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# BUDGET PACKAGE THREATENS SAVING, GROWTH

## Introduction

As this study goes to press, the final version of H.R. 2264, the Omnibus Budget Reconciliation Act of 1993 (OBRA93) is being negotiated in a House-Senate conference. OBRA93 would contain the bulk of President Clinton's economic proposals, as modified by the Congress.

One of the chief objectives of the reconciliation bill is deficit reduction. The chief reason given for seeking deficit reduction is that it would lower government borrowing and, supposedly, raise national saving by decreasing the government's absorption of private saving. Supposedly, the higher national saving would reduce interest rates, permit more private sector investment and faster economic growth, and enhance the global competitiveness of U.S. businesses.

This line of reasoning is fatally flawed. It rests on the assumption that the tax increases that make up the bulk of the reconciliation package would have no adverse effect on private saving and on investment incentives. Yet the tax increases would reduce private saving dollar for dollar, or more. There is no reason to believe that national saving would increase, no reason to suppose that interest rates would be lower, and every reason to believe that saving, investment, and GNP would be less than they would be if this package does not become law.

OBRA93 would depress saving by raising marginal tax rates on individuals and businesses and by curtailing retirement saving plans. Higher tax rates would reduce individuals' and businesses' after-tax incomes, reducing the private sector's ability to save. More importantly, higher tax rates would lower after-tax returns to savers and thereby reduce the incentive to save out of any given amount of after-tax income. As a result, saving and investment would be less than they would be without the tax increases, slowing the growth of GNP. Lower growth of GNP would further reduce the growth of after-tax income and saving compared to levels achievable in the absence of the tax increases.

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In particular, the package singles out personal saving for retirement for some of the heaviest tax penalties. By doing so, the package would interfere with people's efforts to provide for their own retirement. The cost of saving would become greater, and the ability to accumulate enough financial assets or other income-generating property to cover retirement income needs would be diminished. People would be forced to accept later retirement, or retirement with reduced incomes. They would certainly become more dependent than ever on Social Security and other government payments in their retirement years, which would mean even higher taxes on future generations of workers and savers.

The result of the reconciliation bill's attack on saving and investment would be lower growth of productivity, wages, and employment, and a reduction in the global competitiveness of U.S. businesses relative to levels that would occur if the deficit were addressed solely through restraint of government spending. The wholesale assault on private saving in the budget reconciliation bill is especially ironic given the rationale that has been used to justify deficit reduction.

Anti-saving provisions in the House and/or the Senate version of OBRA93 include:

- individual tax rate increases (including a new 36% tax rate and a 10% surtax, higher alternative minimum tax rates, and permanent extension of the phase-outs of the itemized deductions and personal exemptions enacted on a temporary basis in 1990);

- removal of the $135,000 cap on income subject to the HI (Medicare) portion of the payroll tax;

- a capital gains surtax (Senate version);

- increased corporate tax rates, longer asset lives on structures, and restrictive foreign tax provisions;

- increased transfer tax rates on large estates and gifts;

- tax increases on Social Security retirement benefits;

- tightened retirement plan restrictions;

- disallowance of capital gains in determining the amount of deductible investment interest expense;

- denial of capital gains treatment to stripped stock, market discount bonds, and certain hedged positions in stocks and commodities.

In addition to provisions that directly affect saving, the general anti-growth consequences of the bill would reduce national income and, consequently, national saving. The chief culprits among the general anti-growth provisions are the House Btu energy tax and the Senate transportation fuels tax. One or the other of the energy taxes is likely to emerge in the Conference Committee bill.

**Overview of taxes, saving, and deficits**

Federal, state, and local tax code bias against saving.

Under provisions of the federal income tax, income is taxed when first earned. If it is used for consumption, it is free of additional federal income taxes. If it is saved, however, the returns on the saving are taxed again, often repeatedly. This is the well-known bias of the income tax against saving.[1]

After income has been earned and taxed, personal taxes on returns on non-corporate investments, such as interest, rents, and earnings of unincorporated businesses, constitute a second round of taxation — double taxation — of income that is saved. Similarly, personal saving invested in corporate ownership is subject to a second round of taxation — the corporate income tax on the corporate earnings on that saving. A third round of income tax — triple taxation — is imposed if the corporation distributes its after-tax income as dividends to individuals. If the corporation retains its after-tax earnings for reinvestment, the resulting increase in the share price constitutes a capital gain, also resulting in a third layer of tax on the retained earnings if the shares are sold.

Capital gains may also occur when a business's earnings outlook improves for reasons other than reinvestment. A new product or patent, a rise in sales, anything that would lead to a jump in anticipated income (income that the business has not even received yet) may boost the current valuation of the shares or business. If the higher expected business earnings come to pass, they will

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[1] A neutral tax code would raise revenue without distorting economic activity. The tax would do this by increasing the cost of all private sector activities equally. The income tax, because it is assessed on both income that is saved and the returns on that income, taxes saving and investment more heavily than consumption.

Suppose that, in the absence of taxes, one could buy $100 of consumption goods or a $100 bond paying 4% interest, or $4 a year.

Now impose a 20% income tax. One would now have to earn $125, and give up $25 in tax, to have $100 of after-tax income to consume. The cost of $100 of consumption in terms of pre-tax income has risen 25%. To get a $4 interest stream, after taxes, one would have to earn $5 in interest, pre-tax. To earn $5 in interest, one would have to buy a $125 bond. To buy a $125 bond, one would have to earn $156.25 and pay $31.25 in tax. The cost of the after-tax interest stream has gone up 56.25%, more than twice the increase in the cost of consumption.

There are two general approaches to restoring neutrality. One is to exempt returns on capital from tax. One would then have to earn $125 to buy a $100 bond, earning $4 with no further tax. This is akin to the tax treatment accorded state and local bonds. The other method is to allow a deduction for income that is saved, while taxing the returns. One would have to earn $125 to buy a $125 bond, earning $5 in interest pre-tax; after paying $1 in tax on the interest, one would have $4 left. This is akin to the deductible IRA, or qualified 401(k) or company pension plans.

be taxed as corporate income and/or personal business or dividend income. To tax the increase in the current value of the business, either upon sale, gift, or bequest, is to triple-tax the future income.

If the saving outlives the saver, the federal unified transfer (estate and gift) tax may impose yet another layer of tax on the saving. Every dollar in an estate has already been, or will be, subjected to one or more layers of individual or corporate taxation. Insofar as the transfer tax exceeds the transfer tax credit, the saving is triply or quadruply taxed.

The chief exception to the added layer of taxation produced by the transfer tax are unrealized capital gains. Capital gains are not subject to income tax upon a taxpayer's death, and the heirs are allowed to step up the income tax basis of the inherited assets to their market value at the time the death occurred. Step-up avoids an additional layer of multiple taxation. Without the step-up, capital gains held at death would be subject to both the income tax (when the heirs eventually sell the asset) and the estate (transfer) tax.

In addition to the federal income and transfer taxes, state and local income, estate, and gift taxes impose multiple layers of tax on saving and its returns. There are property taxes as well.

These multiple layers of tax on saving and capital increase the cost of saving, leading to a smaller stock of capital than would otherwise prevail. A smaller capital stock means a lower level of labor productivity, which means lower real wages and employment, and lower levels of total income than could otherwise have been achieved.

Gauging the effect of a tax hike on private saving, revenues, and the deficit.

Taxes affect both the incentive to save (how much total saving one wants to accumulate) and the ability to save (the amount of disposable income available to be saved). The effect of a tax rate hike on the incentive to save depends on how much it raises the cost of saving, or, put a bit differently, how much it reduces the after-tax reward to saving, from current levels. The key is to examine the change in the current after-tax reward "at the margin" to an additional dollar of income from saving.

Taxes at all levels must be considered. Business tax increases come directly out of business saving, which is the sum of retained (after-tax) earnings of corporations and capital consumption (depreciation) allowances. Furthermore, changes in business taxation also affect the incentive to save on the part of shareholders and owners of unincorporated businesses.

Individual tax rate hikes of 5 or 9 percentage points may not seem like much at first glance if measured against total income. However, the tax increase is in addition to taxes already being paid. The increase must be measured against the income the taxpayer has left after paying the taxes already in place. Because the taxpayers affected by the OBRA93 income tax increases already pay high tax rates, the drop in their after-tax returns on saving will fall sharply.

Consider a taxpayer in the 31% federal tax bracket, with a state income tax of about 6% at the margin. After the currently-scheduled expiration of the phase-outs of itemized deductions and personal exemptions, his combined marginal tax rate would be roughly 37% on capital income; an extra dollar of capital income would net him only 63 cents, after-tax.

House and Senate versions of OBRA93 would boost the combined federal-and-state marginal rate as high as 43% for a taxpayer not subject to the phase-outs and as high as 49% for a taxpayer subject to the phase-outs. The rate hike would cut the after-tax return on the taxpayers' saving to 57 cents or as little as 51 cents, declines of roughly 10% to 19%. (Factoring in corporate taxes would reveal an even greater decline.) A drop in the after-tax return to saving of that magnitude would significantly reduce investment, investment income, and the growth of productivity and wages.

A given rate hike cuts the after-tax reward by a greater percentage if the tax rate was high to begin with than if it was low. Consequently, rate hikes on the "rich" disproportionately reduce rewards for work, saving, investment, and entrepreneurial activity for the very individuals who do a disproportionately large amount of these activities, and who consequently produce a disproportionately large amount of the GNP.

The effects of the reduced incentives and GNP would not be confined to the rich, however. Upper-income people would reduce the amount of skilled labor and entrepreneurial talent they supply to the workplace, and would save and invest less. Less capital, and less entrepreneurial input, would result in reduced productivity, wages, and employment for all workers. People of all income levels would have lower incomes than in the absence of the tax increases. Consequently, people of all income levels would be able to save less than otherwise.

Moreover, not all of the anti-saving, incentive deadening tax provisions in OBRA93 have their initial effect on the wealthy. Some of the provisions directly affect current saving by persons of all income levels, even those with incomes below $20,000.

Tax rate increases never achieve the revenue gains or the deficit reduction that the proponents of the rate hikes anticipate and hope for. The tax rate increases proposed in OBRA93 would cause taxpayers to change their economic behavior, and the economy would suffer as a result. Total income would be lower than without the tax increases. In addition, there would be greater incentives to divert income into less heavily taxed forms. For both reasons, taxable income would be less than otherwise. Consequently, the revenue gain projected from the proposed tax rate increases is overestimated.

Reduction of effort and investment by upper-income people need not be large to sharply reduce the revenue to the government from the tax rate increases proposed in OBRA93. The various tax rate hikes in OBRA93 would add from 5 to 13 percentage points of tax to each dollar of capital and labor income that the affected taxpayers continue to earn. But the government would lose all revenue, some 31 to 44 cents (including income tax and payroll tax where applicable) for every dollar that upper income individuals choose not to earn as a result of the tax rate increases. Each dollar of income not earned would wipe out the revenue gain on three to four dollars of income that continued to pay tax.

**Tax provisions in OBRA93 affecting saving**

Individual income and payroll tax rate increases.

House and Senate versions of OBRA93 would impose a series of explicit and implicit marginal tax rate increases on upper-income taxpayers. The rate hikes would seriously reduce the after-tax incentives to work, save, and invest among the affected people. GNP, employment, and productivity would grow more slowly than in the absence of the tax increases. Tax avoidance would increase. Taxable income would be lower than without the tax hike. Revenue from the rate hikes would fall far short of expectations.

New 36% bracket, surtax, and increase in AMT.

OBRA93 would impose several explicit marginal tax rate increases. It would create a new tax bracket with a rate of 36% on taxable incomes above $140,000 for married couples filing jointly and on single filers with taxable incomes over $115,000. A 10% surtax would hit those with taxable income over $250,000, creating an effective rate of 39.6%. (Unlike the House, the Senate would apply the surtax to capital gains as well as ordinary income. See below.) The basic Alternative Minimum Tax (AMT) rate would be increased from 24% to 26%, and a second AMT bracket at a 28% rate would be added on AMT income over $175,000. The Senate version would impose half the increases in 1993 (in effect, making the rate hikes effective at midyear): the top bracket rate would be 33.5% in 1993 and 36% in 1994; the surtax rate would be 36.85% in 1993 and 39.6% in 1994. The House version would make the full rate increases effective for all of 1993.

A review of the fine print reveals that both versions would let inflation lower the real income thresholds at which the proposed 36% bracket and the 10% surtax kick in. The current tax brackets, the personal exemptions, and standard deductions are adjusted (indexed) for inflation. These thresholds for the new bracket and surtax would be indexed too, but only after a year's delay, that is, for tax years beginning after December 31, 1994. Assuming 4% inflation between 1993 and 1994, the 36% bracket thresholds for 1994 and beyond would be allowed to slip to $134,615 in real 1993 dollars for married taxpayers and to $110,577 for single taxpayers. The 1994 surtax threshold would slip to $240,385 in real 1993 dollars, and remain at this depressed real level forever after.

The result of the slippage in the bracket thresholds would be to subject more of the nation's most productive people to punitively higher tax rates, disproportionately discouraging output and saving. Punishing the nation's major savers and investors is strange behavior for Members of Congress who publicly fret over the inadequacy of national saving and investment.

Permanent extension of phase-outs of itemized deductions and personal exemptions.

House and Senate versions of OBRA93 would impose hidden marginal tax rate hikes by extending the present law's phase-outs of personal exemptions (PEs) and up to 80% of itemized deductions (IDs) for upper-income taxpayers. PEs are phased out over adjusted gross incomes (AGIs) of $108,450 to $230,950 for single individuals and $162,700 to $285,200 for married couples filing jointly. IDs are gradually lost on AGIs above $108,450 for all filers, without upper limit. The phase-outs were scheduled to expire in 1996 (IDs) and 1997 (PEs).

The phase-outs were enacted as part of the 1990 budget deal — OBRA90 — to raise revenue from the upper income without explicitly raising marginal tax rates, which President Bush had pledged not to do. Because of the phase-outs, however, an additional dollar of income raises taxable income by more than a dollar, effectively raising the marginal rates. For example, in 1993, a married couple in the 31% bracket, with two children, losing IDs and PEs faces an effective 34.3% marginal income tax rate. Under the proposed 36% tax rate, the phase-outs would boost the effective marginal tax rate to 39.8%. (The increase would become steeper over time as the PEs increase with inflation, because the phase-out ranges are not indexed.) Taxpayers affected by the phase-out of IDs and the proposed 10% surtax would face a marginal tax rate of 40.8%. (See table.) These proposed tax rates are far higher than the 31% rate that would apply under current law after expiration of the phase-outs.

Of course, these are federal income tax rates only. Taxpayers subject to state and local income taxes could have marginal tax rates considerably higher. Some or all of wage income is also subject to the payroll tax at the margin.

Elimination of the Medicare wage cap.

House and Senate versions of OBRA93 would eliminate the current $135,000 wage cap on the 2.9% Medicare (HI, hospital insurance) portion of the payroll tax, which would then cover all wage and salary income. Because half of the HI tax is deductible against the income tax by the employer or the self-employed taxpayer, the net increase in the marginal tax rate on labor income over $135,000 would be about 2.4 percentage points. High-salaried employees with a family of 4 could face a combined marginal federal income and HI tax rate of 39.5% to 43.2%. (See table.)

Elimination of the wage cap would not raise marginal tax rates on income from saving, and would not directly reduce the incentive to save. However, it would depress saving by reducing the disposable income of the affected workers. The first activity curtailed by a taxpayer when taxes rise is saving, and much of the tax increase would be matched by a cut in personal saving. Furthermore, the higher marginal tax rate on wage and salary income would reduce work incentives and raise the cost of labor to businesses. Business saving would fall. There would also be less employment of upper-income workers. The loss of their skills and effort would reduce the productivity, income, and saving of other workers, and reduce the productivity and earnings of capital, indirectly reducing saving incentives further.

| Top Federal Marginal Tax Rates, Current Law and Under OBRA93 for a Family of 4 | | | |
|---|---|---|---|
| | Current law | Proposed 36% tax rate | Proposed 36% rate and surtax |
| Marginal base income tax rate | 31.0% | 36.0% | 39.6% |
| plus ID phase-out (and HI tax)* | 31.9% (34.3%) | 37.1% (39.5%) | 40.8% (43.2%) |
| plus ID and PE phase-outs (and HI tax)* | 34.3% (36.7%) | 39.8% (42.2%) | ** |
| * ID=Itemized Deductions; PE=Personal Exemptions; HI=Hospital Insurance portion of payroll tax, half tax deductible by employer (2.9% before deduction, about 2.4% after). ** Few taxpayers would encounter both the surtax and the phasing-out of PEs on the same dollar of incremental income. Most people with taxable income at the surtax levels have AGIs large enough to have lost all their PEs. | | | |

The capital gains surtax (Senate bill).

The Senate version of OBRA93 would extend the 10% surtax to capital gains insofar as taxable incomes exceed the surtax thresholds. The surtax would raise the top tax rate on capital gains from the current 28% to 30.8% (exclusive of the effects of the phase-outs of itemized deductions and personal exemptions). The House version would retain the current 28% cap on the tax rate on capital gains.

Taxation of capital gains is part of the double or triple taxation of capital income, described above and in the following table, on the taxation of corporate income. Raising the rate would aggravate the tax bias against saving, increase the cost of capital, and reduce investment. Furthermore, it is unlikely to raise revenue, because it would immediately reduce the market value of existing capital assets, encourage taxpayers to realize fewer gains, and would depress the growth of investment, employment, and wages.[2]

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[2] Claims that raising the capital gains rate will reduce the deficit and spur investment are spurious. In addition to the direct adverse effects of the rate hike on the cost of saving and investment, raising the capital gains tax rate is unlikely to raise the expected revenue, and may in fact result in less revenue rather than more. The timing of payment of a capital gains tax is largely up to the taxpayer. Owners of real property and financial instruments such as stock can avoid the payment of the capital gains tax by holding on to their assets. After the 40% hike in the maximum capital gains rate from 20% to 28% in the Tax Reform Act of 1986, capital gains realizations began to slide. Capital gains realizations were $173 billion in 1985, before the reform. By 1991, they had fallen to $108 billion. The higher tax rate reduced the amount of gains appearing in taxable income to such an extent that the U.S. Treasury is collecting less revenue from the tax today than it did when the rate was lower.

The fairness issue has frequently been raised with respect to the taxation of capital gains. A significant portion of capital gains accrues to people in the top few percent of the income distribution. It is claimed that cutting the tax rate on capital gains would unfairly benefit upper-income individuals, and, therefore, that raising the tax is fair. The real fairness issue, however, is that the capital gains tax is multiple taxation to begin with. In an unbiased, neutral tax system, there would be no taxation of capital gains, as such.[3] Indeed, the taxation of capital gains is unfair, both to savers and investors who bear the tax directly, and to workers who suffer the loss of productivity and real wage rate gains from the reduced capital formation caused by the tax.

Increased corporate tax rates.

People who invest their saving in corporate stock face combined corporate and individual income taxes at the federal level in excess of 50% on their corporate earnings. OBRA93 would raise the combined rates in some cases to over 60%. The incentive to save would fall; the cost of corporate capital would rise; the economy would be weaker than in the absence of the tax increase.

The House and Senate versions of OBRA93 would increase the corporate tax rate (including the tax rate for capital gains realized at the corporate level) to 35% on taxable profits in excess of $10 million. These changes would add an additional corporate tax bracket and tax rate on top of the current brackets which bear rates of 15%, 25%, and 34%. Current law recaptures the "benefits" of the 15% and 28% rate via a 5 percentage point surtax (effective 39% tax rate) on income between $100,000 and $335,000, leaving firms with higher income paying a flat 34% tax. The altered law would recapture the "benefit" of the 34% rate with a 3 percentage point surtax (effective 38% tax rate) in much the same manner on income between $15,000,000 and $18,333,333.33.

The combined tax rates imposed by the current corporate and personal income taxes on corporate earnings exceed 50% for many savers, leaving the shareholders less than $0.50 in after-tax return on each dollar of corporate earnings paid as dividends. Under the two versions of OBRA93, the combined rates could exceed 60% on dividends, cutting the after-tax return to less than $0.40 per dollar of distributed earnings. (See table.)

The rationale for the corporate income tax is to prevent shareholders from indefinitely postponing tax on their share of corporate income that is retained for reinvestment by the company. However, by imposing a tax on all corporate income, including dividends paid out and taxed again at the individual level, a double tax is imposed. In addition, retained earnings tend to raise the value of the stock. If a capital gains tax is part of the tax system, there will be a double tax on the

[3] Note 1 illustrated two methods of neutral tax treatment of saving. Under the "municipal bond" method, an individual's purchases of corporate stock would not be deductible, but any returns, including dividends and capital gains, would be tax free. However, in the "IRA method", purchases of stock would be deductible, giving one a zero basis in the stock, and all returns, including the full sales price, would be taxable (unless reinvested). In neither method would there be any explicit calculation of or double taxation of capital gains.

retained earnings upon sale of the stock. The tax rate on retained earnings resulting in a capital gain could reach 55% under the Senate version of OBRA93, leaving the individual investor only $0.45 per dollar of reinvested earnings.

**The Multiple Taxation of Corporate Earnings, Under Current Law and OBRA93 Tax Rates**

| | a) Dividend payout | | b) Retained earnings | | |
|---|---|---|---|---|---|
| | Current | OBRA93 | Current | OBRA93 | |
| | | Senate and House | | Senate | House |
| 1) Corporate income | $1.00 | $1.00 | $1.00 | $1.00 | $1.00 |
| 2) Corporate tax at top rate* | $0.34 | $0.35 | $0.34 | $0.35 | $0.35 |
| 3) After-tax income a) paid as dividend or b) retained, raising stock price | $0.66 | $0.65 | $0.66 | $0.65 | $0.65 |
| 4) Individual inc. tax on dividends (line 3), at top rate (31% current law, 39.6% OBRA93)* | $0.205 | $0.257 | --- | --- | --- |
| 5) Individual inc. tax on after-tax retained earnings (line 3) taken as capital gain, at top rate (28% current, 30.2% Senate, 28% House)* | --- | --- | $0.185 | $0.20 | $0.182 |
| 6) Total tax | $0.545 | $0.607 | $0.525 | $0.55 | $0.532 |
| 7) Total tax rate | 54.5% | 60.7% | 52.5% | 55.0% | 53.2% |

* Top corporate rates exclude corporate surtaxes. Top individual rates exclude effects of phase-outs of itemized deductions and personal exemptions. Capital gains are assumed realized in year earned.

The higher tax rates imposed by OBRA93 on dividends, capital gains, and corporate earnings make it even more urgent to ameliorate the multiple taxation of corporate income. Reducing or eliminating the capital gains tax and curbing the multiple taxation of dividends would reduce the tax penalties on capital formation and thereby improve the competitive position of American businesses in the world marketplace.

Since a large part of individual saving, especially for retirement, is invested in corporate equities (either through direct ownership of stock or indirectly through mutual funds, pension plans, and annuities), the additional layer of tax on corporate income is particularly hard on the private provision of retirement income.

Complete elimination of the additional layer of tax imposed by the corporate income tax could be achieved through the integration of the corporate and individual income taxes. Each year, corporate income would be attributed to the shareholders for tax purposes. The corporation would inform each shareholder what his or her share of earnings is, and the shareholder would report that amount as taxable income on his or her individual tax return, and pay tax at whatever rate applies to his or her taxable income.

Most countries employ a modified approach to reducing the double taxation. Many allow corporations to deduct dividends paid from the company's taxable income, resulting in a tax on dividends only at the personal income tax level. This still leaves a double tax on retained earnings that raise the value of corporate stock, which most countries lessen through reduced taxation of capital gains.

Higher income tax rates for estates and trusts.

OBRA93 would raise income tax rates on estates and trusts. Many people save in part to be able to leave a bequest or establish a trust for their children. Higher income tax rates on estates and trusts raise the cost of doing so and would, therefore, discourage saving.

OBRA93 would add a 36% tax bracket to the income tax for estates and trusts with taxable incomes above $5,500, and a 10% surtax on taxable income of estates and trusts above $7,500. It would also decrease the thresholds at which all lower estate and trust tax rates become effective. The 15% rate would apply to income up to $1,500, the 28% rate to income between $1,500 and $3,500, and the 31% rate to income between $3,500 and $5,500. The Senate version would provide blended rates for 1993, and full rates for 1994. The House version would impose the full rate hikes in 1993. The Ways and Means and Finance Committees consider the current 15% and 28% tax rates on small estate incomes to be a "benefit" (as if all income should have been taxed at the current 31% top rate), and rationalize that with a new top rate, even the old 31% rate would become a "benefit". They would narrow the lower brackets of the estate income tax schedule to raise the tax and reduce the "benefit" of the rates below 36% to equal the current "benefit" of the 15% and 28% rates. This reasoning implies that all income belongs to the government, and any income the taxpayer keeps is a "benefit".

Increased transfer tax rates on large estates and gifts.

OBRA93 would permanently increase the top tax rates of the unified transfer tax (combined estate and gift tax) from the current level of 50% on lifetime transfer amounts over $2.5 million to 53% on transfer amounts between $2.5 million and $3 million and to 55% on transfer amounts over $3 million.[4] The transfer tax affects everyone, not just upper-income transferors and their

[4] A unified transfer tax is imposed on an individual's cumulative lifetime gifts and bequests. The tax is imposed at graduated rates, with brackets and marginal rates ranging from 18% to 50%. A unified tax credit of $192,800

transferees.  A recent study describes and estimates the economic damage done by the tax:

> "Transfer taxes penalize success and the creation of wealth.  The benefits of wealth are not confined to the individual who owns it; all of society is served by the enhancement of labor's productivity that depends critically on capital accumulation.  The adverse effects of transfer taxes on saving and capital formation, therefore, are costs imposed on society as a whole.
>
> "... (H)ad the transfer tax been repealed in 1971, ... by 1991 the nation's gross domestic product (GDP) would have been $46.3 billion higher, there would have been 262,000 more full-time equivalent jobs, and the stock of capital would have been $398.6 billion greater than the respective actual amounts in that year."[5]

As discussed above, every dollar making up an estate has been previously taxed, or will be taxed, under some provision of the income tax code.  The unified transfer tax is a further layer of federal tax on accumulated saving.  Under present law, it is imposed at higher rates than either the individual or corporate income tax.  OBRA93 would increase the weight of this additional tax layer.

Milton Friedman has pointed out that the estate tax sends a bad message to savers, to wit: it is O.K. to spend your money on wine, women, and song, but don't try to save it for your kids.  The economic irrationality of the tax is surpassed only by its moral absurdity.

Tax increases on social security retirement and disability benefits.

The so-called tax on social security retirement and disability benefits is really a tax on other, private income — interest, dividends, pensions, and wages — received by individuals collecting

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offsets the graduated tax on transfers of up to $600,000.  The next $150,000 of unified transfers is taxed at 37%, with larger amounts taxed at increasing rates up to 50%.  The present law top rate of 50% currently applies to that portion of lifetime transfers that exceeds $2,500,000.  The "benefits" of the graduated rate structure and the unified credit are taken back by an add-on 5% tax on amounts between $10,000,000 and $18,340,000.  Generation-skipping transfers pay a 50% tax rate.

Prior to 1993, the marginal tax rate was 53% on that portion of an estate between $2,500,000 and $3,000,000, and 55% on amounts over $3,000,000.  The reduction in the two top unified transfer rates to 50% in 1993 was a long-delayed implementation of a rate cut first enacted in the Economic Recovery Tax Act of 1981, which provided for gradual reduction of the top income and estate tax rates to a maximum of 50% by 1985.  Subsequent tax bills aiming at deficit reduction repeatedly postponed the decrease in the top transfer tax rate.

OBRA93 would restore the previous two brackets and the higher rates, and recapture the benefits of the unified credit and any rate below 55% with a 5% add-on tax on the portion of an estate between $10,000,000 and $21,040,000.  Generation-skipping transfers would pay a 55% tax rate.

[5] Richard E. Wagner, *Federal Transfer Taxation: A Study in Social Cost*, Institute for Research on the Economics of Taxation (Washington, DC) and The Center for the Study of Taxation (Costa Mesa, CA), 1993, pp. iv, vi.

social security benefits. Under current law, the tax treatment of social security benefits imposes tax rates of up to 42% on the earnings of private saving — a powerful disincentive to save. OBRA93 would raise the rate as high as 51.8%, and would make saving for retirement or disability even less attractive. Incentives to work would be reduced as well. Beneficiaries subject to the earnings limitation could face tax rates in excess of 100% on wages.

Under current law, benefits start to be taxed when modified adjusted gross income (MAGI) — the sum of a beneficiary's ordinary AGI (wages, interest, pensions, dividends, etc.), tax exempt bond income, and half of social security benefits — exceeds $32,000 for a married couple filing jointly and $25,000 for a single taxpayer. Under current law, for each dollar by which MAGI exceeds the exempt amounts, $0.50 of the taxpayer's social security benefits becomes taxable income, up to half of benefits.

As benefits become taxable, earning another dollar of taxable interest, dividends, pensions, or wages increases taxable income by $1.50, effectively raising the marginal tax rate on the added dollar of income to 1.5 times the statutory rate, e.g., from 15% to 22.5% or from 28% to 42%. An added dollar of tax exempt interest raises taxable income by $0.50, subjecting the otherwise untaxed interest to de facto marginal tax rates of 7.5% for taxpayers in the 15% bracket, and 14% for taxpayers in the 28% bracket. Once half of benefits have become taxable, additional earnings again face normal marginal tax rates. (The 31% rate is not affected. Half of benefits become taxable before a taxpayer's income exceeds the 28% tax bracket.)

The additional tax at super-statutory rates is triggered by the earning of additional private income, not by any change in one's social security benefits, which are set by a formula beyond an individual's control. Consequently, it is the other retirement income that bears the tax, not the benefits. The result is a sharp disincentive for private retirement saving.

The House version of OBRA93 would increase the amount of social security retirement and disability benefits subject to income tax to 85 percent for married couples with MAGI above the current $32,000 threshold and for single beneficiaries with income above the current $25,000 threshold. The Senate version would increase the share of benefits subject to tax to 85 percent for beneficiaries with incomes above $40,000 (married couples) and $32,000 (singles).

Affected beneficiaries would have to add $0.85 of benefits to taxable income for each dollar of MAGI over the House or Senate thresholds until 85 percent of benefits become taxable. This would increase the marginal tax rate spike to 1.85 times normal rates. The 15% marginal income tax rate would become 27.8%, and the 28% marginal income tax rate would jump to 51.8%.

At first, the higher tax rates under OBRA93 would fall on the top 20 percent or less of social security beneficiaries — some (Senate version) or all (House version) of those currently paying tax on benefits. Ultimately, however, over 60 percent of beneficiaries will pay some tax on their benefits, because the income thresholds for benefit taxation are not adjusted for inflation. At three percent inflation, by 2010, when the baby boom is beginning to retire, the thresholds for married and single taxpayers will have fallen to roughly $19,000 and $15,000 in today's dollars. Children now in kindergarten will face thresholds of roughly $5,900 to $4,600 in 2050, and will avoid tax on their benefits only by being too poor to owe any income tax at all.

Under current law, even higher tax rates occur when a beneficiary is subject to the social security earnings limit on wage and salary income (in 1993, $7,680 for beneficiaries ages 62-64, and $10,560 for those ages 65-69) as well as the phase-in of benefit taxation. Beneficiaries lose $1 in benefits for every $2 by which wages exceed the limit for people ages 62-64 or $1 for every $3 by which wages exceed the limit for people ages 65-69, producing effective tax rates of 50% and 33-1/3%, respectively, on the wages. These implicit tax rates due to the earnings test are not strictly additive to the income tax effects of benefit taxation, because the benefit reductions slightly reduce the income tax spike. Nonetheless, together with the employee's half of the payroll tax on the added earnings, the tax rate on beneficiaries' wages can reach confiscatory levels in excess of 96% (and over 101% for the self-employed) before state and local income taxes. Under OBRA93, the marginal tax rates under the combined benefit tax and earnings test could exceed 103% (and over 108% for the self-employed) before state and local income taxes. Benefits lost to the earnings test may be recovered later in life if excess earnings cease, and if the retiree lives long enough, but the added disincentive is surely daunting, and would be made more so by OBRA93. Beneficiaries would surely work, earn, and save less as a result of OBRA93.

**Effective Marginal Tax Rates for Social Security Recipients**

| Statutory tax rate | Marginal income tax rate as benefits become taxable | | With wages subject to the earnings test, payroll* and income taxes | | | |
|---|---|---|---|---|---|---|
| | | | Ages 65-69 | | Ages 62-64 | |
| | Current law (150% of statutory rate) | OBRA93 (185% of statutory rate) | Current law | OBRA93 | Current law | OBRA93 |
| 15% | 22.5% | 27.8% | 62.2% | 66.6% | 78.3% | 82.2% |
| 28% | 42% | 51.8% | 80.7% | 88.8% | 96.2% | 103.5% |

* Assumes employee's half of payroll tax. Add about 5 percentage points for self-employed after tax deductibility of half of benefits and interaction with benefit taxation.

The only reason for including the social security benefits tax provision in OBRA93 is to raise revenue. Current tax treatment of benefits already moves Social Security in the direction of a welfare program by back-door means. The OBRA93 proposals would go further in that direction.

The increased tax poisoning of private retirement saving would send a message to current workers that would not go unnoticed: Congress does not want you to save.

Reform of social security benefit taxation (and the earnings test) is urgent. The current tax treatment imposes mindless disincentives to work and save. The OBRA93 changes would exaggerate these flaws. If the objective is fairness, or similarity to the tax treatment of private pensions, it cannot be achieved with tax rates approaching or exceeding 100%. If the objective is to turn social security into a means-tested welfare program, there are surely more efficient ways to do it.

Tightened retirement plan restrictions.

OBRA93 would seriously impair employer-sponsored "qualified plans" and raise the cost of retirement saving for workers. Ostensibly aimed at reducing pensions for highly-paid employees, the changes would affect low- and middle-income employees as well. Ultimately, the provision could result in the termination of some pension plans.

The House and Senate versions of the bill would reduce the amount of annual compensation that may be taken into account in determining amounts that may be contributed to qualified retirement plans. The current limit is $235,840 in 1993 (indexed for inflation); the bill would lower the limit to $150,000 (indexed). The reduced contribution limit would apply to defined contribution plans, such as 401(k) plans, and to defined benefit plans, such as traditional company pension plans.

Only contributions to qualified plans are tax deductible by the business or employee. To be qualified, a retirement plan must meet non-discrimination rules designed to ensure that the tax benefits are utilized by low-paid as well as high-paid employees. Because of the non-discrimination rules, the reduced contribution limit would affect contributions for workers at all income levels, and hurt the very workers the rules were designed to help.

The biggest burden of the proposal would fall on those with more modest incomes, as low as $18,000. Many middle-income employees would be forced to scale back their contributions to 401(k) plans. Many lower-income workers could see their broad-based, qualified, and largely pre-funded defined benefit plans terminated in favor of unfunded, unqualified plans covering only a business's highest paid executives. In both cases, there would be a sharp reduction in the amount of tax-deferred saving that they could do, or that could be done on their behalf. More saving would be subject to double taxation, and total private saving would undoubtedly decline.

IRAs and employer-sponsored retirement plans that defer taxation of current earnings, such as 401(k) plans and traditional company pension plans, are not "loopholes". They protect a small portion of saving from double- or triple-taxation.[6] The limits on these plans should be eased, not tightened.

Defined contribution plans.

Currently, contributions to 401(k) plans are limited to a maximum of $8,994 (indexed for inflation). The proposal would not affect that limit. However, the law requires that plans not be "top-heavy" with contributions largely restricted to highly-paid employees. For a plan to pass this non-discrimination requirement, the average share of income contributed to a plan by the business's employees earning more than $64,245 in 1993 (indexed) may generally not exceed that of employees earning less than $64,245 by more than 2 percentage points.

In computing the average share of income contributed by highly-paid employees, the total of the contributions of employees earning more than $64,245 is divided by their total eligible annual compensation, and the total contributions of lower-paid employees is divided by their total compensation. If the lower-income employees contributed 4% of their pay to the plan, higher-income employees would be limited to contributions of 6% of their compensation, even if the resulting amounts were below the maximum dollar amount ($8,994) that would otherwise be allowed.

The law sets a limit on the amount of an employee's income that may be counted in computing the limit for the highly-paid employees. That limit is $235,840 in 1993 (indexed). Thus, whether an employee earns $235,840 or $2,000,000, no more than $235,840 is counted in the income of the group. The reconciliation bill would reduce that limit to $150,000. By limiting the amount of income that may be attributed to the highly-paid group, the current formula overstates its percentage contribution. Lowering the income limit would make the overstatement worse, potentially forcing a cutback in high-income-employee contributions to reduce them to the allowable percentage contribution. The employees with the highest contribution percentages in the high-income group would be cut first. The affected workers would generally not be those with the very highest compensation — above $150,000 — but rather those with compensation only a few thousand above the $64,245 dividing line.

For example, assume the lower-income workers are contributing 4 percent of their compensation to the plan. Assume there are three upper-income employees. One earns $70,000

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[6] Ideally, all saving and investment would get either "municipal bond" treatment or IRA treatment (without the required holding period or contribution limits) as described in note 1. Current law has only limited provisions for neutral treatment of saving. These include IRAs, 401(k) plans, 403 (b) plans, SEPs, and Keough plans. These plans have a variety of severe restrictions, including limits on the level and deductibility of contributions, tax penalties or other restrictions on withdrawal before a minimum age, mandatory withdrawal before a maximum age, and, in some cases, maximum amounts that can be withdrawn tax free. Ideally, there should be no income or age limits on contributions or withdrawals.

and contributes $5,250 to the plan — a contribution rate of 7.5 percent. The second earns $150,000 and contributes the $8,994 maximum — a rate of just under 6 percent. The third earns $235,840 (or more) and contributes the maximum — a contribution rate considered to be 3.8 percent. Under current law, their average contribution rate is computed to be 5.1 percent, within the allowed range vis-a-vis the lower-income contributors.

However, if the limit were lowered to $150,000, the $235,840-plus employee would be considered to have earned only $150,000, and be contributing 6 percent. The average for the top three workers would jump to 6.28 percent. The group's contribution would be $1,038 over the limit, and the $70,000 worker would have to reduce his contribution to $4,212 (just over 6 percent) to make the plan legal again. The two highest-income employees would not have to cut back.[7]

<u>Defined benefit plans.</u>

The amount of deductible contributions that a business would be allowed to set aside to fund defined benefit plans would be curtailed by the reduction in the income limit from $235,840 to $150,000 (both indexed for inflation). Because of a bizarre catch-22 situation in the law, businesses would be constrained in the amount of deductible contributions they could make for workers at all compensation levels early in their careers. The businesses would have to contribute much greater sums later on, raising the cost of providing retirement benefits, and creating incentives to terminate qualified plans.

Promised benefits in a defined benefit plan are generally a percent of the employee's projected pre-retirement salary. Firms that offer qualified plans are required by the Employee Retirement Insurance Security Act (ERISA) and the tax code to meet <u>minimum</u> funding requirements based on strict actuarial assumptions. <u>They must estimate the future salaries of their employees, adjusted for anticipated real growth plus inflation</u>, and begin to set aside enough money — assuming reasonable rates of return and considering employees' current incomes and ages — to pay the future benefits.

At the same time, the tax code sets <u>maximum</u> deductible amounts to limit deductions and current revenue loss to the Treasury. Although businesses are required to anticipate inflation in determining their future liabilities and minimum funding requirements under the plan, <u>they are expressly forbidden to take into account future inflation adjustments of the income limits on compensation eligible to participate in the plan</u>. The maximum deductions for 1993 are determined with respect to the current income limit — $235,840 — <u>unadjusted</u> for inflation. If an employee's inflated income in the year before retirement is projected to exceed the current uninflated limit, only a portion of the employee's current income — an amount that will grow over time to equal the current limit at retirement — may be used as a basis for deductible contributions.

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[7] For fuller discussion and illustrations, see: Mary Rowland. "Your Own Account: Watch the Clinton Pension Bill", *The New York Times*, June 20, 1993; Section C, p. 17.

Many employees whose incomes are now well below the current limit are affected by it nonetheless. For example, at a 5.5 percent annual growth rate (an average wage growth rate assumed in the Social Security System's Annual Trustees' Report), a 35 year old worker earning $55,000 today would have a salary of $259,827 by age 64, prior to retirement at age 65. This future salary would be $23,987 above the current limit, an excess equivalent to $5,078 in terms of today's salary. Therefore, only $49,922 of the worker's current salary (an amount that will grow to the current limit in 29 years) could be counted in determining current pension contributions.[8]

Even though current law provides that the current limit will be raised in line with inflation in the future, and the employee's current income would not grow to exceed the future limit by age 64, the current contributions are curtailed. In future years, as the limits are raised, the company may, and must, set additional funds aside to make up for the curtailed contributions and the lost time. Unfortunately, the delay is very expensive. The sooner a business begins to set aside money to build reserves to pay an employee's future retirement benefits, the longer the funds can compound, and the cheaper it is for the firm to finance its pledged payments.

**Minimum Income Affected by Current and Proposed Qualified Plan Income Limits***

| | Age | | | |
|---|---|---|---|---|
| | 25 | 35 | 45 | 55 |
| Income at which current $235,840 limit curbs deductible contributions | $29,227 | $49,923 | $85,275 | $145,662 |
| Income at which proposed $150,000 limit would curb deductible contributions | $18,589 | $31,752 | $54,237 | $92,645 |

* Assumes 5.5% growth of nominal wages through age 64, retirement at age 65.

If the dollar limit is lowered to $150,000, many more workers, at lower current salaries, would be affected. The burden would be harder on plans covering younger workers. Assume, again, that salaries grow at 5.5% per year with productivity gains and inflation. The following table shows for workers of various ages the current minimum salaries that would grow to exceed the current limit of $235,840 and the proposed limit of $150,000 by age 64. Deductions might be curtailed for a 25 year old worker with income as low as $18,589 under the proposal, versus $29,227 under

[8] For a fuller discussion and illustration, see: Mary Rowland, "Your Own Account: A Death Knell for Some Pensions? The Clinton Proposals Pose a Threat to Baby Boomer Benefits," *The New York Times*, June 27, 1993, Section F, p. 15.

current law. A 35 year old worker would need a salary of only $31,752 to hit the limit under the proposal, compared to $49,923 needed to hit the current limit.

By further limiting the amounts currently deductible to fund future benefits of highly-paid employees, OBRA93 would raise the business's cost of providing pensions to its personnel. According to pension experts, many businesses would find it less costly to abandon their current qualified defined benefit plans — which by law must cover most of their workers — in favor of non-qualified plans limited to top executives, such as Supplemental Executive Retirement Plans (SERPs). Lower-income workers whose plans were terminated would be hurt. Higher-income workers shifted to unfunded plans would have less security. No deduction is allowed for contributions to non-qualified plans, such as SERPs. Consequently, businesses that promise benefits under such plans generally do not pre-fund them (reducing private saving), and the employees are not guaranteed payment in the event of future financial distress of the company.[9]

<u>Four miscellaneous capital gains provisions to raise revenue.</u>

OBRA93 contains four provisions purporting to prevent ordinary income from being treated as capital gains. In fact, these are miscellaneous revenue grabs, and are bad tax and economic policy. These provisions would raise the cost of saving and the cost of capital in the United States, thereby slowing the growth of investment, productivity, wages, and employment. Moreover, these provisions would raise the tax wedge between buyers and sellers in the affected financial transactions, raising transaction costs and reducing the efficiency of capital markets. Raising the cost of saving in any category of assets raises the cost of saving generally; there are no iron walls separating one kind of saving from another. All savers, including those saving for retirement via other assets, would be hurt.

<u>Disallowance of capital gains in determining the amount of deductible investment interest expense — further restrictions on deduction of investment interest.</u>

This provision is a back-door tax increase on capital gains, and would worsen the tax code's bias against saving.

Under current law, investors may deduct the interest on money they borrow to purchase stock, bonds, or other property up to the amount of their investment income — whether interest, dividends, rent, or capital gains. The interest deduction reduces total taxable income, and in that sense is deductible against ordinary income subject to the 31% top tax rate even if some of the investment return is in the form of capital gains subject to a top rate of 28%. The Ways and Means

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[9] For a fuller discussion see text and comments of Sylvester Scheiber, Wyatt Company, and Russell E. Hall, Towers Perrin benefits consultants, in: Mary Rowland, 6/27/93, *op.cit*.

and Finance Committees view this as converting ordinary income into capital gains.[10] House and Senate versions of OBRA93 would limit the interest deduction to the amount of investment income subject to ordinary tax rates; they would do so by excluding capital gains from the definition of investment income in computing the deduction limit. Any interest deduction in excess of the curtailed limit would have to be carried forward. (The taxpayer would have the option of treating some capital gains as ordinary income to take the interest deduction earlier.)

For example, suppose the taxpayer has $10,000 in interest expenses, $5,000 in interest income, $5,000 in capital gains, plus $50,000 in salary. Under current law, the taxpayer could deduct the full interest expense. Under OBRA93, the taxpayer could only deduct $5,000 in interest expenses in the current year. He could deduct the full interest cost only if he were willing to give up the 28% tax rate on the $5,000 capital gain.

The Tax Committees' analysis in defense of this proposal is wrong. When saving is mobilized to purchase a productive asset, the asset produces income that is subject to tax. The mobilization of the saving should not be allowed to give rise to a second layer of net taxation; that would be double taxation. Therefore, the correct analysis of this problem would focus on the transaction between the borrower and the lender, not on the borrower alone, to avoid double-taxing the economic activity in which they have jointly engaged. The borrower pays interest; the lender receives interest. If the lender is taxed on the interest, the borrower should be allowed to deduct the interest against any and all income. The interest deduction of the borrower should not depend on what sort of asset the borrower used the money for, or on what form the income from the asset took.

The flap over limits on interest deductions, therefore, is just another case of the Congress looking narrowly at the borrowing taxpayer and ignoring the other side of the transaction. In the Congress's view, the ideal situation is one in which all lenders are taxed on the interest they receive, and borrowers may not deduct their interest payments. This is "Heads I win, tails you lose." [11]

<u>Treatment of all gains on market discount bonds as ordinary income — assault on tax-exempt bonds; double tax on saving.</u>

Bonds are generally issued at face value and pay explicit interest on the face amount. If interest rates rise after the bond is issued, the price of the bond will fall. A new buyer will receive the higher market interest rate in the implicit form of a gradual rise in the price of the bond toward face value at maturity plus the explicit interest payment in force at the time of issue. The gradual rise in price is called accrued market discount, and is generally taxed as ordinary interest. (A rise in

[10] See, for example, House Ways and Means Committee Print 103-11, "Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Ways and Means", May 19, 1993, Section 199.

[11] For a more detailed discussion, see *IRET Congressional Advisory* No. 19, June 3, 1993.

price in excess of the implicit interest — as would occur if interest rates subsequently fell — is considered a capital gain.)

There are two exceptions to the interest treatment of accrued market discount. Gains on bonds issued before July 18, 1984 (when current law treatment began) and gains on tax exempt bonds are treated as capital gains when the bonds are sold. (Note that this component of the interest on tax exempt bonds is not tax exempt under current law.) OBRA93 would eliminate these two exceptions, and treat any gain resulting from purchase at a market discount as ordinary income.

There is no denying that the rise in the price of a bond from a discounted level at time of purchase toward face value at maturity is interest. However, taxing interest is part of the double tax on saving. Any reduction in the tax, including giving the grandfathered bonds capital gains treatment, is a small step in the right direction, and should not be eliminated. If anything, it should be extended to all bonds.

In the case of tax exempt bonds, interest is not supposed to be taxed. If the rise from market discount to face value is interest, as the Ways and Means Committee print admits, then there should be no tax at all on the rise if the bond is tax exempt. Far from changing the current capital gains treatment of such increases to ordinary income, the correct adjustment is to exempt such gains from tax entirely.[12]

<u>Stripping stripped stock of capital gains treatment — worsening the double tax on saving.</u>

"Strips" are the principal component of bonds stripped of their interest coupons (which are sold separately) and resold at an original issue discount to yield interest via price appreciation. The accruing price appreciation is treated as taxable interest for tax purposes. The practice has spread to preferred stock. The stock is stripped of its dividend rights (which are sold separately) and the stock is resold at a discount from a fixed redemption price payable at a future date. Current law treats the rise in the stock price as a capital gain. OBRA93 converts the treatment to ordinary income. In doing so, it accentuates the income tax bias against saving.

With no deduction allowed for saving, the correct "neutral" tax treatment for the interest on bonds or the dividends on stock is not to tax either one of them. However, the case for relief from multiple taxation is even greater in the case of stripped stock than in the case of stripped bonds, because of the added layer of tax on dividends under the corporate income tax. The correct solution to the stripped preferred stock problem is to stop taxing the regular dividends, or, as a second best answer, to allow the corporation a deduction for the dividends it pays out. Absent such fundamental reform, the capital gains treatment of the stripped stock is preferable to the higher tax rates on ordinary income.[13]

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[12] For a more detailed discussion, see *IRET Congressional Advisory* No. 17, June 3, 1993.

[13] For a more detailed discussion, see *IRET Congressional Advisory* No. 18, June 3, 1993.

Denial of capital gains treatment to certain hedged positions in stocks and commodities.

The House and Senate versions of OBRA93 would tax capital gains on commodities and stocks as if they were ordinary income if the positions were hedged by means of futures contracts. The Ways and Means Committee print claims that a hedged position — in which the holder of the stock or commodity has a firm agreement to sell the asset to a buyer at a certain price at a specific future date — is "indistinguishable from loans in terms of the returns anticipated and the risks borne by the taxpayer". The asset-holder is supposedly in a position like that of a lender whose interest income is due to the "time value of money" rather than market risk, earning interest rather than profits from speculation. The contention is absurd. The rationale is based on semantics, not economics.

This distinction about the risk to a particular holder of the asset at a particular point in time is not good tax policy and completely misses the economics of the situation. The distinction between interest and capital gains has nothing to do with risk, and is not merely semantics. Interest is a flow of current income reflecting current economic output. People borrow to invest in assets that earn a return greater than the cost of the loan. For example, they may borrow to buy a machine that earns a profit. The profit reflects the addition to GNP that the machine provides. If the profit is large enough to cover the debt service and the wear and tear on the machine, with a little left over, the investor will proceed with the transaction. The interest received by the lender in effect gives the lender credit for much of the net increase in the GNP produced by the machine.

A capital gain is the result of a change in the valuation of an asset. The gain is a pure price change, not additional GNP or national income. For example, a share of stock may rise in price today because of an increase in the company's expected future production and profits. The future production and associated wages and profits will be part of GNP when and if they occur (and will be taxed then, too). The current jump in the share price is merely the present value of the company's expected future after-tax income. The capital gain itself is not income. Counting it as income would double count the future profit, and overstate GNP. Taxing the gain would double tax the future profit.

In a hedged position, the two parties to the futures contract are engaged in activities that help the market value an asset. The seller of the contract is betting that the price of the commodity or stock is not going to exceed the contract price by the date set. The buyer of the contract is betting that it will. Neither is necessarily the ultimate user of the commodity. Any profit, interest, or dividend resulting from the use of the commodity or the operations of the company whose stock underlay the futures trade is part of GNP, and will be taxed as such by the income tax. The futures market valuation process is not part of GNP and clearly represents a capital gains situation for both parties to the futures process. It is bad economics to regard it as anything else.

In brief, the rise in the value of a hedged asset is a capital gain, period. It is not a loan; there is no borrower; there is no investment of borrowed money in an output-producing, income-generating piece of property; there is no interest paid to share the returns with the provider of the funding.

The result of the OBRA93 provision would be to pressure some individuals to use options rather than futures. Potential futures buyers, who bear the risk that the Ways and Means Committee print views as meriting a differential, would have to bid more for the contracts as a result of the higher tax on the seller, and would share the penalty. Risk would be harder to spread, the attractiveness of owning assets would be reduced, and the amount of productive capital created by the economy would be less than in the absence of this tax bias.

In fact, however, the case against the OBRA93 provision does not depend solely on the distinction between interest and capital gains. In a neutral tax system, neither interest nor the capital gains that trouble the tax Committees in the hedging situation should be taxable items. The current treatment of gains on hedged asset holdings is multiple taxation. Insofar as the gains receive somewhat diminished tax rates due to the limited capital gains differential, it is a small degree of relief from multiple taxation. That relief ought not to be ended.[14]

**Energy and other anti-growth tax provisions.**

In addition to provisions that directly affect saving incentives, the general anti-growth consequences of the bill would reduce GNP, national income and, consequently, national saving. The chief culprits among the general anti-growth provisions are the House Btu energy tax and the Senate transportation fuels tax and the extension in both versions of the 2.5 cent portion of the gasoline tax that is currently scheduled to expire on September 30, 1995. Tax increases on foreign source income and the proposed extension of the write-off period for structures from 31.5 years under current law to 39 years (House version) and 38 years (Senate version) are other significant anti-growth features. Insofar as these tax provisions reduce GNP, they will lose a portion of the revenue anticipated by the revenue estimators. Insofar as they reduce personal and business saving, they will not increase national saving, even if the revenues are used for deficit reduction.

**Conclusion**

Congress and the President have made a major issue of increasing U.S. capital formation, technological prowess, productivity, and high-value-added jobs. Doing so requires an increase in saving and investment.

Increasing saving and investment requires reduction or elimination of the numerous layers of multiple taxation of saving and investment in the current tax code, and a move toward a more nearly neutral, less biased tax system. Yet, at every point where an additional layer of multiple

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[14] For a more detailed discussion, see *IRET Congressional Advisory* No. 16, June 3, 1993.

taxation is currently imposed on saving, either the House and/or the Senate version of OBRA93 worsens rather than improves on the current treatment.

OBRA93 would increase marginal tax rates by more than is apparent from a glance at the explicit tax rate changes alone. Determining the economic consequences of the rate hikes requires taking account of the drop in the after-tax returns to labor and capital services as the tax rates increase, and of the responses of the suppliers of these production services to the decrease in their rewards.

The proposed individual tax rate hikes would discourage saving, investment, employment, and hours worked to a significant degree. The various proposed energy taxes and business tax increases would increase the economic damage. The economy would be smaller and less efficient under OBRA93 than under current law. Retirement saving would be one of the major casualties of this latest budget agreement.

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