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A TROUBLING TAX BILL FROM THE HOUSE WAYS AND MEANS COMMITTEE

The tax plan that is emerging in Congress is not based on fundamental principles of good taxation but on the priorities and revenue targets in the budget agreement struck between President Clinton and Congressional leaders. Unless the tax plan is substantially modified, it will produce a tax system that is more complicated and more arbitrary than the current one. Further, although some parts of the plan are pro-efficiency, other provisions move in the opposite direction.

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The principles toward which tax reform should strive are: greater neutrality, so that people are less likely to take otherwise wasteful actions for tax reasons; simplicity, so that taxpayers are not forced to expend as much time and money on unproductive tax paperwork; visibility, so that people can better know how much they are paying for government services when deciding what level of government to demand; and equity, which means that the tax system should not discriminate among people because of differences in their activities and incomes. A few aggregate numbers show the different priorities embodied in the budget deal.

The agreement allows a gross tax reduction of $135 billion over 5 years but requires $50 billion of offsetting tax increases. Thus, the net tax cut is only $85 billion over 5 years. At the President's insistence, approximately $35 billion of this must be devoted to tax subsidies for college students. The budget agreement also requires that the tax plan include a $500 child credit, which is hugely expensive.

In the plan approved by the House Ways and Means Committee under the leadership of Chairman Bill Archer (R-TX), the child credit and the college-student tax breaks have revenue costs of $71 billion and $31 billion, respectively. Thus, these two items, neither of which would simplify the tax code nor reduce tax biases, consume over 100% of the net tax cut. That is to say, the budget agreement forces the remainder of the plan, which includes many tax reductions as well as numerous revenue raisers, to be a net tax increase. (Over 10 years, the budget agreement permits a $250 billion net tax cut, but the child credit and tax subsidies for college students absorb $225 billion, or 90%, of that.)

The child credit, which would be in addition to personal exemptions, is targeted tax relief; it is intended to lighten the income tax burden on people who pay taxes and have children under age 18, subject to an upper-income phase out. On the basis of tax principles, though, it is not evident why these people are more deserving of tax relief than other people. Unfortunately, because the credit would not change most people's marginal tax rates, it would not relieve the many distortions the tax system imposes on people's work, saving, production, and consumption decisions. Moreover, the credit would add some complexity to many people's tax returns, and for people in the phase-out zone, the loss of the child credit would be a work and saving disincentive.

In conformity with the budget agreement, the Ways and Means bill includes a $1,500 college tax credit and a $10,000 college-expense tax deduction. Also, it would establish tax-deferred saving accounts for higher-education expenses and tie the $10,000 deduction to distributions from either those accounts or state-sponsored prepaid tuition programs.

These college-student tax subsidies raise concerns regarding cost, complexity, and tax neutrality. First, their revenue cost is high. Second, they are the antithesis of simplicity, with complicated rules that would require time-consuming tax calculations and lead many people into significant tax errors. Further, it is not clear that additional help beyond the generous amounts already provided through many federal and state spending and student-loan programs is appropriate, even if one feels that the government should aid higher education. It is also not clear why additional aid should be furnished through taxes rather than on the spending side.

The Ways and Means tax package represents a major setback for efforts to conform tax laws with the standards appropriate for a free society relying on the market system rather than government dictates to direct economic activity.

The major pro-efficiency reforms in the Ways and Means bill are reduction in the capital gains tax rate, moderation of the alternative minimum tax (AMT), easing of the estate and gift tax, and expanded individual retirement account (IRA) availability. These provisions would lessen the tax bias against saving and investment, but the scope of each is severely limited by the budget agreement's low ceiling on their total revenue cost. For instance, the maximum capital gains tax rate would be reduced from 28% to 20%, but cutting it in half to 14% would have been better. Inflation indexing of capital gains would start in 2001, but a 3-year holding period requirement would prevent taxpayers from using indexing before 2004. Indeed, with an eye on the revenue constraint, the capital gains provision was constructed so that it would actually be a revenue raiser in its first 5 years. As another example, the amount exempt from the estate and gift tax would rise from $600,000 to $1 million but this increase would be stretched out over 10 years. The higher exemption is desirable because the tax is extremely complicated and applies at very high rates to assets that have generally been subject to multiple layers of income taxes, but the very long phase in delays the benefits.

To comply with the budget agreement, the Ways and Means plan also contains a host of tax increases. The largest single revenue raiser, accounting for over half the total, is an extension, with modifications, of the air passenger excise tax. Some of the other revenue raisers are sharply higher arrival and departure taxes on international travelers, treating certain hedges against risk (including short-against-the-box positions) as "constructive sales" triggering capital gains tax, treating certain corporate spinoffs (including Morris Trust arrangements) as realizations triggering capital gains tax, applying a holding period requirement based on individual dividend dates rather than on how long the underlying stock has been held for purposes of the dividend received deduction, limiting the ability of companies to net current-year losses against income and taxes from prior years, disallowing the use of the like-kind exchange rules if one property is domestic and the other foreign, and denying corporations a portion of the interest-expense deduction based on their holdings of municipal securities.

It is evident from these examples that most of the proposed revenue raisers would be extremely complicated and collected at the business level. As such, they violate the goal of simplifying the tax system. Instead, they add complex tests to boost tax collections. They are also largely hidden, which conflicts with the principle that taxes should be as visible as possible in order that people know how much they are paying to support government services. Moreover, these tax changes would increase the real marginal tax rate on income produced by corporations, intensifying the existing bias against saving and investment. That would discourage saving and investment and, thereby, slow growth.

The tax plan approved by the House Ways and Means Committee is a hodgepodge of tax law changes that meet no relevant criteria of good tax policy because it has been guided by the White House's tax priorities as expressed in the budget agreement. In conformity with the budget deal, the plan's two biggest items target relief to specific groups, people with children and people with college expenses, rather than addressing the basic and serious deficiencies in the current law. The plan would complicate the tax code and further hide from people how much they are paying in taxes. The plan does have some valuable pro-efficiency elements, but because of the budget deal's tight revenue-cost constraint on them, they are quite limited.

The Ways and Means tax package represents a major setback for efforts to conform tax laws with the standards appropriate for a free society relying on the market system rather than government dictates to direct economic activity. It is probably too late to change the thrust of this year's tax legislation, but Mr. Archer and others who have so eloquently explained the deficiencies of the existing tax laws should recognize that they are creating new barriers to attaining the better tax structure they seek.

Michael Schuyler
Senior Economist
