IRET Congressional Advisory

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ANOTHER CONGRESSIONAL SLAP AT SAVERS

Once again Congress is telling Americans not to save. The latest message is directed at people with below average incomes. In early April, when Congress passed legislation restoring the 25% health-insurance cost deduction for the self-employed for 1994 and increasing it to 30% thereafter, it financed the majority of the revenue loss by denying the Earned Income Tax Credit (EITC) to people with investment income above $2,350. When the EITC provision becomes effective in 1996, it could cost a tax filer with 1 child up to $2,152, a tax filer with 2 or more children up to $3,556, and a tax filer with no children up to $323 (based on estimates of the maximum EITC in 1996).

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Although this provision affects EITC eligibility, it is really a tax penalty on investment income. The reason is that investment income above a specified level, $2,350, is what triggers loss of the EITC. The loss is sudden, like going over a cliff. For example, a family with 2 or more qualifying children, $16,000 of earned income, and $2,300 of investment income would be able to claim an EITC of $2,080 (estimate for 1996). If the family's investment income rises to $2,400, however, its EITC would fall to zero. In this case, the extra $100 of investment income would cost the family $2,080; that is a marginal tax rate on investment of 2,080%! In the absence of this provision, the family would still lose some of the EITC because the EITC phases out as adjusted gross income (AGI) rises. Under the phaseout based on AGI, an extra $100 of income, whether from wages or investments, would lower the family's EITC by $21.06. That's a marginal tax rate of 21.06% just from the phaseout, an awfully stiff disincentive against additional work and saving, but a far cry from 2,080%.

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Another of the bill's revenue raisers, repeal of a controversial rule that allowed capital gains to be deferred on some sales of broadcasting facilities to certain minorities, received widespread attention. The EITC provision, however, involves much larger revenues and has much more effect on the incomes of the poor; yet it attracted scant attention. Congress's Joint Committee on Taxation estimates that EITC recipients with investment income will pay 60% more over a 5-year budget window than sellers of broadcasting facilities, rising to twice as much over a 10-year budget window.

Relatively modest asset holdings will trigger EITC disqualification. For instance, $30,000 of accumulated saving in a bond fund paying 8% interest pushes a family above the threshold. A family with a low yearly income but a strong desire to save can accumulate that amount over a number of years. With regard to rental income, suppose a family owns a house, rents a room to a lodger, and in consequence receives net

rental income above $2,350. Depending on how the U.S. Treasury interprets the provision's statutory language, the family could well be disqualified from receiving the EITC, even if its wage income is very low. People otherwise eligible for the EITC should not be punished by the government for "excessive" saving (with the statute defining any returns above $2,350 as "excessive investment income".) Further, because the $2,350 threshold is not indexed for inflation, its real size will fall continuously through time, meaning that smaller and smaller real amounts of saving will bar people from obtaining the EITC.

The government already sends welfare recipients a powerful message not to save. This legislation broadens the signal to include the working poor and the lower middle class. That is precisely the opposite of what the message should be. Saving and investment are highly desirable activities. They provide added security and flexibility to people who save, and they help all of society by speeding up gains in productivity, employment, and output. The government should not get in the way by imposing an extraordinarily harsh punishment on people who have been able to save and are obtaining relatively modest returns on that saving.

The EITC was originally intended as an offset to a portion of the employee's payroll tax for low-income workers to encourage employment. The EITC was substantially expanded in 1990 and again in 1993, and its rate far exceeds the employee's payroll tax rate on the credit-eligible income. A case can be made that the credit has grown beyond its original objective and has become too large, expensive, and prone to fraud. Instead of taking a meat ax to saving incentives, however, a better way to rein in the EITC would be to trim the extremely generous formula used in computing the credit. That would permit the federal government to save several billion dollars yearly while still giving lower-income people a large reward for working, and would do so without savagely punishing those people for saving.

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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.