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THE SENATE FINANCE COMMITTEE'S TAX BILL BLOCKS RECOVERY AND GROWTH

By a straight party line vote, the Democrats on the Senate Finance Committee have approved a tax package that places income redistribution above economic growth. The plan would establish a new, top statutory tax bracket of 36 percent and further raise marginal tax rates by means of a 10 percent "millionaires" surtax". The bill's main political treat is an expensive, nonrefundable child credit that would decrease total taxes for most people with children but have mixed incentive effects, reducing marginal tax rates for many lower-middle income taxpayers while substantially raising tax rates for many people in the $50,000 - $70,000 adjusted gross income range. Although the bill includes several provisions that, taken by themselves, would modestly lessen government-created tax barriers to economic growth, its overall thrust would be a setback for the economy.

The President's 7-Point Plan

The immediate impetus for the Finance Committee Democrats' action is the President's tax plan and his demand for quick Congressional action. Reacting belatedly to the prolonged recession and three years of meager economic growth, President Bush used his State of the Union Address to call for quick-fix and pro-growth policy initiatives. Unfortunately, the 7-point tax plan the House Republicans extracted from the President's package was more show than substance. Several of these proposals identified areas of the tax code that conflict with sound tax principles and that strongly discourage saving and investment -- the capital gains tax, the alternative minimum tax, the passive loss limitation rules, and cost recovery schedules that bar investors from deducting capital costs when incurred. But to minimize the government's revenue loss, the Administration so limited the provisions as to strip them of most of their potency. The President's bill was rejected by the House.

The key to a successful, pro-growth tax package is the reform of tax policies that are now slowing down the economy. The current income tax system weakens America because it penalizes people when they work (earnings from work effort are taxable while the rewards of non-monetary pursuits are tax free) and it taxes people more heavily when they save than when they consume. People naturally respond to these tax disincentives by working, saving, and investing less than otherwise. The result is that the nation produces less and has less income than if the tax laws less penalized these efforts. In addition, future increases in productivity, international competitiveness, job opportunities, real wages, and living standards are smaller than otherwise because the tax tilt against saving and investment reduces capital formation, which is a primary contributor to economic growth. The President's bill did not effectively address the anti-growth elements in the existing tax system.

The House Bill

The tax bill devised by House Democrats and passed by the House would impede economic growth. The thrust of the bill is income redistribution. The legislation would permanently increase tax liabilities for higher-income individuals by adding a fourth statutory rate bracket of 35 percent, a 1 percent increase in the individual alternative minimum tax, and a 10 percent "millionaires" surtax. All of these measures would permanently increase marginal tax rates for the very people who tend to be the most productive and have

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the greatest capacity to save and invest. The bill would provide "middle-class relief" in the form of a temporary income tax credit, capped at several hundred dollars, for part of the employee-share of payroll taxes. Although this would temporarily reduce the marginal tax rate for a relatively small number of lower-income taxpayers, it would not alter the tax rate facing most people on an additional dollar of income. It would not, therefore, ease disincentives for working and saving.

The principal positive proposals in the bill call for reducing the capital gains tax rate on an extremely narrow category of stock and indexing the basis of newly acquired assets for inflation. On balance, the House bill would have perverse incentive effects.

The Senate Finance Committee's Bill

The bill approved by the Senate Finance Committee, like the House bill, emphasizes income redistribution, although the bills differ in their specifics. Senate Finance Committee Chairman Bentsen served notice that economic growth had been shoved aside as the bill's objective when he said, "Today we can start putting fairness for middle-class American families back into our tax code." This is a blatantly divisive, an appeal to class envy. One group, containing the majority of voters, is being told (falsely, as it turns out) that it can pay less taxes by forcing another group to pay more. The group that would pay more under the bill already pays a vastly disproportionate share of the total income tax bill. The Senator did not explain why it is "fair" to make these people pay still more taxes while people who have lower tax liabilities should pay less.

To be sure, many provisions and features of the income tax are unfair, especially those that impose differentially heavier taxes on the rewards for saving and investment. Many of these biases also impede economic growth. But the Finance Committee bill addresses few of these problems directly and, by raising marginal tax rates for upper-income individuals, would make the biases more intense.

<u>Higher Tax Rates</u> By far the largest item in the Finance Committee bill (under the heading "Proposals To Ensure High-Income Taxpayers Pay Their Fair Share") is the establishment of a fourth statutory tax bracket of 36 percent, which would begin at a taxable income of $175,000 for couples ($150,000 for single filers). This is similar to a provision in the House bill. The rate bracket would begin at a higher income level than in the House bill but would be 1 percent higher when it did kick in. The Finance Committee bill, like the House measure would impose a "millionaires" surtax. This would be a 10 percent surtax on taxable incomes above $1 million; for taxpayers subject to the alternative minimum tax, the surtax would be 2.4 percent. (Because the surtax is apparently not indexed for inflation, the surtax would commence at progressively lower real incomes in future years as inflation erodes the value of the dollar.) Together, the added rate bracket and the "millionaires" surtax would hike taxes by more than $50 billion over 5 years, according to Joint Tax Committee estimates.

If these increases became law, upper-income individuals would find that the tax system was taking a larger bite out of their rewards for work, saving, and investment. In other words, the Finance Committee bill would have the perverse effect of encouraging upper-income individuals to cut down on these worthwhile, productive activities by ratcheting up the tax penalty imposed on them. Although they would bear the added tax liabilities, the fall off in production and growth would be felt throughout the economy and hurt everyone.

<u>$300 Child Credit</u> The Santa Claus component of the bill is a $300 tax credit for each child under age 16. For a taxpayer in the 15 percent rate bracket, this is equivalent to an extra $2,000 personal exemption per child. (The equivalent in the 28 percent tax bracket is an additional $1,071 child deduction.) The credit would be phased out, however, for families with adjusted gross incomes between $50,000 and $70,000. For a couple with two children who claim the standard deduction, the phase out would start at a <u>taxable</u> income of under $35,000 and be completed at a taxable income of

under $55,000. The credit would be denied entirely to taxpayers without eligible children or with adjusted gross incomes over $70,000. (Because the phase-out range is apparently not indexed for inflation, it would begin at lower and lower real incomes in future years.)

People getting the credit would pay lower taxes. But except for the relatively small number whose tax liability would drop to zero because of the credit, they would not see any reduction in the tax rate they face on an additional dollar of income. Suppose, for example, that a couple earn $25,000, have two children under age 16, and claim the standard deduction. They would pay $600 less tax due to the credit, but they would remain in the 15 percent tax bracket, and any additional income would be taxed at that rate. Thus, they would have no more incentive than previously to work harder or save more.

For people in the phase-out range, the credit would produce a negative incentive effect. Suppose the couple in the example have an adjusted gross income of $60,000 (which puts them in the middle of the phase-out range) and a taxable income of $44,800. If they earn an extra dollar under current law, 28 cents of that is owed in federal income tax; they get to keep 72 cents. Under the child-credit-phase-out rules, they would also have to pay back, in effect, 3 cents of child credits (1.5 cents per child). That would effectively raise their marginal tax rate from 28 percent to 31 percent; out of a dollar of extra income, they'd get to keep only 69 cents. The increase would be to 29.5 percent if they had one child and to 34 percent if they had four children. Over the phase-out range, this provision would actually aggravate tax biases against productive activities.

Perceptions of fairness are extremely subjective; whether the credit is "fair" is subject to debate. Most taxpayers with dependent children already claim personal exemptions for them (though this exemption is phased out for taxpayers at high income levels). Many lower-income taxpayers with children now qualify for the earned income tax credit (EITC). Moreover, a separate provision of the bill would slip in an expansion of the EITC. The $300 credit would become a third device for reducing the tax liabilities of people with children. An initial question, then, is whether a larger share of tax liabilities should be shifted away from taxpayers with children and onto taxpayers without children? Further, if it is determined that taxpayers with children deserve additional relief, why should it be phased out at such low levels of taxable income? The fact that these questions have received little attention suggest that the credit is an ill-considered election year gimmick.

<u>Limitation on the Deductibility of Executives' Salaries</u> An original feature of the House bill is that a corporation could deduct no more than $1 million annually for any executive's compensation. The Finance Committee adopted this limitation. As an example of how it would work, suppose a company pays an executive $1.5 million. Under this limitation, the company could deduct no more than $1 million as a business expense; it would have to include the remaining $0.5 million in its corporate income and pay tax on it. Because the executive would be subject to personal income tax on the full $1.5 million, both the company and the executive would pay income tax on the $0.5 million subject to the limitation. This double taxation obviously violates sound tax principles. It is another example of the demagogic class warfare that has increasingly dominated tax policy in recent years. It also represents a heavy-handed effort by Washington legislators to micromanage businesses' internal affairs. The people who should decide whether executives are overpaid are not those based in Washington but corporate shareholders and directors.

<u>Longer Depreciation Period For Nonresidential Real Estate</u> Another provision that would slow recovery and inhibit economic growth is an increase in the depreciation period for nonresidential real estate by almost one-third, from 31.5 to 40 years. This item is very similar to one found in the House bill. Both are ill-advised. The real estate industry is in enough trouble -- largely because of tax shocks stemming

from the 1986 Tax Act and the government's awkward respond to the S&L crisis -- without hitting it with a new disadvantage. Indeed, if this provision further depresses real estate prices, it might end up costing the government money by raising the expense of the financial industry bailout.

Higher Taxes on Brokerage Firms' Stock Inventories A tax increase originally suggested by the Administration is to force brokerage firms to value their inventories of stock at current market value. Currently, brokerage firms have the options of valuing their inventories at cost, at market value, or at the lower of cost or market value. This is basically consistent with the options available to most businesses for valuing their inventories. The new rule would single out brokerage firms for unfavorable treatment and cost them an estimated $1.5 billion over 5 years. Besides weakening this important financial industry, the mark-to-market inventory rule would prod security forms into cutting back their inventories. That would reduce the firms' ability to buffer fluctuations in stock prices, resulting in greater stock market volatility, a change hardly conducive to stronger economic growth.

Extensions of the Itemized Deduction Limitation and the Personal Exemption Phase Out The 1990 Budget Deal arbitrarily decreed that for every $1 by which an individual's adjusted gross income exceeded $100,000, the individual would lose 3 cents of legitimate itemized deductions (subject to some exceptions). The Budget Agreement also provided for the phase out of personal exemptions for higher-income individuals. They are bad tax policy for four reasons: they are complicated; they are hidden; they are not based on sound tax principles; and by raising effective marginal tax rates, they worsen tax biases against work and saving. These limitations were scheduled to expire in 1995. The Finance Committee bill would extend them permanently.

Capital Gains The Finance Committee bill has several provisions that would to varying degrees support economic growth. Most are variations on proposals in the President's State of the Union Address or his 7-point legislative initiative. The single tax issue on which the Administration has placed the most emphasis is the capital gains tax.

The capital gains levy worsens the multiple taxation of saving and investment. Because of it, people invest too little, are reluctant to move existing funds into promising new ventures, and are hesitant to make equity investments. While the overall level and quality of investment suffer, the damage tends to be particularly great for the risky, entrepreneurial ventures activities that play such a vital role in generating new jobs and improving productivity. The Finance Committee would ease the capital gains tax but, regrettably, in an extremely complicated and limited manner.

The bill would establish a separate tax rate schedule for capital gains, with rates ranging from 5 to 28 percent. Compared to current law, the relief would be greatest for people in the current 15 percent bracket. For people now paying a 28 percent tax rate on their capital gains, no rate reduction would be provided. Besides being so complicated as to thoroughly befuddle most taxpayers, this schedule provides the least relief where the capital gains tax is doing the most damage to incentives.

Another problem with this provision is that it follows the fine print of the President's plan in treating the entire capital gain as a preference item to be included in alternative minimum taxable income. The consequence is that many people with substantial capital gains would see little if any reduction in their effective capital gains tax rate because their gains would be taxed at the 24 percent rate of the alternative minimum tax. Indeed, in many cases, the marginal rate would be higher than 28 percent. The bill also copies the President's plan in broadening the depreciation recapture provisions with respect to real property. This means that some investors in real estate would discover the tax rate on their capital gains rising to 31 percent from the current maximum of 28 percent. Other restrictions taken from the President's plan are that this

provision would cover neither collectibles nor capital gains realized at the corporate level. There would be a 2-year holding period, which is slightly more flexible than the 3 years in the President's plan. Presumably, this holding period is aimed at getting savers to lock in their investments for at least two years. The tax law, however, should not presume to tell individual investors how long it is wise to hold assets. Another provision would permit a 50 percent exclusion for capital gains derived from a very narrow category of newly issued small business stock. The many restrictions attached to this exclusion, however, would severely compromise its applicability and usefulness.

Meaningful capital gains reform needs to be much broader and less convoluted than proposed in this bill. The capital gains tax rate should be reduced and then, to prevent inflation from covertly pushing up the effective real rate, the basis of capital assets should be indexed for inflation.

<u>Alternative Minimum Tax Depreciation</u> The corporate alternative minimum tax (corporate AMT) includes two special depreciation schedules. The Administration recommended that one of them (the so-called ACE adjustment) be removed, and so does the Finance Committee. The shortcoming of these proposals is that they treat only the smallest part of the problem. No portion of the depreciation allowances found in the regular tax system should be a "preference" item for AMT purposes, period. In fact, regular depreciation allowances are too slow already. A tax system that is neutral towards capital formation would allow investors to deduct their capital outlays when they are made. The inefficient and unfair result of including a portion of regular depreciation allowances in the AMT is to push into the AMT many individuals and businesses that invest heavily in capital equipment, especially if their profits are temporarily low.

<u>10 Percent Investment Tax Allowance</u> The President's package includes an additional 15 percent first-year depreciation allowance for equipment acquired between February 1, 1992 and December 31, 1992, and placed in service by June 30, 1993. The value of the allowance is lessened, however, because it would reduce the property's basis in that and subsequent years. The Finance Committee bill includes a roughly similar provision, but the allowance is trimmed back to 10 percent. The allowance's temporary nature further restricts its value because a brief allowance provides no long-run assistance in combating tax disincentives against investment. At the least, the allowance should be permanent and substantially larger. Ideally, the tax code would permit the expensing of capital assets.

<u>Relaxation of the Passive Loss Limitation Rules for Real Estate Developers</u> The 1986 Tax Act limited the deductibility of so-called passive investment losses. Because of a quirk in how the rule was drawn, people in the real property business found that they were generally prohibited from netting losses against nonrental income. This capricious division of a business's activities into artificial subunits violates basic, long-standing tax principles. The President's bill offers only the most limited relief. The Finance Committee provision would afford somewhat less restricted relief for people in the real property business than would the President's plan but would not completely exclude such taxpayers from the reach of the passive loss provisions. A better approach would be to treat the real property business like other businesses, which are not subject to the passive loss rules. The best strategy would be to repeal the passive loss rules in their entirety and develop simpler, better directed procedures to deal with the relatively small number of abusive tax shelters.

<u>Luxury Taxes</u> The main victims of the "luxury" taxes enacted as part of the 1990 Budget Deal have been the mostly middle-class people who were producing the taxed goods. Many of those people lost their jobs or suffered reduced pay when sales plummeted. The Administration recommended repealing the taxes on boats and planes; the Finance Committee, following the House, would repeal all the "luxury" taxes except the one on higher-priced autos, which it would index for inflation. This is a positive action that might bring back a few of the

jobs indirectly destroyed by the 1990 Budget Agreement. As if it can't stand doing something right, however, the Finance Committee would replace the repealed taxes by extending the "highway" excise tax on diesel fuel to noncommercial motorboats. The new tax would kill jobs, though with less visibility and probably less virulence than the old taxes.

Individual Retirement Accounts (IRAs) The strongest feature of the Finance Committee package is a three-pronged expansion of IRAs. First, the income-based restrictions on IRA deductibility that were imposed in 1986 would be repealed. These restrictions, which kicked in at middle-class incomes, made IRAs much less appealing to many people and precipitated a dramatic decline in IRA contributions. Second, the $2,000 individual limit on annual contributions, which has been unchanged for over a decade, would be indexed for inflation. Third, the legislation would establish a new class of IRAs. With conventional IRAs, people claim a deduction for their contributions and pay tax on their gross withdrawals. The new IRAs would be prepaid: individuals would pay tax on their contributions instead of their withdrawals. This arrangement would be most attractive to people who believe their current marginal tax rate is lower than their marginal tax rate will be in the future.

In addition, the provision would waive the early-withdrawal penalty if the funds withdrawn from an IRA are used to finance a first-time home purchase, educational expenses, or medical expenses. By allowing people to have increased access to their savings when genuine needs develop, these waivers would lessen one of the major disadvantages of putting money into an IRA. Although these waivers would lead to some additional IRA withdrawals, the net effect would probably be an increase in IRA deposits because IRAs would become more attractive, especially to young savers.

Expanding IRAs would moderate one of the income tax system's biases against saving. When a person earns income and uses it for immediate consumption, the income is only taxed once. If the person saves the income, though, both the initial amount and the returns on it are taxed. The multiple taxation of the saving stream compared to the single taxation of the immediate consumption reduces the reward for saving relative to that for consuming, creating an anti-saving tax bias. A conventional IRA removes this bias with respect to the IRA saving by taxing the saving stream only once, at the point of withdrawal. The new class of IRAs would also avoid the bias, by taxing the saving stream only at the point of contribution. The bill's IRA provisions would be even better, of course, if the annual contribution limit were raised immediately and if more of the other arbitrary restrictions on IRAs were relaxed.

Pension Fund Real Estate Investments Under current law, pension fund managers must carefully structure some of their real estate investments to avoid becoming entrapped in the unrelated business income tax. These restrictions serve no valid purpose. They limit the funds' investment flexibility and consume time that fund managers could more productively spend elsewhere. The President's 7-point package would ease these restrictions, and the Finance Committee bill takes a similar path.

Extenders An assortment of generally desirable tax provisions are scheduled to expire unless renewed. These include the R&D tax credit, the targeted jobs tax credit, the orphan drug credit, the low-income housing credit, the exclusion for employer-provided educational expenses, and the qualified mortgage bond program. There is little dispute that they should be extended, and the Finance Committee bill would do so. To permit improved long-term planning, though, it would be better if some of the provisions, particularly the R&D credit, were made permanent. Also scheduled to expire is the 25 percent deduction for the health-insurance costs of the self-employed. In addition to extending the deduction, the bill would put the self-employed on the same footing as other workers and permit a 100 percent deduction.

First-Time Home Buyer Credit This is a modification of a proposal made by the President.

First-time home buyers purchasing a newly constructed home between February 1, 1992 and December 31, 1993 would be eligible for a tax credit of up to $5,000. This credit should be viewed as a tax subsidy to first-time home buyers (though some of the subsidy would be passed along to home builders via higher sale prices). The credit might cause a few more homes to be built in the near term, but it would not meaningfully strengthen the economy. The credit would not lower the resource cost of building new housing; it would not encourage people to increase their work efforts; and if it had any effect on investments in plant, equipment, and machinery, it would be to divert resources away from those areas that have such a large influence on future productivity into housing. The proposed housing credit, in short, is thoroughly misguided.

Conclusion

Government tax policies have injured the U.S. economy by penalizing people when they work, save, and invest. The predictable result is the economic malaise of the last several years. Tax reforms designed to correct some of the tax biases against productive activities would provide a quick economic boost in the short term while laying the groundwork for a healthier economy in the long run. Unfortunately, the Finance Committee tax bill would do little to ease existing tax restraints on growth. The legislation would, on the whole, have the reverse effect; it would intensify tax biases against growth-generating activity and further slow the economy. Although the bill's authors claim to be champions of the middle class, their program would produce a weaker economy, with fewer opportunities and less prosperity for everyone.

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