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WHERE'S THE GROWTH? PRESIDENT BUSH'S 7-POINT PACKAGE IS TOO WEAK; THE HOUSE DEMOCRATS' ALTERNATIVE IS ANTI-GROWTH

In his State of the Union Address, President Bush presented a program of tax and other policy changes intended to overcome the recession and promote economic growth. At the President's request, a shortened list of his tax proposals was introduced in the Congress. The Democrats on the House Ways & Means Committee, led by Rep. Rostenkowski, quickly countered with a plan of their own. Both packages are disappointing, but for different reasons. Both are collections of ad hoc measures rather than carefully constructed programs for removing tax barriers to economic progress. The President's bill, although it has a few positive features, is much too weak; it would do little to correct government-created tax and regulatory disincentives to work and saving. The plan developed by the Ways & Means Committee Democrats is primarily redistributional; its insistence on big tax increases for upper-income individuals would further damage work and saving incentives. Its two key elements are a temporary tax reduction for the poor and middle class and permanently higher tax rates for people with larger incomes.

A growth plan, to be successful, must focus on reducing made-in-Washington barriers to production and employment. The existing tax system, particularly the income and payroll taxes, raises the cost of working. The corporate and personal income taxes impair America's ability to grow by penalizing saving and investment relative to immediate consumption. Government regulatory policies increase production costs, diminishing the economy's capacity to produce goods and services.

Several good ways to mitigate tax biases against saving and investment would be to reduce or eliminate the capital gains tax, to ease restrictions on individual retirement accounts so more households will use them, to speed up capital cost recovery allowances so businesses can deduct capital expenses closer to when the costs are incurred, to replace the passive loss limitation rules with other rules that hit only abusive tax arrangements, and to downsize if not abolish the ill-conceived alternative minimum tax. A powerful way to encourage work effort, particularly by low- and middle-income individuals, would be to roll back the 1990 social security tax increases.

The reforms should be permanent, not temporary. Temporary measures bring no lasting improvements in production or employment. They invite a stop-and-go economy in which any apparent gains today are only borrowed from the future. Permanent measures, on the other hand, encourage quick and continued increases in work effort and investment. If tax biases against saving and investment were moderated, for example, production and employment would begin rising almost immediately as many more investment projects suddenly became attractive. The benefits would build through time: the progressively larger and more modern stock of capital would sustain improvements in productivity, international competitiveness, job creation, real wages, and living standards.

A frequent objection to permanent tax reforms is that they lose too much revenue. But the official revenue estimates ignore the favorable impact of a

less obstructionist tax policy on economic growth. That is a devastating omission because economic growth is the single most powerful generator of added tax revenues. The emphasis on tax revenues also amounts to saying that guarding government tax collections is more important than looking after the well being of the American people.

The President's "Fast-Track" Growth Initiative

The shortened Bush package appears to have several helpful provisions -- until one notices the severe restrictions contained in the fine print.

Capital Gains The highlight of the plan is a capital gains exclusion of up to 45 percent, which would reduce the top effective capital gains tax rate to 15.4 percent. This would be an excellent reform if it applied to all capital gains, if it provided for a single, short holding period, if the exclusion were larger, and if the hidden inflation tax on asset sales were eliminated by indexing the measurement of capital gains for inflation. A close reading of the provision, however, reveals many restrictive stipulations. No capital gains realized at the corporate level would be eligible for the exclusion. No collectibles would be eligible, either. The amount of the exclusion would depend on how long assets are held, in effect substituting an arbitrary tax law provision for the signals of the market place as to the optimal time to hold assets. The exclusion of most capital gains would be a "preference item" for minimum tax purposes, which would throw many people with substantial capital gains into the alternative minimum tax; that would peg their effective capital gains tax rate at 24 percent, which is almost 10 percentage points above the supposed top rate of 15.4 percent. (If these people are in the broad income range over which the AMT exclusion is phased out, $150,000 to $310,000 for couples, the AMT would push their marginal tax rate on capital gains to 30 percent.) Expanded depreciation recapture rules would further limit the scope of the exclusion; on some real estate it would actually raise the top tax rate from 28 to 31 percent.

Passive Loss Limitation Rules The Bush plan scales back the passive loss limitation rules for people in the rental property business. However, the relief would be limited to the small number of real estate dealers who themselves developed the properties that they now actively manage. Real estate dealers should never have been subject to the passive loss rules, and all of them, not just a few, should be removed from the rules immediately. More fundamentally, the passive loss rules are artificial, arbitrary, very complicated, and conflict with the proper definition of income. It is disappointing that the Bush plan does not call for their full and immediate repeal. Better targeted methods of dealing with abusive tax shelters could and should be devised.

Investment Tax Allowance Another provision, the investment tax allowance (ITA), which is not to be confused with the old investment tax credit, would provide an additional 15 percent first-year depreciation allowance for assets purchased between February 1 and December 31, 1992 and placed in service by June 30, 1993. Ideally, businesses should be able to deduct the costs of their production facilities when the costs are incurred. That calls for either expensing (the immediate write-off of capital expenditures) or a schedule of cost recovery allowances with a discounted value equal to the cost of the facilities. The ITA, therefore, is a very modest step in the right direction.

The ITA, however, is undercut by severe restrictions. Because it would apply only to assets acquired during an extremely narrow time window, it would exclude most big-ticket investment projects, which usually have long planning and development horizons. Moreover, since the tax treatment of investment expenditures would soon revert to its old status, any rise in investment would be short lived and be offset for the most part by a fall in subsequent investment. Also, what little effect the ITA might have would be diluted because the additional 15 percent first-year allowance would be subtracted from an asset's depreciable basis, causing

regular depreciation allowances to be lower. What is needed is not a quick-fix gimmick but basic, permanent reform of the capital cost recovery provisions in the income tax.

Alternative Minimum Tax The Bush plan makes a modest change in the corporate alternative minimum tax (corporate AMT), replacing two special depreciation schedules with one. Although this is better than nothing, accelerated depreciation should be removed entirely as an AMT preference item. The depreciation schedules for ordinary income tax purposes are themselves too slow, not too rapid. Adding back a portion of those allowances to the AMT tax base as a preference item is unwarranted and has the perverse effect of subjecting to the AMT many companies that invest heavily in the future or have low current profits, particularly if both occur simultaneously. Because the complicated, politically motivated AMT violates sound tax principles, a bolder reform would be to eliminate both the corporate and individual AMTs altogether.

First-Time Home Buyer Credit The plan's most talked about feature, next to the capital gains rate cut, is a tax credit of up to $5,000 for first-time home buyers. The credit would be temporary. A first-time home buyer would qualify by buying a home between February 1 and December 31, 1992 and reaching settlement by June 30, 1993. The home buyer could claim half the credit against 1992 taxes and the other half against 1993 taxes.

To be sure, the recession is closely associated with the precipitous downturn in the real estate sector of the economy, brought about by the punitive provisions in the 1986 Tax Act. But long-term economic growth, the appropriate concern of tax policy, is not served by hustling young people into making their first home purchase. Subsidizing home purchases is not an effective means for reducing tax barriers to growth, any more than subsidizing the consumption of any other products or services. The Administration is operating on the false assumption that the economy's main problem currently is inadequate consumption demand. It is amazing that the Administration is worried about underconsumption when America has consistently displayed one of the lowest saving rates in the world.

At another level, the tax subsidy would misfire because it would not actually increase overall demand. If the government finances the credit by raising other taxes, Americans would still have the same number of after-tax dollars; if the government resorts to deficit financing (more borrowing from the public), the reduction in people's taxes would be sopped up by an increase in their lending to the government. The credit also fails to have any beneficial effect in lowering the cost of producing housing.

Pension Fund Investments At present pension fund managers have to be very careful as to how they structure their real estate investments lest they inadvertently run afoul of the unrelated business income tax. An element of the Bush plan would give them greater freedom to make real estate investments. This idea is noncontroversial, since it would have virtually no revenue cost, and a definite plus, since it would both give pension funds more flexibility and provide a little support to the battered real estate market. It is far from clear, however, whether enactment of this proposal would have any substantial effect on the real estate market.

Individual Retirement Accounts The Administration would also allow first-time home buyers to withdraw up to $10,000 from their individual retirement accounts (IRAs) without incurring the usual early withdrawal penalty. This feature looks more like a political goody than a serious attempt to strengthen the economy. The early withdrawal penalty is a major shortcoming in the IRA, so any occasion for limiting its applicability has some advantage.

In his State of the Union Address, the President outlined a much more forceful IRA provision (creating a new class of IRAs), but it is not included in this stripped-down tax package. That is regrettable. Another pro-growth strategy would be

to rescind the unpopular IRA restrictions enacted in 1986. IRAs lead to more saving and, consequently, higher productivity and employment in the future because they remove some of the income tax's bias against saving.

Absence of Increased Child Exemption Much attention has been called to the absence from the "fast-track" package of the recommendation the President made in his State of the Union Address of a $500 increase in the personal exemption for children. It appears from the text of the speech, however, that the President intended all along to include the increased child deduction in a second tax bill. In any case, the additional deduction would not be a spur to economic growth. In terms of supply, it would not reduce most peoples' marginal tax rates and, therefore, would not change their incentives to work and save. (To be sure, the added deduction would drop a small percentage of taxpayers into a lower tax bracket, with beneficial incentive effects.) With regard to demand, it would, on net, be a wash. People would either pay more to the government in other taxes or they would lend more to the government due to greater government borrowing resulting from a larger federal budget deficit. The increased child deduction should be debated, instead, on the basis of whether taxpayers with children deserve relief relative to the rest of the population.

The House Democrats' Alternative

The Democrats on the House Ways & Means Committee have produced a substitute that, after offering a few perfunctory bows to growth, concentrates on redistributing tax liabilities. The package has also become a vehicle for much other legislation, including extension of a number of expiring tax provisions, tax simplification measures, and various other tax proposals. The growth oriented provisions are too modest to be very useful. The income redistribution provisions are similar to ones that Congressional Democrats have floated on several prior occasions. In the context of a package that claims to be supportive of economic growth, they are mischievous because their net effect would be to intensify tax biases that interfere with growth.

Temporary Income Tax Credit for Portion of Payroll Taxes At the center of the package is what is described as a middle-class tax cut. This provision would allow individuals to claim a refundable income tax credit for 20 percent of their social security tax payments, up to a maximum credit of $400 for joint filers and $200 for single filers. The credit would apply only in 1992 and 1993. During these two years, the credit would reduce the effective tax rate on approximately the first $26,000 of wage income for couples and the initial $13,000 of wage income for singles. For people whose wage income is below the cap, the credit would temporarily improve work incentives by reducing the marginal tax rate on their wages. The majority of employees, though, have higher wage and salary incomes, and they would be at the credit maximum. For them, the credit would not lighten their tax rate on additional work effort and, hence, would afford no favorable incentive effects.

Another result of the caps is that the credit's tax relief would go primarily to lower-income individuals rather than the so-called middle class. The credit would be much more helpful to growth if it applied to all wage income (thereby lowering the marginal tax rates of most individuals) and were permanent (so it would continue to provide support). A straight-forward payroll tax cut, such as that proposed by Senator Kasten, would better serve the economic growth goal.

The credit would not stimulate growth by increasing aggregate consumption demand. First, more consumption does not promote growth. Second, the credit would not significantly affect overall demand since it would be offset either by increases in other taxes or higher government borrowing from the public.

Permanent Rate Increases for Higher-Income Individuals To offset the revenue loss resulting from the credit, the House Democrats' bill would

increase tax rates for upper income individuals. A new bracket with a 35 percent statutory rate would apply for joint filers with taxable incomes above $145,000 ($85,000 for single filers). In addition, the bill would impose a 10 percent "millionaires" surtax. And because this surtax would apparently not be indexed for inflation, inflationary bracket creep would push progressively more individuals into it over time.

The House Democrats bill would also raise the individual AMT tax rate from 24 to 25 percent. Because the AMT tax rate is already so close to the regular tax rate, this increase would push many more taxpayers into a complicated, arbitrary, alternative tax system that lacks any basis in good tax theory. (There would also be a "millionaires" AMT surtax of 2.5 percent.) These marginal rate increases are a direct threat to economic growth. By magnifying tax biases against work, saving, and investment, they would induce people -- specifically the most productive people with the greatest capacity to save and invest -- to work less, save less, invest less, and spend more time thinking up other ways to reduce their taxes. Soak-the-rich tax increases exact a heavy price from everyone by quickly cutting output from what it would be otherwise and then slowing the economy's subsequent growth.

The House Democrats' plan includes several other growth depressants in a section of the package labelled "Require Wealthy To Pay Their Fair Share". One proposal is to extend for two years the itemized deduction limitation and personal exemption phase out, both of which are now scheduled to expire in 1995. The limitation and phase out are punitive, complicated, hidden, and contrary to all sound tax principles. Moreover, they discourage work and saving by raising the marginal tax rates of the directly affected taxpayers. Another provision would raise the estimated tax payments that taxpayers would need to make in order to be sure of avoiding underpayment penalties. A provision with topical political appeal would bar a corporation from claiming a business expense deduction for any compensation it pays that exceeds $1 million per executive. This is ham-fisted government intervention in a private business matter that ought to be left up to corporate directors and stockholders. (This limitation also violates sound tax principles because it would create another category of double taxation: corporations and their executives would both be paying income taxes on compensation in excess of $1 million.)

Additional Tax Increases The real estate industry, still reeling from the 1986 Tax Act and the government's response to the S&L fiasco, would receive another hard kick. The House Democrats' plan would lengthen the depreciation period on commercial real estate from 31.5 to 40 years (almost a one-third increase) and on most residential real estate from 27.5 to 31 years. As though the real estate and construction industries did not have enough problems already, this is guaranteed, if it becomes law, to wipe out many of the project now on the drawing boards.

Borrowing a bad idea from the President's 1993 Budget, the House Democrats would impose a whopping tax increase on securities firms (about $2.5 billion over 6 years) by forcing them to value their inventories of securities at market value rather than the lower of historic cost or market value. Another bad idea from the President's Budget would extend the motor fuels tax, most of which is earmarked for the Highway Trust Fund, to the diesel fuel used by motorboats. This excise tax has no justification and selectively discriminates against the producers and consumers of a particular activity.

Other Provisions Although thoroughly overshadowed by the harmful provisions, the package also contains an assortment of tax changes that would either be benign or mildly helpful. In place of the Administration's capital gains rate cut, the House Democrats would index for inflation newly acquired assets, allow a 50 percent exclusion on a narrow class of newly issued stock in small companies, and index for inflation the $125,000 one-time capital gains exclusion available to home sellers who are at least age 55. The indexing provision is good, but it would be better if it

covered all assets. Further, since the capital gains tax is undesirable, indexing should supplement, not substitute for, a rate cut.

The bill would increase the expensing allowance now available to small businesses from $10,000 to $25,000, but only for two years and only for small businesses. Another provision follows the President's recommendation for a temporary investment tax allowance. The bill also follows the President's recommendation to replace the corporate AMT's two special depreciation schedules with one. Still another provision would relax the passive loss limitation rules for real property investors. It is somewhat broader than the President's proposal but much narrower than it should be and limited to current properties. The plan also goes slightly beyond the President's package in easing the rules for pension fund investments in real estate. The President's suggestion that first-time home buyers be permitted to make penalty-free IRA withdrawals would be expanded to cover some medical and educational expenses.

An earlier draft of the plan had called for permanent rate cuts of 1 percentage point in both the regular corporate income tax and corporate alternative minimum tax. Many House Democrats opposed these cuts, however. Accordingly the bill was revised to change these pro-growth reforms from permanent to temporary (2 years) and then revised again to scuttle them entirely.

A hodge-podge of items are based on possibilities mentioned in the President's State of the Union Address but not included in the 7-point package. There would be a tax credit for interest on student loans. (The President had mentioned a deduction.) A number of expiring tax provisions, including the R & D credit, the targeted jobs credit, the low-income housing credit, and mortgage revenue bonds, would be extended permanently. (The President had suggested a permanent R & D credit and temporary extensions for most of the rest.) Several expiring provisions would be extended temporarily. The "luxury" taxes on boats, airplanes, jewelry, and furs would be repealed, and that on autos would be inflation indexed. (The President had only urged repeal of the boat and airplane excises.) The House Democrats also throw in a scaled-down version of the enterprise zone initiative that President Bush mentioned.

Conclusion

Neither the President's package nor the one from the House Democrats warrants being called a growth package. The President's proposals would give some modest support to economic growth, but much less than could be obtained from a well designed, coherent package that recognized the central role of incentives in economic activity. The President's plan is overly concerned with jump starting the economy and incorrectly focuses on aggregate demand. It does not concentrate on work and saving incentives and basically disregards the long run. The House Democrats' plan, on the other hand, is a threat to growth. Although it has some provisions that could be helpful if they were greatly expanded and made permanent, the plan is top-heavy with tax rate increases that would further undermine work and saving incentives. If adopted, the House Democrats' plan would be another government-generated drag on economic growth.

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