IRET Congressional Advisory

July 7, 1995 No. 47

GEPHARDT TAX PLAN: COMPLEX AND BIASED AGAINST SAVING AND GROWTH

House Minority Leader Richard Gephardt (D-MO) has entered the tax restructuring sweepstakes with a misguided proposal that would damage the economy and do nothing to simplify the tax system.

The Gephardt proposal has completely missed the economic point of tax restructuring -- ending the bias of the current tax system against saving and investment so that productivity, wages, employment, and GDP can grow faster. Instead, the Gephardt plan would accentuate the anti-saving bias to pay for modest rate cuts for low income taxpayers. The result would be a temporary windfall for low income taxpayers but at a terrible price. The Gephardt plan would reduce saving and capital formation, would cut the growth of productivity, wages, and employment relative to current law, and would hurt the very people it claims to help. Claims that the proposal would simplify the tax system are largely spurious, and there may be substantial additional costs of enforcement and compliance associated with the plan.

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At odds with real tax restructuring proposals

The Gephardt proposal runs counter to the thrust of every other major tax reform proposal currently on the table – the savings exempt income tax of Senators Domenici and Nunn, the Armey flat tax and its variations, the national sales tax recommended by Representative Archer and Senator Lugar – all of which seek to end the current tax system's destructive bias against saving and investment. The income tax is imposed once on income used for consumption. It is imposed two or three times on income that is saved in bank accounts, bonds, or corporate stock, and a fourth layer of tax is levied on gifts and estates.

The other proposals seek to end the multiple taxation of income that is saved so that savings, investment, productivity, wages, and employment can grow more rapidly. In the process, they would truly simplify the tax code by ending the provisions that generate the majority of regulations and confusion: calculation of capital gains; complex depreciation rules for inventory, plant, equipment, and structures; confusing tax rules regarding foreign source income; and limitations on pension and other saving plans. The Gephardt proposal does none of these things.

Increased bias against saving and growth

Most of the so-called "loopholes" that the Gephardt plan seeks to eliminate are not loopholes at all, but merely partial relief from the multiple taxation of saving and investment that would otherwise occur. While other reforms seek to tax all income once and only once, the Gephardt plan seeks to expand and perfect the multiple taxation of capital.

Institute for Research on the Economics of Taxation

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Under the Gephardt plan, people contributing to pensions would be hit with higher taxes, and people receiving pensions would be hit with more complexity. Pension contributions, currently tax deferred, would be taxed. Only the inside build-up would still be tax deferred. Each pension recipient would have to calculate how much of his or her pension income is taxable build-up and how much represents a tax free (already taxed) return of contribution. Under the Gephardt plan, pensions would become like non-deductible IRAs instead of deductible IRAs. People would have to earn more to make a pension contribution of a given size, after taxes, and it would be harder and less rewarding to save for retirement. People would become more dependent than ever on Social Security, Medicare, and Medicaid, all bankrupt systems – to survive in old age. Payroll and income taxes would have to soar to shore up and expand the retirement transfer payments to compensate.

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The Gephardt plan would worsen the double taxation of capital gains. Capital gains represent either the reinvestment of previously taxed business income or the anticipation of increased future business income that will also be taxed when earned. Under current law, capital gains are only partly protected from this double tax with a cap on the tax rate of 28%. Under the Gephardt plan, the double taxation would be complete, at full tax rates. Dividends would be double taxed under the corporate and personal income tax, as under current law. The other major tax reform plans would eliminate these sources of double taxation.

The Gephardt plan would not correct the under-statement, for tax purposes, of the cost of plant and equipment and structures. Current law depreciation schedules only permit the write-off of a fraction of the cost of plant and equipment, in present value, because they delay the write-offs for years. Unlike all the other tax restructuring proposals, the Gephardt plan would not provide expensing of inventory, equipment, factories, commercial buildings, apartment buildings, and research and development costs. Relative to the other plans, the economy under the Gephardt plan would lose several trillion dollars of potential investment over the next decade.

The Gephardt plan (and the other proposals) would repeal deductions for state and local income and property taxes, increasing the cost of state and local government services for taxpayers. The Gephardt plan, however, would also make tax exempt interest income taxable, a double whammy for state and local governments. Recipients of such income get a lower interest rate than on taxable bonds. The tax saving really accrues to the states, counties, and cities issuing the bonds in the form of a lower cost of borrowing. Under the Gephardt plan, the cost of borrowing would soar for state and local governments, putting upward pressure on state income tax rates and property tax rates.

Simplicity a myth

The Gephardt plan claims to improve simplicity and to reduce the tax form to the size of a postcard. For taxpayers with no substantial savings, the tax forms are already as simple as they can be: wages less personal exemptions and the standard deduction equals taxable income. That would be unimproved under the Gephardt plan. In fact, employers would have to calculate and report to employees, and employees would have to add up and report to the IRS, employer provided fringe benefits not now taxed.

For people with savings income and real estate, there would be no improvement under the Gephardt plan. Mortgage interest would still have to be listed as a deduction (schedule A). Interest and dividends (schedule B) would still have to be added up.

Capital gains (schedule D) would still have to be calculated. The amount of Social Security subject to tax would still have to be determined. Owners of small businesses and farms would still have to calculate their incomes as well (schedules C, E, and F). The only way for the tax form to look like a postcard would be if the Gephardt plan did not require that these schedules be attached to the returns, but the taxpayer would still have to figure the totals to be able to put them on the postcard (otherwise known as the good old 1040 form). If the schedules were dropped, unless some complex withholding scheme were implemented, at great cost to businesses, the plan would become an enforcement nightmare for the IRS. Businesses would still have to struggle with depreciation schedules, recapture rules, and the alternative minimum tax.

There would be no relief under the Gephardt plan from the complex tax treatment of either individual or corporate foreign source income, treatment that puts U.S. companies and individuals at a substantial competitive disadvantage in the world economy. U.S. citizens working abroad would see a substantial tax hike on foreign earned wages and salaries.

Conclusion

The Gephardt tax plan would retard growth and would do nothing to simplify the tax system. The Gephardt plan would exacerbate the income tax bias against saving and investment, and would do nothing to eliminate the real sources of complexity in the tax system. Millions of wage earners and retirees would find the tax form more, not less, complex than under current law. Everyone would suffer from reduced saving and investment and the resulting slower growth of income and employment.

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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.