987.

[112] Internal Revenue Service, *Statistics of Income Bulletin*, Winter 1996-97, 1997, p.147.

Inclusion of Households without Tax Liability

Another major problem results from the fact that the Treasury data include many millions of non-filers with no income or payroll tax liability, generally for legitimate reasons sanctioned by tax policy. In addition, there are millions of households who do not pay taxes and also rely on federal and state public assistance. Common sense might question whether it is appropriate to include those without tax liability in an analysis of income tax changes.

Since most of these non-filers without tax liability will be assigned to the bottom quintiles, the predictable outcome is that any income tax reduction will not appear to provide significant benefits to low income households. Thus, the Treasury method does not really analyze the effects of tax changes on taxpayers, but on taxpayers and non-taxpayers alike. In addition, despite the term "***Family*** Economic Income," many of these non-filers actually are non-family households -- that is, single persons. Thus it would not be surprising that an income tax cut with a child tax credit provided much larger average benefits to taxpaying families than to those who are non-filers without children who are disproportionately assigned to the bottom fifths. The larger relative presence of non-filers and single persons in the bottom quintiles means that the average benefits of an income tax reduction in a distribution table will appear to be lower than they otherwise would be.

Furthermore, the addition of many millions of non-taxpayers at the bottom of the income range ratchets up the relative position of taxpayers in the income distribution. For example, millions of taxpayers who were in the fourth quintile are pushed up into the top fifth of households. In other words, the Treasury approach increases taxpayer income in relative as well as in dollar terms.

Family Economic Income (FEI) Is Unfamiliar to Most Taxpayers

In sum, given the context of a discussion on tax policy, most citizens would refer to the income concept used on their tax return, which is AGI. Estimates of tax effects based on FEI cannot be understood in light of AGI because they are very different concepts. Only a very small group of academic specialists outside of Washington would have any familiarity with FEI, and they can in no way be regarded as representative of the general population. When the Treasury attempts to frame a discussion on tax changes using an arcane income concept that greatly differs from the income concept actually

used by all taxpayers on their tax returns, it is certain to mislead many about the impact of pending tax legislation.

As discussed, one major problem in distributional analysis under FEI is that its overstatement of income levels can produce misleading results. For example, the Treasury Department recently released a table stating that 67.9 percent of the benefits of a pending tax bill would be received by those in the top quintile, taxpayers earning $93,222 or more[113]. However, the comparable point in the IRS data is reached at $49,150 in 1994 dollars, or about $55,540 in adjusted 1998 dollars; these taxpayers in the top fifth pay 74 percent of personal income taxes. Thus tax benefits that appear to be targeted at taxpayers with incomes over $93,222, commonly supposed to be a very small elite group, actually would benefit a broad group of middle class taxpayers who bear most of the income tax burden. These middle class taxpayers only appear to be "rich" by the inflation of their income under the Treasury's methodology.

TAX SHARES UNCHANGED BY CONGRESSIONAL TAX REDUCTION LEGISLATION

The selective release of a limited amount of data on tax changes by the Treasury leaves the impression that the congressional tax legislation is skewed. However, data on the tax changes are meaningful only in the context of the relationship between current and future tax payments, and this information was not released by the Treasury Department. Since the Treasury has failed to release tax data that would permit the tax changes to be viewed in this context, the JEC has used a mathematical technique to reconstruct the Treasury data base. The results of this JEC analysis put the Treasury data on the tax reduction in an appropriate context. The JEC analysis reconstructed the Treasury data both by income quintile and by income class.

Graph 1 presents the tax shares by income quintile (each quintile represents one fifth of households). **As can be seen, the tax share of the top fifth is the same before and after the tax reduction, at 63 percent. Likewise, the tax shares of the bottom and middle fifths are unchanged by the tax reduction.** Note that the bottom fifth pays 1 percent of the tax burden, while the next to lowest quintile assumes 4 percent of this burden, with or without the tax legislation. In other

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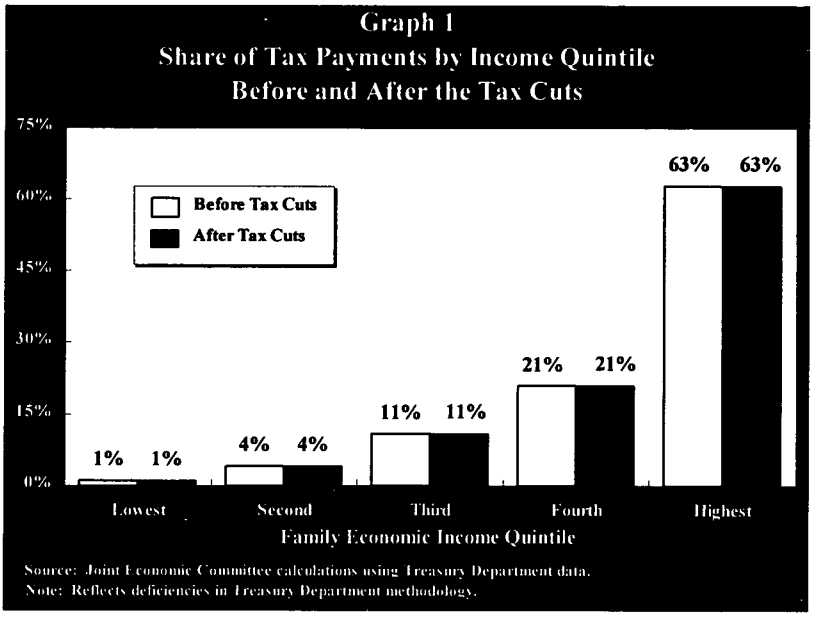
[113] Letter from Treasury Secretary Robert Rubin to Ways and Means Committee Chairman Bill Archer, dated June 11, 1997.

words, far from redistributing the tax burden as charged, the congressional tax bills leave it unchanged. It is also worth noting that with or without the tax legislation, the tax system is sharply progressive in its impact.



The results of this JEC analysis are especially remarkable given the biases in the Treasury methodology. For example, certain tax payments on capital gains that would result from lower capital gains tax rates and associated unlocking effects are ignored in the *distributional analysis*, even though they are acknowledged for the purposes of the Treasury's overall *revenue analysis.* In other words, in estimating the effects of a capital gains tax reduction, the Treasury's analyses of distribution and revenues are internally inconsistent. Furthermore, the official Treasury methodology on capital gains revenue estimates is inconsistent with three in-depth studies published by the Office of Tax Analysis (OTA) in the Treasury Department.[114]

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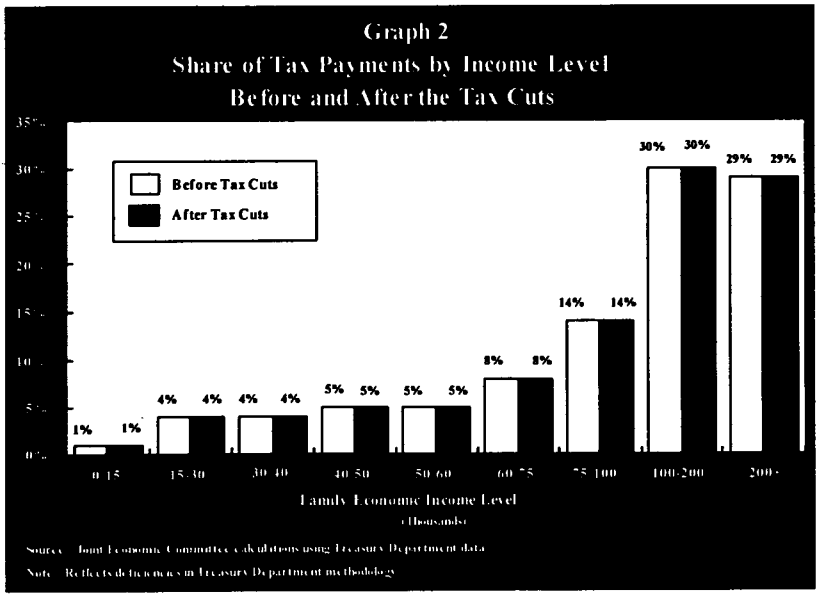
[114]Jonathan D. Jones, *An Analysis of Aggregate Time Series Capital Gains Equations*, OTA Paper 65, U.S. Department of the Treasury, 1989; Robert Gillingham, John Greenlees, and Kimberly D. Zieschang, *New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross-Section Data,* OTA Paper 66, U.S. Department of the Treasury, 1989; and Gerald E.

Furthermore, by omitting any effect on economic growth, the indirect benefits of improved economic incentives are ignored. **The reality of income mobility, documented by the JEC and Treasury for a number of years, is also overlooked.**

Graph 2 presents the tax shares by income class. Once again, there is no change in the tax shares of the various income groups before and after the congressional tax legislation is taken into account.

This graph supplies a more detailed view of the tax burden by dividing households into more groups than does the quintile breakdown. Once again, the households in the bottom group bear 1 percent of the tax burden, while those over $75,000 of FEI assume about 73 percent of the tax burden before and after the tax reduction is taken into account. As suggested previously, many of the households in this group over $75,000 of FEI are actually middle class taxpayers with much lower levels of AGI. **Once again, even according to the reconstructed Treasury data, there is *no change* in the tax shares of any income group before and after the congressional tax reduction is taken into account.**



Auten, Leonard E. Burman, and William C. Randolph, *Estimation and Interpretation of Capital Gains Realization Behavior: Evidence From Panel Data,* OTA Paper 67, U.S. Department of the Treasury, 1989.

CONCLUSION

The statistical evidence demonstrates that the Treasury Department's FEI measure significantly overstates income for most households. The result is that tax relief for many middle class taxpayers appears as tax relief for upper-income taxpayers.

A JEC reconstruction of an undisclosed set of Treasury data shows that, although tax relief is provided for all income groups, their shares of the tax burden are unchanged before and after the congressional tax reduction is taken into account. The results of this JEC analysis demonstrate the misleading effects of an incomplete release of data and illustrate why the Treasury Department should be more open and less selective in providing information to the public.

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