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MOSTLY GOOD STUFF IN THE HOUSE AND SENATE TAX BILLS

How to Judge a Tax Bill

The House and Senate tax bills are good proposals that could become much better proposals with modest changes. The tax plans should be judged by whether or not they move us closer to the goals of fundamental tax reform — a simple, neutral, unbiased, pro-growth tax system. How do the House and Senate tax bills stack up against that objective?

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A reformed tax system would have these attributes:

- A single low tax rate applied neutrally to all income, properly measured, with no tax-induced economic distortions.
- Neutral treatment of income used for immediate consumption and income used for saving and investment. It would either defer tax on saving until it is withdrawn for consumption, or not tax returns on after-tax saving, i.e., all saving would get pension or IRA treatment (regular or Roth). Investment outlays would be expensed, not depreciated.
- No double taxation of corporate income.
- No death tax.
- No excise and "nuisance" taxes.
- No payroll tax. Social Security contributions and benefits would be replaced by personal retirement saving plans owned by individuals, and bolstered by a federal safety net as needed.

Elements of the House and Senate Tax Bills

Rate cuts (both bills). The 10% across the board tax rate cut in the House bill would lower marginal tax rates in all brackets, and enhance after-tax work and saving incentives at the margin for all taxpayers. The Senate plan only reduces the 15% bracket (to 14%), and is not "at the margin" for many taxpayers. The House rate cuts would do more to boost the economy.

Lower rates are good, but the rate structure and the tax base (what we tax) matter too. Neither rate cut proposal flattens the tax rate structure nor makes the tax code less biased.

Graduated tax rates punish people the more they produce, and the rising disincentive chokes off effort. The most damage is done by the highest rates, which should be cut the most.

Marginal tax burdens on saving and investment come from the combined tax rates that result from the repeated taxation of income that is saved and invested, not just the rates imposed at any one level. The biggest cut in disincentives and the greatest gain in GDP would come from eliminating the double or triple taxation of capital, not from lowering the basic tax rates.

A bottom rate cut could interfere with tax reform. A flat rate tax would probably need a tax rate somewhere between 17 and 23 percent of income used for consumption in order to pay for a reasonable level of government. Lowering the bottom tax rate to 14% or 13.5% would make it difficult to enact a single-rate tax in the future.

These considerations suggest an alternative reform. Instead of cutting the bottom income tax

Institute for Research on the Economics of Taxation

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1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

rate, it might be better to reduce the payroll tax with the requirement that the money be put into personal tax-deferred retirement accounts, with some offset to future Social Security benefits. For income tax payers, concentrate on ending the tax base bias against investment and saving, roll back the 36% tax rate and the 39.6% surtax rate, and get rid of the phase-outs of exemptions and deductions that generate hidden tax rate spikes.

Phase out the federal estate and gift (transfer) tax (House bill). The federal "death" tax is an added layer of tax on income that is saved, part of the anti-saving bias in the tax system. It should be eliminated.

Expanded IRA contribution and eligibility (Senate bill). In a neutral tax world all saving should get IRA treatment. Enhancing IRAs as in the Senate bill is a big step toward fundamental tax reform.

Cutting the capital gains rate (House bill). Cutting the capital gains tax is consistent with fundamental tax reform. The right rate is zero. Cutting the capital gains rate reduces the basic tax bias against saving, and cuts the double-taxation of corporate income.

Dividends and capital gains are both double-taxed. After paying the corporate tax, firms either pay dividends, which are taxed again as individual income, or they reinvest the earnings, which boosts share prices and triggers the capital gains tax. The Treasury has warned that tax relief for capital gains without relief for dividends distorts how businesses distribute their earnings. ("Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once," Department of the Treasury, 1992). The lower capital gains rate should be extended to dividends, as has been proposed by Senator Connie Mack (R-FL). That is better than the House provision that phases in an exemption of $250 per person ($500 per couple) in interest and dividends from tax.

Corporations that receive capital gains get no rate reduction in current law. (They get partial relief for dividends received.) The corporate capital gains tax inserts yet another layer of tax between the income of the paying firm and the shareholders of the receiving firm. The House bill would cut the corporate capital gains rate modestly. The rate on corporate gains and dividends should be zero.

Incentives for long term health care (both bills). Long term care insurance is a form of saving, which should therefore get IRA treatment.

Education incentives (both bills). Extending tax deferral to prepaid tuition plans and expanding tax-deferred education saving accounts would reduce the tax bias against saving. Though narrowly drawn, they would extend the range of saving receiving fundamental tax reform treatment.

Depreciation reform (neither bill). Neither bill accelerates depreciation write-offs toward expensing. Depreciation delays recognition of the cost of plant, equipment, and buildings. The delay cuts the present value of the write-offs, overstates business income, and raises effective tax rates. Bringing the value of the write-offs closer to the true cost of the investments would be the most powerful stimulus to the economy that a partial tax reform could provide. Either the write-offs should be accelerated, or interest should be paid on the unused balances to bring their present value up to 100% of the cost of the investment.

Eliminating the AMT (House bill). There is no excuse for an AMT under any tax system. The AMT forces individuals and businesses to defer or lose legitimate tax deductions for the sole purpose of accelerating their tax payments. It hits businesses suffering from low earnings in recession, and individuals with "too many" personal exemptions (children and, under the long term care provision, sick parents), business expenses, or child care and education tax credits. The tax is punitive, complex, and arbitrary. The House bill phases out the AMTs for individuals and businesses. The Senate bill provides only slight relief.

Marriage penalty relief (both bills). Tax reform with a flat tax rate with equal exempt amounts for

each adult would end the marriage penalty. The House bill solves part of the problem by making the standard deduction for joint filers double that for singles, but does not make tax brackets for couples twice as wide as for single filers. The Senate bill goes further, letting couples file as singles if it saves them money. Marriage penalty relief is costly and crowds out other reforms. Economic growth that other reforms would make possible would boost family income more than full marriage penalty relief. Do some marriage penalty relief, but leave the rest for later.

Foreign tax provisions (both bills). These abstruse provisions slightly mitigate the very complex, harsh, and anti-competitive tax treatment of U.S. multinationals. They are important reforms.

Stephen J. Entin
Executive Director & Chief Economist

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.