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SENATOR MACK'S PRO-GROWTH TAX PLAN

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Cut capital gains taxes to 7.5% and 15%, and index for inflation; cut dividend tax rates to 7.5% and 15%.

The rate cuts. Senator Mack's proposal would reduce the tax rates on long term capital gains and dividends to a top rate of 15% (for people in income tax brackets above 15%) and a bottom rate of 7.5% (for people in the 15% income tax bracket). The capital gains cut would be effective on January 1, 2000. The dividend rate cut would be phased in from 2001 to 2005.

Currently, long term capital gains are taxed at 20% (for people in higher tax brackets) and at 10% (for people in the 15% bracket). Dividends are taxed at ordinary tax rates, up to 39.6%. The capital gains and dividend tax relief would lower the cost of capital and increase the incentive for entrepreneurial risk-taking, spurring additional capital investment, which, in turn, would increase productivity, wages, and employment.

Corporate income is subject to an extra layer of tax compared to other earnings of saving. The corporation pays tax on its profits. If a portion of the profit is paid out as a dividend, the income is subject to an additional tax on the shareholder's tax return. If the after-tax earnings are retained for reinvestment, which boosts the share price, there is a capital gains tax on the increase when the shares are sold. Either way, corporate income is effectively taxed twice.[1]

Current law provides a partial offset to this excess layer of corporate tax, and to the capital gains on non-corporate assets, by means of a reduced tax rate on gains on assets held more than one year. There is no offset for the double taxation of dividends paid to shareholders. The Mack proposal would reduce the excess tax on capital gains further, and extend the same relief to dividends. The extension to dividends would eliminate the current tax bias against dividends as compared to retained earnings/capital gains under the current system. The Treasury recommended eliminating this bias in its 1992 study of integration of individual and corporate tax systems.[2] The Mack proposal does this in an appropriate manner.

Indexing the basis. Senator Mack's proposal would also adjust the purchase price of stocks, bonds, and other financial assets for inflation, reducing the calculated nominal gains subject to tax. Reducing capital gains taxes is always a good idea, because they are double taxation to begin with. It should be stressed, however, that taxing real gains is as bad as taxing the gains due to inflation. Furthermore, while we are great fans of income tax indexing in general, there may be better ways of dealing with the effect of inflation on capital assets.

Indexing the basis of capital assets is a complicated procedure, involving substantial

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calculations by the taxpayer. The usual formulas fail to cover the reinvestment of corporate retained earnings on behalf of the shareholder. Thus, over time, more and more of the shareholder's investment in a stock goes unprotected; if the asset is held from young adulthood to retirement, up to 90% of the actual impact of inflation can be uncorrected. There are complex formula changes that could offset this omission. However, it would be much simpler just to lower the capital gains rate further.

Best of all would be to expand IRAs, either regular or Roth, eliminate the income restrictions, and allow withdrawals at any age without penalty. The Breaux-McCrery bill takes this approach. IRAs, 401(k)s, etc., eliminate the tax bias against saving and make capital gains treatment moot. Indeed, under fundamental tax reform, all saving would receive one or the other type of IRA treatment, and there would be no separate taxation of capital gains and no need to index the basis.[3]

Increase the amount of investment eligible for expensing.

Expensing, not depreciation, is the economically optimal treatment of investment for tax purposes. Under fundamental tax reform, all investment outlays would be expensed. Senator Mack's proposal takes a significant step in that direction.

Senator Mack's proposal would increase the amount of capital investment that businesses are allowed to expense from $25,000 annually to $500,000 annually as of January 1, 2002, and index the amount for inflation. (The amount under current law is $18,500 for 1999, but is scheduled to rise in stages to $25,000 in 2002 and beyond.) Unlike the current law expensing provision, the $500,000 expensed amount would not be phased out for businesses making large amounts of investment.

Under current law, the tax code requires that most costs incurred in purchasing capital assets be deducted over many years (depreciated) instead of being reported in the year they are incurred (which is expensing, or first year write-off).[4] Delaying the deduction of these business costs raises the cost of capital and depresses investment below optimum levels, in addition to increasing tax complexity.

The current tax code allows small amounts of investment to be expensed, as a help to small businesses. Amounts above the expensing limit, however, receive no reduction, at the margin, in the cost of capital. In addition, under current law, the $25,000 (by 2002) that may be expensed is phased out dollar for dollar for businesses investing more than $200,000 annually, which actually penalizes investment between $200,000 and $225,000.

Senator Mack's proposal would increase the number of businesses whose annual investment is completely covered by the expensing provision. These businesses would receive a significant additional incentive to add to their capital stock. Indexing the amount would keep the incentive from being eroded by inflation. The proposal is worthwhile, and a step in the right direction.

While encouraging small business to invest more, the expensing provision would not boost capital spending for larger businesses that invest amounts in excess of the expensing limit. The proposal could be improved by adding a reduction in the time periods over which other investment costs may be deducted (shorter "asset lives") for all businesses. Ideally, the asset lives would be reduced gradually until all investment is allowed immediate write-off.[5]

Index the exempt amount under the individual Alternative Minimum Tax (AMT) for inflation.

Senator Mack's proposal would inflation-index the amount exempted from AMT taxable income for individuals beginning in 2000. This would slow the projected rise in the number of taxpayers subject to the AMT.

The individual alternative minimum tax currently affects fewer than 900,000 taxpayers today, but is expected to snare more than 9 million taxpayers ten years from now. The rising number

of taxpayers affected stems in part from failure to adjust the exempt amount for individuals ($33,750 for single filers and $45,000 on joint returns) for inflation. Part of the increase is due to rising incomes, because some of the deductions and exclusions that trigger the AMT, such as state and local income and property taxes and some private use tax exempt bond income, rise as incomes increase. The recent proliferation of tax credits, including education tax credits for low and moderate income families, may also trigger the tax, unless Congress renews special exclusions of such credits from the list of preference items.

Senator Mack's proposal is a step in the right direction. Ideally, the AMT should be repealed outright, for both individuals and corporations. Repealing the AMT would greatly simplify the income tax and restore the full use of legitimate deductions that affect saving, investment, and growth.

Repeal the estate and gift tax (unified transfer tax).

Senator Mack's proposal would repeal the estate and gift tax over 5 years, beginning in 2002. The federal unified transfer tax is imposed on lifetime gifts and estates, after a credit that effectively exempts the first $650,000 (rising to $1 million in 2006). It is an additional and unwarranted layer of tax -- a fourth layer in some cases -- on income that has been saved.[6] It disrupts the transfer of property, especially farms and other small businesses, between generations. It is a powerful disincentive to save and invest. Its repeal would boost capital formation, productivity, wages, and employment.

Make the R&D tax credit permanent as of July 1, 1999.

The R&D credit has been renewed on a temporary basis for decades, making it a less certain incentive than it ideally should be, and a nightmare for corporate planners. Businesses may expense the labor and supplies used in laboratories and research departments, but big ticket items such as the lab buildings and depreciable equipment must be written off over many years. The added cost of capital is especially detrimental to risky endeavors such as R&D. The credit counters this flaw in the tax treatment of investment. Until all investment may be expensed, under a full-blown tax reform, the R&D credit should be made permanent.

Repeal the second tier taxation of up to 85% of Social Security benefits.

The way in which Social Security benefits are taxed in current law is a virtual mandate to the elderly not to work and not to save. It cries out for change.

The 1983 Social Security Amendments required middle income retirees to include up to 50% of Social Security benefits in taxable income when their income exceeded certain thresholds. In 1993, beneficiaries with incomes above a higher threshold were required to add an additional 35% of benefits to taxable income, bringing the total to 85%. Senator Mack's proposal would eliminate the "second tier" of taxation of up to 85% of Social Security by scaling back the 35% add-on over 5 years, 2002-2006. It would leave in place the taxation of up to 50% of benefits enacted in 1983.

Taxation of benefits leads to very high rates of tax on additional income from saving and work by the elderly, especially in conjunction with the Social Security earnings limit.[7] Rolling back the second tier of benefit taxation is a step in the right direction. It will improve saving incentives for workers who now fear high future tax rates, and will reduce the enormous tax hurdle now imposed on experienced older workers who want to keep working. Further steps should be taken, including repeal of the earnings limit.

Increase the standard deduction to $14,400 for married couples, and to $7,200 for singles, over 9 years (2001-2009), and resume indexing thereafter.

The increase in the standard deduction is primarily aimed at reducing the marriage penalty to correct a social inequity, rather than increasing economic growth. The provision does not boost incentives to work or save by reducing tax rates at the margin, except for the limited number of taxpayers who would fall from one tax bracket to a lower one, or drop off the tax rolls entirely.

Making the deduction for couple twice that for singles would reduce the marriage penalty to a significant degree for couple who pay income taxes. It would eliminate the penalty for couples in the 15% bracket. It would not fully offset the penalty for two worker couples in higher brackets; that would require making tax brackets for upper income couples twice as wide as for singles, or moving to a flat rate tax. The provision does not address the marriage penalty created by the loss of the earned income tax credit when a low income working single parent marries and family income rises by enough to begin losing the EITC.

Senator Mack's provision would more than double the standard deduction for couples: it would increase the standard deduction for singles by about one-third in real terms and set the standard deduction for couples at twice that new, higher level. The increases would exempt a number of additional taxpayers from the tax rolls, and raise the revenue cost of the provision. Some caution is needed here. It is not good to exempt too large a number of people from paying tax. If non-taxpayers think of government services as free, they may demand that the government take over an increasing share of the economy, and shift more of the cost of goods and services on to the taxpaying portion of the population.

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Endnotes

1. Retention of earnings is not the only source of capital gains. Capital gains also occur when there is an upward revision in the expected future income of any business, corporate or non-corporate, for any reason (perhaps a new discovery, or increased demand for the business's products). The value placed on a business (or piece of land, or share of stock, or other asset) today is the present value of the expected after-tax earnings of the asset in the future. If the projected rise in future earnings takes place, those earnings will be taxed under the ordinary income tax. To tax the increase in the present value of the future after-tax earnings as a capital gain effectively is to double-tax the future earnings. Thus, the taxation of capital gains is always double taxation, whatever the reason for the gain.

2. "Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once," Department of the Treasury, Jan. 6, 1992.

3. Income is taxed when earned. If it is used for consumption, there is usually no further federal tax on the items purchased. If it is saved, and used to buy a stream of additional earnings, there is a tax on the earnings. Thus, saving is treated more harshly than income used for consumption. The tax bias against saving comes from taxing both the income that is saved and the earnings of the saving. There are two ways to end the bias. One is the saving-deferred approach, which allows savers to defer tax on income that is saved, and pay tax when it is withdrawn for consumption, as in a deductible IRA. The second is the returns-exempt approach, which allows no deduction for saving (saving is done with after-tax dollars), but does not tax the returns, as in a Roth IRA or the tax treatment of tax exempt bonds.

In either method, capital gains per se would not be taxed. In the saving deferred-approach, savers would deduct the cost of shares when purchased, and pay tax on the total sales proceeds at the time of sale (unless they reinvest -- indefinite

roll-over). In the returns exempt approach, there would be no deduction for share purchase, but the sales proceeds (including any price appreciation) would not be taxable. The saving-deferred and the returns-exempt methods give the same tax-neutral treatment to income that is saved versus income that is used for consumption. All of the major tax reform proposals (national sales tax, flat tax, USA/Nunn-Domenici tax) explicitly or implicitly use one or another of these approaches to restore tax neutrality between saving and consumption uses of income.

4. Equipment must be written off over 3, 5, 7, 10, 15, and 20 years. Most structures (buildings) are written off over 39 years. Low income housing is allowed a 25 year life, and railroad track beds are stuck with a 50 year write-off period.

5. The same result could be had by allowing some percent of investment to be expensed without dollar limit, rising over time. For example, allow 10% of all investment above $500,000 to be expensed, and the rest depreciated, for assets bought in 2000, 15% for assets bought in 2001, etc., until expensing of all investment is achieved over 20 years. Alternatively, adopt a "neutral cost recovery system" (NCRS), under which investment is written off over time, but the amounts are augmented to make the present value of the write-offs equal to immediate expensing. NCRS would immediately produce the same incentive to invest as expensing, but much of the revenue cost to the Treasury would be deferred.

6. Estates are made up of saving, done mostly out of after-tax dollars (tax layer 1). That saving, as it has compounded, has been further subjected to taxation of interest income, or to the corporate income tax if stock is purchased (layer 2). In the case of the stock purchase, there is then a personal income tax on dividends and capital gains (layer 3). The estate tax is either the 3rd or 4th layer of tax, a monstrous imposition. If the estate contains an IRA, not previously double-taxed, that portion of the estate will be subject to the heir's income tax in addition to the estate tax, still a case of unfair multiple taxation. No matter the form or source of the saving, the estate tax is a case of unwarranted multiple taxation, and should be abolished.

7. See testimony of Stephen J. Entin, Institute for Research on the Economics of Taxation, before the Committee on Ways and Means, January 19, 1995, and the Subcommittee on Social Security, Senate Finance Committee, January 9, 1995.

The 1983 Social Security Amendments provided that up to 50% of Social Security benefits would become taxable, phased in as retirees' incomes exceeded $25,000 (single filer) or $32,000 (married). The phase-in (50 cents in benefits added to taxable income for each dollar that income exceeds the threshold) was equivalent to boosting the federal income tax rate on the affected retirees' saving and wage income by half, for example, from 28% to 42%. (A dollar in additional interest income would boost taxable income by $1.50; in the 28% tax bracket, the tax liability would rise by $0.42 when income rose by $1.00.) The effective marginal tax rate on a retiree's wages subject to the payroll tax could exceed 56%. On wages in excess of the Social Security earnings limit, tax rates could exceed 85% for workers age 65 and above, and more than 100% for workers ages 62 through 64.

In 1993, another tier of tax was added. As income exceeded $34,000 (single) or $44,000 (married), up to 85% of benefits would be added to taxable income (at 85 cents in benefits per excess dollar of income above the thresholds). This was equivalent to boosting the 28% tax rate to 52% (28% x 1.85). Combined federal and state income taxes and payroll taxes could boost the effective marginal tax rate on a retiree's wages to 65%; and on wages in excess of the earnings limit, to more than 90% (age 65+) or 109% (ages 62-66). State taxes would raise the rates further.

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.