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PRESIDENT CLINTON'S TAX(ING) AGENDA — A CHARTER FOR AMERICA, INC.?

Although President Clinton's tax proposals have not been formally presented to the Congress, some of the things he may be considering are set forth in his white paper, "Putting People First". Other ideas likely to be considered by the new Administration are presented in *Mandate for Change*[1], a volume prepared by some of Mr. Clinton's leading campaign advisers. The tax initiatives that actually emerge from his Oval Office deliberations may differ from those discussed below, but the cast of President Clinton's thinking about taxes is evident therein.

A World View at Odds with Reality

Clinton's associates seem to think the economy is like a car with a dead battery. All it needs, they say, is a jump-start with a charge of temporary "fiscal stimulus", and it will run all right. Unfortunately, a better analogy is a clogged fuel injector, with excessive tax rates on capital and labor forming the sludge. Unless the blockage is removed, permanently, the economy will sputter along at less than peak performance.

An Inconsistent Program

Clinton's tax and budget program contains a major inconsistency. Clinton has promised to promote investment and growth. He has also promised to promote "fairness" by raising individual income tax rates on upper income people. There are indications he may seek higher energy taxes as well. These tax increases would be strongly anti-saving, anti-investment and anti-growth. Clinton and *Mandate* ostensibly would reconcile this inconsistency by using a portion of the revenue from the tax increases to reduce taxes on middle-income individuals, to provide narrow tax credits for incremental investment by businesses, and to pump up federal spending on infrastructure. The anti-growth effects of the tax increases would be substantial. The proposed targeted incremental

[1] *Mandate for Change*, Will Marshall and Martin Schram, eds. (Washington, DC, Progressive Policy Institute, 1992).

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investment tax credit (ITC) would be a pitifully weak incentive, as would the proposed middle-income tax cuts. The net effect would be to reduce capital formation by corporate and non-corporate businesses.

Instead of trying to substitute taxes for private saving, and directing saving into government infrastructure spending and targeted private investment, the Clinton Administration would be well advised to reduce the tax and regulatory barriers to growth, and let the market work. To reduce the cost of labor, a payroll tax rate reduction, a cut in individual tax rates, or both, would be useful. To reduce the gross-of-tax cost of capital, broadly-based provisions to reduce existing tax penalties on investment would be desirable. Saving should be encouraged. The goal should be a neutral tax code in which government distortion of the economy is kept to the absolute minimum.

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Clinton's Proposed No-Growth Middle Class Tax Cut

President-elect Clinton promised middle class tax relief, either in the form of a rate reduction or a cut in the 15 percent tax rate. *Mandate* proposes to lower the 15 percent rate to 13.5 percent, and to substitute an $800 tax credit for dependents for the personal exemption. Both People and *Mandate* recommend increasing the earned income tax credit (EITC) to assist low income workers. In terms of incentives, these proposals take a small step forward and a small step backward, and go nowhere. President Clinton and members of the new Cabinet now seem to have put such tax relief on hold, citing concern about the deficit.

Lowering the 15 percent tax rate to 13.5 percent

Lowering the 15 percent tax rate to 13.5 percent would cut tax rates at the margin only for those with taxable income in the bottom tax bracket — below $36,900 for joint filers and $22,100 for single filers in 1993. There would be a very modest increase in work incentives. Factoring in the payroll tax and state income taxes, such workers now face a marginal tax rate of about 30 percent. The cut would raise their after-tax share of added income from 70 percent to 71.5 percent, a 2 percent increase in the incentive to work. It is doubtful that this incentive would be sufficient to offset the disincentive effects of the proposed higher tax rates on "high" incomes. The net effect would be a contraction of output.

Tax credit versus personal exemption

The personal exemption for 1993 will be $2350. At a 31% tax rate, it will offset $728.50 in tax; at a 15% tax rate, $352.50. The Clinton team has proposed trading the exemption for dependents for an $800 child credit, equivalent to an exemption of $5333.33 per dependent for a taxpayer in the 15 percent tax bracket. The credit would be scaled back for children between the ages of 6 and 11 until it was equal in value to the current exemption.[2] The switch to the credit favors the lower income; it would reduce the tax liability for those in the 15% bracket by $447.50 per eligible child, and for those in the 31% bracket by $71.50 per eligible child.

The incentive effects of the switch from exemption to credit, however, would be adverse. A family with two children would lose $4700 in exemptions, and its taxable income would rise by that amount. Many families in the zero bracket would be pushed into the 15% bracket; many in the 15% bracket would be pushed into the 28% bracket, and so forth. Several million workers would find that their marginal tax rate would be higher than under current law. Any additional income, from working overtime, getting a raise, or saving more, would be taxed more heavily as a result of the switch from exemptions to credits. The *Mandate* discussion of the equivalence of the credit and the exemption reveals a lack of understanding of the different incentive effects of the two approaches.

Increase the Earned Income Tax Credit

The earned income tax credit (EITC) is a refundable tax credit given to low income workers with dependent children. Its initial purpose was to offset the payroll tax on low income workers without reducing the income of the Social Security trust funds. More recently, it has become a tool of income redistribution. The EITC was increased in stages by the Omnibus Budget Reconciliation Act of 1990 (OBRA90), from 14% of the first $6,810 of earned income (1990 level, adjusted for inflation) to 23% (for taxpayers with one child) or 25% (for those with two children) in 1994. The credit is phased out by means of an income tax surtax on earnings above $10,730 (1990 level, adjusted for inflation). The phase-out rate was increased in stages from 10% in 1990 to 16.43% (one child) and 17.86% (two children) in 1994. Combined with a 15 percent basic income tax rate, the combined employer-employee payroll tax rate, and state income taxes, the phase-out has the effect of raising the recipient's marginal tax rate to well over 45 percent or higher. Increasing the EITC would result in further increases in the phase-out rate or in the range of income subjected to the phase-out, intensifying work disincentives.

Mandate points out that the EITC is a more efficient way of fighting poverty among families with children than the minimum wage. Many poor families with children have jobs not covered by the minimum wage. Many who receive the minimum wage (often teenagers with working parents) do not live in poor families. (*Mandate* fails to point out that the minimum wage reduces employment and increases poverty for those it deprives of jobs.) *Mandate* proposes tying the EITC

[2] *Mandate*, op.cit., pp.165-168. *Mandate* assumed the inflation-adjusted personal exemption for 1993 would be $2,400; final IRS calculations set it at $2,350. *Mandate* rounded the credit-equivalent exemption to $5,330.

more closely to family size and elimination of poverty. It suggests making the EITC into a wage supplement equal to the difference between the minimum wage for a full-time, year-round worker and the poverty level for the worker's family size. Any full-time working parent with children would then receive an income of at least the poverty level. The credit would increase with hours worked and the number of children being supported.[3]

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Mandate implies that the rise in the benefit with hours worked would encourage recipients to work more hours per week. This is true for some workers but not for others. In order to limit the cost of such a wage supplement, it would have to be phased out beginning at incomes not much above the poverty line for each size family. The phase-out range would have to be different for families of different sizes, but that is not a significant difficulty. The higher benefit, however, would mean boosting marginal tax rates higher, or extending the tax rate "spike" over a wider range of income than at present. Thus, although the growth of the credit with hours worked would encourage additional work by those in low wage jobs, the phase-out would discourage the earning of income significantly above the minimum.[4]

Clinton's Proposals Increase the Bias Against Saving, Investment, and Growth

The remainder of the Clinton tax proposals, taken together, would have the effect of increasing the tax code's bias against saving and investing. The net result must be to reduce the rate of capital formation and growth below levels that would otherwise occur, and impair the competitiveness of the U.S. economy, contrary to the announced goals of his economic program.

<u>The tax bias against saving and investment</u>

The income tax does not fall in a neutral fashion on all economic activity. It is heavily biased against saving. Income is taxed when first earned. If it is used for consumption, it escapes further federal tax in most cases. If it is saved, the earnings of the savings are taxed again and again. The

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[3] *Mandate*, op.cit., p.169.

[4] The *Mandate* discussion inadvertently makes a good case for a substantial reduction in the minimum wage. If the reformed EITC were in place, a cut in the minimum wage would not reduce the income of poor families, but would expand employment opportunities for all workers.

effect is to raise the cost of saving — buying a source of future income —- relative to spending on consumption in the present.

That the income tax imposes a double tax burden on saving relative to consumption is a well-established principle of tax analysis.[5] To avoid double taxation of saving, the amounts saved should be tax deductible, while the gross returns — interest, dividends, proceeds from the sale of assets in which the saving is invested, etc. — should be subject to tax (example: deductible IRAs). Alternatively, the amounts saved should be taxed when first earned, but the earnings of the saving — interest, dividends, proceeds from asset sales — should be exempt (example: tax exempt bonds). Analogous treatment for business investment requires that all expenditures for plant, equipment, and structures be deductible in the year purchased, while taxing the gross returns. Thus, first-year write-off (expensing) is the economic optimum, and should be preferred to depreciation or amortization over an extended period. "Accelerated depreciation", capital consumption allowances greater than "straight line" depreciation (but less than expensing), are often called "loopholes" or "tax expenditures", but are actually adjustments that offset a portion of what otherwise would be a double tax.[6]

<u>Tax the rich</u>

Rate hike and surtax

Clinton would create a new higher individual income tax bracket for the top (roughly) two percent of taxpayers and a 10% surtax on millionaires and would increase the Alternative Minimum Tax (AMT) rate. These steps would have serious anti-growth consequences.

These proposals were included in Clinton's white paper, "Putting People First". *Mandate* seconds these proposals. The new 36 percent marginal tax rate would apply to married couples with roughly $200,000 or more in adjusted gross income (AGI) and to single filers with roughly $140,000 in AGI. The proposed 10 percent millionaires surtax would lift the top marginal tax rate to 39.6 percent (before state and local income taxes and payroll taxes, where applicable). The AMT rate would rise from 24 percent to 28 percent.

The affected 2% of the taxpayers produce about one-fifth of the national income. Boosting their combined federal and state marginal income tax rates to between 40 and 45 percent would lead to significant cutbacks in their work, saving, and investment. The resulting loss of productive effort

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[5] For discussions and illustrations of the tax bias against saving, see Norman B. Ture and B. Kenneth Sanden, *The Effects of Tax Policy on Capital Formation* (New York, Financial Executives Research Foundation, 1977), pages 57-73; Michael A. Schuyler, *Consumption Taxes: Promises and Problems* (Washington, D.C., Institute for Research on the Economics of Taxation, 1984) pages 8-12; Norman B. Ture and Stephen J. Entin, *Save, America* (Washington, D.C., Institute for Research on the Economics of Taxation, 1989) pages 15-16.

[6] See Norman B. Ture and John B. Egger, *Corporations' "Fair Share" of Federal Taxes* (Washington, D.C., National Chamber Foundation, 1988) pages 25-50.

by these individuals and a lower stock of capital would reduce productivity, wages, and employment throughout the labor force. Much of the assumed revenue gain would be lost.

Cut retirement income transfers and tax benefits

Mandate declares that the rich are getting a disproportionate share of the retirement income transfers and retirement tax benefits of federal programs, meaning a share in excess of their share of the population. This is a tautology masquerading as a revelation. Elderly persons with above average income from pensions or saving are generally those who had relatively high earnings during their younger days, and who were able to save at relatively high rates. Since Social Security benefits are set by formula as a percent of a retiree's history of covered earnings, it is inevitable that those with higher private retirement earnings will get a larger per capita share of the benefits than those with lower private earnings. Is it the intent of the Clinton Administration to divorce Social Security benefits entirely from work, earnings, and contributions, and to turn it into a guaranteed annual income?

Mandate proposes to tax Social Security benefits more heavily than at present, including up to 85 percent of total benefits in taxable income. For many current beneficiaries, this would roughly correspond to the amount of benefits they receive in excess of their lifetime "contributions" (i.e. the employee share of the payroll tax). Future retirees, however, will fare less well; many of today's young workers will put more into the system than they will get back. A more immediate problem with this proposal is that the current method of phasing in taxation of Social Security benefits sharply increases marginal tax rates on a beneficiary's other retirement income from saving or working, discouraging private provision of retirement income. It would be far better to trim the growth of benefits than to pay out excessive benefits and, in taxing them, raise taxes on other income as well.

Equally worrisome is the vagueness of the *Mandate* language regarding "retirement tax benefits". The deferral of tax on pension contributions in Keough, 401(k), and 403(b) plans, SEPs, IRAs, and company pension arrangements could be construed as being covered by this language. These private plans ease the bias of the income tax against saving, and may not legitimately be considered "loopholes". Any move against these plans would raise the cost of saving and reduce investment and growth.

Raise estate taxes and tax capital gains at death

Proposals have been floated to raise estate taxes by reducing the combined estate and gift tax exemption from $600,000 to $200,000. President-elect Clinton stated in a December 18, 1992 Wall Street Journal interview that he opposed lowering the estate tax exemption, but that he would look at proposals to tax capital gains at death. This is an inconsistent position. Taxing capital gains at death would adversely affect estates of all sizes.

The taxation of capital gains is double taxation. This double taxation is over and above the general bias against saving inherent in the income tax. The income that initially is used to purchase stock, real estate, and other assets or that is invested or reinvested in unincorporated businesses is first taxed when earned and then again if these investments produce income. In the case of investment in businesses, invested or reinvested after-tax earnings raise the value of the business and result in capital gains. The taxation of the gains is equivalent to double taxing the reinvested, previously-taxed earnings. Capital gains may also occur when there is an increase in the expected future income of a business. Higher expected earnings generally increase the current price of a business or its stock. If and when these higher future earnings occur, they will be subject to income tax. To tax the increase in the value of the asset or business as well is to double tax the future earnings. These forms of double taxation greatly reduce the incentive to save, and raise the cost of acquiring capital for investment.

Failure to allow a step-up [of the basis of inherited assets to market value] would subject the [capital] gains to <u>both</u> the estate and income taxes, imposing two additional layers of double taxation (above and beyond the basic double taxation of saving under the income tax).

The income that goes into building estates is taxed when earned, and taxed again on its earnings. Taxing estates in addition, therefore, is an additional layer of double taxation. Under current law, capital assets, as well as other assets included in gross estates, are taxed under the estate tax. However, heirs may "step up" the basis of the inherited assets to the market value on the date of death of the decedent, and, as a result, pay less income tax on the capital gain if the asset is later sold. For example, assume an asset bought for $100 had increased in value to $200 dollars at the death of the first owner. The $200 valuation becomes the heir's basis for income tax purposes, rather than the original $100 purchase price. If the heir kept the asset for a period, and sold it for $250, he would have to declare only $50 in capital gains, not $150.

Failure to allow a step-up would subject the gains to <u>both</u> the estate and income taxes, imposing two additional layers of double taxation (above and beyond the basic double taxation of saving under the income tax). Indeed, this was one of the major reasons for enactment of the step-up provision. The step-up limits the additional double taxation of the gains to the estate tax alone. Step-up is the appropriate treatment, and should remain in effect unless a consumption-based tax system is adopted.

If the Clinton Administration does seek to tax capital gains that now "escape" tax at death, one method would be to force estates to revalue their assets to current market prices and pay income tax on the unrealized gains before computing estate taxes and passing the assets on to the heirs. This would generate some near-term revenue for the Treasury, but it would force many executors or heirs to sell assets to pay the tax. Thousands of small businesses and family farms would be broken up or lost.

A less disruptive alternative would be to eliminate the step-up in basis. Under this approach, no revenue would be realized until the heirs sold the assets. Such a change in the tax law, however, would "lock in" even more gains than at present.

Either method of subjecting the accumulated gains on property passed on to heirs to the income tax as well as the estate tax would reduce capital formation and growth of productivity, wages, and employment. Revenue growth from taxation of payroll or income other than capital gains would be depressed. The economy, and possibly the Treasury as well, would be better served by leaving current law alone. The economy would be best served by eliminating the estate and gift taxes as well as the double income taxation of capital gains entirely.

Mandate is clearly in the camp of the "broad-based" income tax, in which income devoted to saving and capital formation is deliberately taxed more heavily than income used for consumption in the mistaken notion that this will somehow redistribute income and lift the living standard of the poor.

In a consumption-based income tax, such as has been proposed by The Strengthening of America Commission[7] or described in Treasury's *Blueprints for Basic Tax Reform*[8], proceeds from assets sales would be taxed as ordinary income, <u>but only because the purchase of the financial asset or property was allowed as a tax deduction at the time of purchase</u>. (Any capital gain or loss would be included in the difference between the sales and purchase prices, and would not be calculated or taxed separately, resulting in enormous tax simplification.) Furthermore, if the proceeds were saved (rolled over or "reinvested"), they would be immediately re-deducted, postponing the tax until the proceeds were ultimately used for consumption. Until all saving is given this sort of treatment, akin to a universal IRA, the correct rate of tax for capital gains is zero. In particular, the step-up in basis at death permitted under current law, which allows a portion of capital gains to escape double taxation, should remain in effect unless the law is changed to permit the deduction of saving and investment.

<u>Tax capital: reduce selected "tax expenditures" or tax-related "subsidies"</u>

Mandate proposed eliminating or reducing a number of so-called tax expenditures or subsidies. Virtually all of them represent efforts to bring the deduction of business expenses closer to first year write-off (expensing), which is the economically neutral and optimal tax treatment of such expenses.

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[7] *The Strengthening of America Commission First Report* (Washington, D.C., Center for Strategic and International Studies, 1992), pages 20-22, 82-89.

[8] David F. Bradford and the U.S. Treasury Tax Policy staff, *Blueprints for Basic Tax Reform*, second edition, revised (Arlington, VA, Tax Analysts, 1984) pages 8-12, 101-126.

The proposed reforms would move the tax code further away from the proper treatment of business income. *Mandate* is clearly in the camp of the "broad-based" income tax, in which income devoted to saving and capital formation is deliberately taxed more heavily than income used for consumption in the mistaken notion that this will somehow redistribute income and lift the living standard of the poor.

The threatened items include:

- expensing provisions for extractive industries,
- percentage depletion for extractive industries,
- tax credit for profits earned in U.S. possessions,
- accelerated depreciation on rental housing and other buildings,
- deductibility of business expenses for meals and entertainment,
- tax preference for credit unions,
- tax preference for private-purpose revenue bonds,
- tax credit for rehabilitating older buildings,
- expensing of advertising costs.

<u>Clinton's international agenda: increase taxes on multinational firms</u>

Clinton proposes to raise taxes on U.S. firms operating abroad and on foreign companies operating in the United States. The Clinton proposals would substantially reduce the integration of the U.S. economy with that of the rest of the world, to the great detriment of our productivity, competitiveness, and living standards.

Tax U.S. firms investing abroad

Clinton incorrectly assumes that the current tax treatment of foreign investment encourages U.S. businesses to close factories in the United States and open them abroad. Under current law, U.S. taxes on foreign-source income are deferred until the income is repatriated to the United States. Clinton would curtail or repeal deferral.

Curtailing deferral would increase the tax burden on U.S. investment abroad, and would reduce foreign investment by U.S. multinational businesses. This would not drive the investment back to the United States as Clinton supposes, however; it would merely eliminate a portion of the investment. Foreign assets of U.S. firms would not "come home"; they would be divested or simply not renewed. Raising taxes on foreign income does not reduce them on domestic income, does not lower the gross return needed to cover domestic taxes and the normal (after-tax) cost of domestic capital, and, therefore, does not increase the domestic stock of capital.

If deferral were repealed, U.S. firms would become less able to compete with foreign firms in servicing foreign markets efficiently. They would order fewer U.S. parts to supply their plants abroad. U.S. saving, investment, employment, and income would be lower than otherwise, and tax revenue would be lower, not higher.

Tax foreign firms

Clinton would impose a discriminatory tax increase that would drive foreign capital away. "Putting People First" claims that foreign firms operating in the U.S. have been overcharging their U.S. subsidiaries for parts and products, reducing taxable profits in the U.S. and inflating them abroad. The IRS has found little or no evidence of this. Nonetheless, the Clinton paper claims that $13.5 billion could be raised each year by cracking down on this assumed abuse.

It would not pay most foreign investors to shift reported income from the United States to Japan or Europe, because corporate tax rates in those countries generally exceed U.S. levels. Little U.S. tax is due from firms that have expanded here in recent years and are still writing off major outlays for plant, equipment, and structures. As they use up their capital consumption allowances, their U.S. taxable income will rise.

Nothing like the amounts assumed in the Clinton paper could be raised by imposing new transfer pricing rules on these companies. Only by imposing arbitrary taxation in excess of normal rates on actual income could such sums be attached. Taxation of non-existent income would deter new investment in the United States by foreign companies and would drive foreign investment out of the United States. It would also invite retaliation by foreign governments against U.S. multinational firms, cutting U.S. earnings abroad and reducing U.S. exports.

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Driving foreign capital away is bad policy because the United States benefits from capital formation within its borders even if the owners of the capital live abroad. Although the earnings of that capital do not accrue to U.S. residents, much of the income resulting from the use of that capital accrues to labor and government in the form of higher wages and tax revenue. Indeed, labor and government typically capture more of the additional income resulting from additional capital than the investors.[9] Driving foreign capital away would reduce the growth of productivity, wages, and employment in the United States, unless the capital were replaced, dollar for dollar, with the home-grown variety. Given the proposed tax rate increases on domestic savers, this is unlikely. Indeed,

[9] Gary Robbins and Aldona Robbins calculate that, for each dollar of sales, on average: 43.6% goes for federal, state, or local excise taxes and taxes on labor and capital; 43.7% goes (after-tax) to labor; 9% goes to depreciation; and 3.7% goes (after-tax) to capital owners. "Capital, Taxes and Growth", *NCPA Policy Report* No. 169, National Center for Policy Analysis, Dallas, January 1992, p. 8.

Mandate explicitly relies on an increase in foreign investment in the U.S. to make up for some of the reduced domestic saving likely to occur if marginal tax rates are increased.[10] Clearly, there are inconsistencies in the Clinton program with respect to the tax treatment of international capital.

The "green" agenda: excise taxes on energy

Proposals have been circulating for some time that call for sharply higher gasoline taxes ranging from an additional $0.10 to $1.00 per gallon on top of the current federal gasoline excise tax of $0.141 per gallon. Prior to the inauguration, Clinton opposed an "excessive" increase in the gasoline tax, apparently on the grounds that it is a regressive tax, falling more heavily on the poor than the rich, as a percent of income. More recently, Treasury Secretary Bentsen has indicated that a broadly-based energy tax was under consideration.

Any significant energy tax would have seriously depressing effects on the economy. Even a relatively small gasoline tax increase...would raise transportation costs for virtually all goods produced in the country, hurting consumers and damaging U.S. competitiveness in the world economy.

A "carbon tax" proportional to the carbon content of various fuels is favored by many environmentalists. Vice President Gore has suggested a BTU[11] tax, proportional to the heat content of fuels. The carbon tax would fall on heating oil and other petroleum products as well as on gasoline, on natural gas, and on coal. The BTU tax would fall on these fuels and on hydroelectric, solar, and nuclear power as well. The justifications given for these taxes include curbing pollution, fighting global warming, or reducing dependence on foreign oil. The real motivation for these proposals, however, appears to be raising a lot of revenue.

There is more to excise taxes than their distributional consequences, however. Excise taxes have important economic effects. They do not simply fall on the consumers of the taxed item. An excise tax raises the cost of producing the taxed product, forcing producers to raise its price. As consumers cut their purchases of the more expensive product, much of the impact of the tax is shifted to the labor and capital used to produce it. Furthermore, the tax increases the cost of other goods and services that use the taxed product in production. The tax spills over to affect the labor and capital used in these activities as well. At a further remove, since final consumers of the products are also workers and savers, the higher tax reduces the value of income and the incentive to supply labor and capital throughout the economy.

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[10] *Mandate, op. cit.*, p.9.

[11] British thermal unit.

Any significant energy tax would have seriously depressing effects on the economy. Even a relatively small gasoline tax increase, e.g., $0.10 per gallon, would raise the annual cost of living by about $125 per family. It would raise transportation costs for virtually all goods produced in the country, hurting consumers and damaging U.S. competitiveness in the world economy. Approximately 240,000 jobs would be lost, and real wage rates would be depressed by about 0.2 percent. About 40% of the projected revenue gain would be offset by smaller revenues from payroll and income taxes.[12] Larger increases in the tax rate would have larger impacts in rough, though not perfect, proportion. A broader-based carbon or BTU tax would have similar effects depending in magnitude on the rate of tax imposed.

<u>Incentives for growth: cheap — and ineffective</u>

Temporary job credit

Mandate proposes that "for 12 months, firms should be able to receive a tax credit for a significant portion of the first $10,000 paid to new employees...limited to businesses that increase their total work force and their total wage bill."[13] Employment growth has slowed in part because of the 1988 and 1990 payroll tax hikes, two large minimum wage increases, a host of new regulations, and sharply higher taxes on investment since the 1986 Tax Reform Act. No temporary credit can undo that damage. A rollback of the payroll tax rates and serious tax relief for investment would be better solutions.

Capital gains: relief for start-up businesses

Clinton and *Mandate*[14] would provide a 50% "tax exclusion", presumably including capital gains, for investments of at least five year's duration in small start-up enterprises. This is a highly restrictive and distorting incentive for savers to lend to the riskiest businesses. It will lead to major enforcement problems as established firms seek to set up new subsidiaries to take advantage of the lower-taxed source of financing. As discussed above, all capital gains should be excluded from tax.

Investment Tax Credit — incremental and targeted — but maybe not temporary

Mandate proposes an incremental investment tax credit (ITC) for investment in productive plant and equipment. In the past, all types of equipment have been eligible, most structures have not. The credit would be permanent, but in a nod to the jump-start folks, it would apply at a higher rate in 1993 than in later years.

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[12] Norman B. Ture, Carlos Bonilla, and Stephen J. Entin, "The Impact, Shifting, and Incidence of an Increase in the Gasoline Excise Tax," IRET, July 17, 1992.

[13] *Mandate*, op. cit., p.5.

[14] “Putting People First,” *op.cit*, p.7. *Mandate*, op. cit., p.44.

It is good that the proposed credit would be permanent. The disappointing rate of investment in recent years is not just a business cycle phenomenon. The stock of capital has been depressed relative to levels that would otherwise have occurred because of higher taxes imposed on capital in the Tax Reform Act of 1986 and increased costs of regulation. The lower growth path of the stock of capital will persist as long as the regulations and higher taxes on capital do. A temporary cut in the tax on capital would cause some near-term increase in investment, but much of this investment would be borrowed from a future time period, and the time path of desired capital holdings would not be increased on a permanent basis.

An ITC that applies to certain assets and not to others would distort investment decisions and be a form of industrial policy.

It is unfortunate that the credit would be "incremental", applying to levels of investment in excess of that in some base year. Incremental credits are capricious, affecting businesses differently according to their investment histories, which may have been badly distorted by the recent recession. An incremental ITC would discriminate against businesses whose investment has dropped below previous years' levels in the recession. Existing businesses would be discriminated against relative to new enterprises.

Further problems would arise if the base period were moved up over time, as is done for the R&E credit. A moving base period would cancel much of the reduction in the cost of capital, because each dollar of investment in the current year would raise the base level for subsequent years and deny the credit to additional amounts of future investment. Today's "incremental" piece of equipment will wear out in five to seven years. At that time, under a moving base period, the outlay would be a non-incremental replacement investment subject to the same high tax rates currently discouraging the investment. Only the most myopic business would increase its capacity under that type of incentive.

Another problem with an ITC is its history of on-again, off-again availability. The credit has too often been justified as a means of "jump-starting" the economy rather than as a means of permanently lowering excessive taxation of capital. The percentage of the credit has been arbitrary, and the credit has been raised, lowered, repealed, and reinstated many times.

The Clinton team may have chosen an incremental credit because it is cheap. A broad-based ITC has the drawback of reducing tax revenue immediately at a time of large budget deficits. In fact, there are more effective alternatives that provide proper, neutral tax treatment and are far cheaper in the near term.

A better approach: neutral tax treatment of investment

In an ideal neutral tax system, business would be allowed an immediate write-off (expensing) of each dollar spent on plant, equipment, and structures. The capital consumption (depreciation) write-offs in current law, however, are stretched out over many years and are not adjusted for inflation. As a result, the write-offs have a real present value well below the full purchase price. As a result, the investment is partially double-taxed. The loss of value is larger the longer the life of the asset, and the higher the rate of inflation.

Expensing would eliminate the double-taxation, but would be costly for the Treasury in the near term. However, the same incentive for investment could be achieved by enactment of a neutral cost recovery system (NCRS). NCRS would raise the present value of the write-offs to 100% of the value of the investment in the property for all assets and for all rates of inflation. It would do so by expanding those parts of the write-off not taken in the first year by a normal annual real return of 3.5 percent plus inflation.[15]

NCRS can be designed to raise or lower tax revenues during the budget period by altering the basic depreciation schedules before adjusting the out-year write-offs.[16] The long-term static revenue losses (losses before adding in revenue gains from higher economic growth) from NCRS are small as a percent of GNP. By the time there were annual static losses of significant size, there would be additional capital stock, employment and real wage growth, and higher income and payroll tax receipts, to offset them.

In addition to its revenue advantages, NCRS is more adaptable than an ITC to changing economic circumstances. To be neutral across assets, an ITC would have to be universal (not incremental). It would have to be set at a different rate for each asset life, and reset with each change in the rate of inflation. NCRS adapts to different asset lives and changing inflation automatically.

Evaluation of the Package

The Clinton program would take two giant steps toward restructuring the U.S. economy as America, Inc. First, the government would pre-empt, even more than at present, the role of private savers and the financial markets in creating and directing financing for private investment. A portion of the proposed anti-saving tax increases would pay for incentives for favored investments. Businesses would become more dependent on the goodwill of the government for financing. Second, much of the tax increase would be used to finance public spending on infrastructure, otherwise known as "pork barrel" spending. These projects would likely be of less value than the

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[15] For example, if the second-year depreciation deduction for a property under the existing capital cost recovery schedules were $100, and if inflation had been 5 percent over the previous year, the second year write-off would be increased to $108.675 (1.035 x 1.05 x $100). Additional adjustments would be made for subsequent years.

[16] An NCRS option was introduced in the current Congress on January 21, 1993 in H.R. 539 by Representative Nick Smith and 52 cosponsors. Depreciation write-offs would be adjusted annually by a compounded real return of 3.5% and the percentage change in the Gross Domestic Product deflator. In order to make the bill revenue neutral over the budget period, firms electing to use NCRS would be limited to the 150 percent declining balance method of depreciation. The NCRS schedules would apply under the Alternative Minimum Tax as well as ordinary income tax to ensure that all firms benefit. Other versions of NCRS were introduced in the last Congress as elements of the DeLay-Wallop bill (H.R.960 and S.381) and the Kasten-Weber bill (S.1920 and H.R.3744).

private sector activity the infrastructure spending will displace. The program is reminiscent of Italy during the 1920s and 1930s.

The Clinton policy is to have investment without savers. Higher individual tax rates, an increase in the AMT, taxation of capital gains at death, and curtailment of so-called tax expenditures that reduce the anti-saving bias in the income tax would all depress domestic saving and the after-tax rates of return on business earnings. *Mandate* explicitly and incorrectly assumes that any tax-induced reduction in domestic saving can be made up by foreign investment in large U.S. corporations.[17] Significantly greater amounts of foreign saving would be made available for investment in the United States only at higher rates of return. Nothing in the Clinton program, however, would raise the rates of return to foreign savers. Indeed, foreign direct investment would fall if it were subject to higher rates of taxation under the new transfer pricing rules that *Mandate* also proposes. Not all of the reduction in domestic saving would be made up from foreign sources. The damage done to domestic savers and small businesses would certainly not be eliminated, either. Clearly, an increase in taxes at either the personal or corporate level would reduce investment and output.

More fundamentally, Clinton and *Mandate* err in viewing saving only as a means of meeting some government-determined goal for business investment in the United States. Individuals save for retirement, for emergencies, for large purchases such as a downpayment on a home, or for investment in their human capital (e.g., college tuition). Failure to save makes people poorer and more dependent on Federal and state programs for retirement, housing, education, and training — all areas about which Clinton has expressed concern. The independence and security that private saving provides individuals and families cannot be made up by tax transfers to business or by additional infrastructure spending.

Conclusion

One does not have to be a supply-side economist to be concerned with the incentive effects of tax policy on saving, investment, and employment. Over the last two decades, there has been a substantial accumulation of knowledge by academics and policy-makers of many persuasions to the effect that lower tax rates and less government intrusion in the economy promote faster growth. In "Putting People First," Clinton talks at length about strengthening the economy. However, his program is a collection of ad hoc measures designed to fill political promises. The creators of the program do not seem to have addressed the major issue: does the plan alter tax policy in a way that will contribute to or hinder economic growth and competitiveness? It is clear from a reading of the program that it will hinder rather than help.

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[17] *Mandate, op. cit.*, p.9.

Now that he is installed in the White House, Mr. Clinton would do well to go back to the drawing board to devise a better tax agenda for removing tax deterrents to economic growth. He should discard the maunderings of his think tank advisers and rely instead on the basic common sense of a good tax policy, viz., tax something more and you get less of it; tax something less and you get more of it.

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