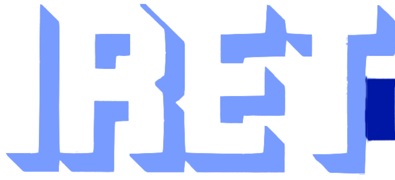

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STRENGTHS AND WEAKNESSES OF THE DOLE ECONOMIC PLAN

In explaining what his agenda would be should he be elected President, Bob Dole has presented a plan that emphasizes smaller government. According to Mr. Dole, the U.S. government has become too large and too intrusive in people's lives. A major part of his program for reducing the government's role is to trim the federal income tax. A campaign document declares, "The American people are over-taxed. And our tax system is too burdensome, too complex, and anti-growth."[1]

In explaining what his agenda would be should he be elected President, Bob Dole has presented a plan that emphasizes smaller government... A major part of his program for reducing the government's role is to trim the federal income tax.

Some of Mr. Dole's income tax proposals are to reduce individual income tax rates by 15%, establish a $500 child credit, cut the capital gains tax in half, roll back the 1993 tax increase on social security benefits, and create a new class of individual retirement accounts. The staff of Congress's Joint Committee on Taxation (JCT) estimates that the package would cost the federal government $545 billion over the six year period 1997-2002, which is very close to the $548 billion that Mr. Dole's advisers estimate. The rate reduction accounts for 74% of this, the child credit for 14%, and all the rest accounts for 12%.[2]

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[1] Bob Dole for President, Fact Sheet, "Restoring the American Dream: Bob Dole's Pro-Growth Plan for America's Families," August 5, 1996.

[2] For detailed descriptions of the proposals, see Joint Committee on Taxation, "Staff Description of Tax Cut Proposals in Republican Presidential Candidate Bob Dole's Economic Plan," Released by House Ways and Means Committee, August 8, 1996, Reprinted in *Daily Tax Report*, August 12, 1996.

Institute for Research on the Economics of Taxation

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The tax proposals are one component, albeit the most visible, of a broader plan to leave more decision making and economic power in the hands of individuals and claim less power and fewer resources for the government. Besides the tax reductions, the Dole program would cut government spending (which really means slow its rate of growth), reduce government regulations and paperwork, and reform the tort system. Later, Mr. Dole would undertake a fundamental overhaul of the tax system. The payoffs, according to the Dole campaign, would be more individual liberty and stronger economic growth.

The Dole Tax Proposals

In evaluating the tax package, a number of questions must be addressed. Are the specific tax proposals consistent with sound tax principles? Would they help individuals? Would they strengthen the economy? Has Mr. Dole set reasonable goals for tax policy? Would Mr. Dole's proposals deliver what he claims? And even if the proposals are improvements over current law, are they the best way to revamp the tax system?

Across-the-board, 15% cut in individual income tax rates The centerpiece of the Dole tax plan is a 15% reduction in individual income tax rates, phased in over four years. For example, the 28% bracket would eventually decline to 23.80%, but the full reduction would not be phased in until the fourth year (the year 2000, if the phase-in starts in 1997). The plan would reduce taxes by 3.27% in 1997, 8.274% in 1998, and 13.274% in 1999.

The centerpiece of the Dole tax plan is a 15% reduction in individual income tax rates, phased in over four years... The 15% across-the-board cut in marginal tax rates ... would significantly moderate the existing anti-work, anti-saving tax biases.

The tax cut proposal is designed to reduce the existing income tax bias against work, saving, investing, and entrepreneurship. It does not aim at merely increasing individuals' disposable incomes. The distinctive feature of the proposed tax cut, instead, is that it reduces marginal tax rates — the tax rates that apply to additional income from additional labor, saving, or investment activities.

The individual income tax is biased against work because it reduces the reward for work relative to leisure and other nontaxed activities. Further, the income tax is biased against saving because it taxes income used for saving more heavily than income used for consumption. These biases are harmful because people work and save less than otherwise due to the tax penalties. Consequently, the economy is less productive than otherwise, and it has less investment to fuel growth. Cutting marginal income tax rates would benefit the economy by reducing the severity of these destructive biases.

To illustrate why marginal tax rates matter, consider an example of the anti-work bias. In a zero-tax world, suppose a person works 8 hours at $10 per hour. Also suppose the person values the eighth forgone hour of leisure at $10. At that rate of pay, the person regards the trade-off of the rewards for work and leisure as optimal. Now, suppose the government imposes a tax at a rate of, say, 40%. With the tax, the eighth hour of work yields only $6 after tax. But the eighth hour of leisure is still worth $10. The tax increases the cost of working relative to that of leisure and makes it worthwhile for the person to work less and use more of his time in leisure activities. Next, suppose the tax rate were 50%. That would lower the after-tax reward for the last hour of work to just $5, further distorting incentives to discourage work and encourage leisure. The higher is the tax rate, the greater is the bias against work.

In much the same way, the income tax raises the cost of saving compared with consumption uses of current income. For instance, suppose that a person earns $1,000 and, in the absence of taxes, could use the earnings either to buy $1,000 of consumption goods and services or to buy a $1,000 bond that would pay $100 of interest in every future year (10% interest). In this example, providing a $1 income stream in future years costs $10 of forgone current consumption ($1,000 / $100). If the government now imposes an income tax of, say, 40%, the pre-tax earnings of $1,000 would become $600 of after-tax earnings. The person could use this after-tax amount either to buy $600 of consumption goods and services or to buy a $600 bond that would pay $60 of interest in every future year. But the $60 of interest would also be subject to income tax, reducing its after-tax amount to $36. Now, providing a $1 income stream in future years costs $16.67 of forgone current consumption ($600 / $36). The multiple income taxation of the saving stream has increased the cost of saving in terms of sacrificed current consumption by two-thirds. This bias could be corrected either by taxing the saving but not the returns on the saving or by not taxing the saving but then taxing the gross returns. Either approach would tax the saving stream once, putting it on the same tax footing as earnings used for consumption. If the tax rate were higher, the anti-saving bias would be greater. At a tax rate of, say, 50%, providing a $1 income stream in future years in the example would cost $20.00 of forgone current consumption.

Reducing marginal tax rates reduces these tax biases. The 15% across-the-board cut in marginal tax rates that Mr. Dole proposes, therefore, would significantly moderate the existing anti-work, anti-saving tax biases. Although people would still work and save too little because of remaining tax disincentives against productive activities, they would work and save more than in the absence of the rate cuts and spend less time rearranging their activities based on tax considerations.

The phase-in lowers the rate cut's revenue cost to the government, but it delays the benefits to the economy. With the rate cut occurring in stages, the improvements in people's work and saving decisions will come more slowly. In 1997, for instance, the top income tax rate bracket would only drop from 39.6% to 38.3%. That will diminish the tax bias against work and saving, but not by very much. Further constraining the positive incentives, there is the danger that, sometime between 1997 and 2000, the government might decide to freeze rates instead of continuing the phase-in. (This has happened more than once with scheduled tax cuts.)

A problem which Mr. Dole and his advisers need to correct is that the Dole plan, in its original version, would not synchronize the cut in regular income tax rates with a similar reduction in alternative minimum tax (AMT) rates. The AMT is, in effect, a parallel income tax. A taxpayer must pay either the regular income tax or the AMT, whichever is bigger. If regular tax rates were lowered 15% but minimum tax rates were unchanged, several million additional individuals would have to perform complex AMT computations in order to determine which tax they owed. Six or seven million of these individuals could suddenly find themselves owing the AMT. Pushing individuals from the regular income tax into the little-understood AMT would afford these people considerably less than a 15% rate cut. Moreover, the need for millions of individuals to begin calculating the AMT would add much complexity to an already excessively complicated tax system.

Although the child credit would reduce the tax bills of people who received it, it ... usually would not reduce marginal tax rates ... [and so] generally would not moderate tax disincentives against work and saving.

These problems can be entirely avoided if the 15% across-the-board cut were also to apply to AMT rates. Doing so, however, would increase the revenue loss from the rate reductions. One possible means of doing this without increasing the deficit would be to include more spending cuts in the Dole plan.

Rate cuts are not the only tax changes desirable in the interest of reducing tax barriers to growth. Although rate reductions would be a positive development, the tax system suffers from numerous flaws that cannot be corrected merely by lowering rates. Many biases spring from how the tax base (that is, what is taxable) is defined. Correcting such problems demands major changes in the definition of taxable income, using basic principles of acceptable taxation. Thus, lower rates can certainly allow the economy to perform better, but still greater improvements could be attained by a thorough overhaul of the income tax system. Reform of the tax base is also needed to move towards the goal of a less complicated and arbitrary tax system.

<u>$500 child credit</u> Under the Dole plan, taxpayers could claim an income tax credit for eligible children under the age of 18. This would be in addition to the current personal exemption for dependents. The maximum credit would be $250 per eligible child in 1997 and $500 per eligible child in subsequent years. The credit, however, could not exceed regular income tax liability after subtracting the earned income tax credit; the credit, in other words, would not be "refundable" (i.e., would not provide a government check to individuals whose income tax liability, as adjusted, is less than the child credit.) The credit would be phased out starting at an adjusted gross income (AGI) of $110,000 for joint filers ($75,000 for single filers). For each $1,000 of AGI above the threshold, $25 of credit would be lost.

Although the child credit would reduce the tax bills of people who received it, it typically would not shift those people into lower tax brackets. Hence, in most cases it would not reduce the tax a

person receiving the child credit would pay on an additional dollar of income from work or saving.[3] Because the child credit usually would not reduce marginal tax rates, it generally would not moderate tax disincentives against work and saving, and would not lighten the tax system's drag on economic activity.

This is not to say that the child credit is necessarily unjustified, but it does say that the case for it cannot rest on grounds of economic efficiency. It should be viewed as a social policy that is intended to reduce the tax burden of people with qualifying children.

The phase-out of the credit with rising income slightly reduces the credit's revenue cost but is troublesome for three reasons. First, the phase-out works at cross purposes to the Dole plan's 15% rate cut: in the phase-out range, the loss of the credit boosts marginal tax rates by 2.5 percentage points.[4] For people in the phase-out range, that would take away much of the spur to productivity arising from the rate cut.[5] Second, tax phase-outs are a source of complexity; attaching a phase-out to the child credit adds another layer of complexity to a tax system that is already too complicated. Third, if people with children are deemed worthy of special tax relief because they have children, it is not clear why they should lose their worthiness on account of some other factor, namely, their AGI. Phase-outs are increasingly common in the tax code, but all of them raise the question of selective discrimination in tax treatment based on income. They rely on the notion that tax fairness means using the tax system to redistribute income. In this conception of fairness, the end of redistributing income justifies the means, which is to deny high-income taxpayers, solely on the basis of their incomes, deductions and credits to which taxpayers, in general, are entitled.

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[3] To illustrate this, suppose a couple with 2 children have $100,000 of AGI this year and $20,000 of itemized deductions. Their taxable income would be $69,800 (AGI - itemized deductions - personal exemptions), putting them in the 28% rate bracket, and their tax liability (found by using the tax rate schedule) would be $14,331. If the couple earned an extra $1,000 of AGI, their tax bill would rise by $280, or 28% of the extra $1,000, to $14,611. Now assume the couple could claim a $500 credit per child this year. That would enable them to subtract $1,000 from their tax bill. At an AGI of $100,000, their tax liability would become $13,331; at an AGI of $101,000, it would become $13,611. The tax increase on the extra $1,000 would still be $280, or 28%.

[4] Suppose a couple with 2 children have $110,000 of AGI this year and $20,000 of itemized deductions. Also assume they could claim a $500 credit per child. Their taxable income would be $79,800, putting them in the 28% rate bracket, and their preliminary tax bill (found by using the tax rate schedule) would be $17,131 before subtracting the child credit; after subtracting the credit, their tax bill would be $16,131. If the couple earned an extra $1,000 of AGI, their tax liability would rise to $17,411 before subtracting the credit. Due to the phase-out, the extra income would reduce their credit by $25 to $975. After subtracting the credit, their tax liability would be $16,436. Thus, the $1,000 of extra income would have increased the couple's tax bill by $305; the marginal tax rate on the added income would be 30.5% (28% plus 2.5% due to the phase out).

[5] For taxpayers in the phase-out zone, the 15% rate cut becomes only a 6.1% rate cut at the margin. To return to the example in the previous footnote, the 15% rate cut, once it is fully phased-in, would lower the couple's tax bracket from 28% to 23.8%. The 2.5 percentage point bump due to the phase-out of the child credit would push the couple's marginal tax rate back up to 26.3%. That is still a rate cut, but it is much smaller than 15%.

Cutting the capital gains tax rate The Dole plan would cut in half the maximum tax rate on capital gains, from 28% to 14%. (Capital gains now taxed at 15% would instead be taxed at 10.5%.) Coordinated with this cut, a 14% tax rate would also be used in computing the tax on capital gains under the alternative minimum tax. In 1997, however, the effective cut in the capital gains tax rate could be quite modest. According to the JCT's explanation, the gain realized in 1997 on assets purchased in earlier years would be apportioned between 1997 and prior years and only the portion of the gain attributed to 1997 would qualify for the lower rate.[6] In addition to the rate cuts, the present $125,000 lifetime exclusion on capital gains from the sale of a principal residence for taxpayers over age 55 would increase to $250,000 (more for taxpayers living in the residence over 10 years).

By cutting the top capital gains tax rate in half, from 28% to 14%, the Dole plan would greatly reduce the capital gains tax's bias against saving and investment ... [leading] to increased saving and investment and a more productive economy.

The capital gains tax is inconsistent with acceptable tax principles. The income tax is already biased against saving, and the capital gains tax compounds that bias. The income tax is levied both on income that is saved and the income that saving produces. On income-producing assets, capital gains are the discounted present value of any expected changes in future returns. Because those returns will be taxed in the future, taxing the present value of expected changes in them places two taxes on the same returns from saving. In addition, returns on saving that are invested in corporate equity are also subject to the corporate income tax. After-tax corporate earnings that are paid as dividends are taxed to the dividend recipients. If a corporation's after-tax earnings are instead retained and reinvested by the corporation, the additional earnings produced thereby are also taxed. If the individual shareholder sells the stock, any gain realized thereby, often representing the reinvested after-tax corporate earnings, is also subject to tax.

Through its overtaxation of saving and investment, the capital gains tax increases the cost of those activities, leading to less saving and a smaller stock of capital. Small businesses and businesses involved in the development and application of new technologies are among those hardest hit by the capital gains tax. With fewer capital tools than otherwise, the economy's output is smaller and workers are less productive, meaning that they earn lower real wages. Also, because the capital gains tax is triggered by selling assets and realizing gains, it increases the costs of capital asset transactions, hence, impedes the flexibility of the capital market.

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[6] For example, suppose a person who is paying 28% capital gains tax under current law realizes a $100 gain in 1997 from selling an asset that has been held 10 years. The JCT's explanation suggests that one-tenth of the gain ($10) would qualify for tax at the 14% rate but the other $90 would be taxed at 28%.

By cutting the top capital gains tax rate in half, from 28% to 14%, the Dole plan would greatly reduce the capital gains tax's bias against saving and investment. The decrease in that bias should lead to increased saving and investment and a more productive economy.

An added inducement to cutting the tax is that the government can do it at very little, if any, revenue cost. A lower tax rate results in more capital gains realizations, higher asset values (asset values rise when future gains are not subject to such heavy taxes), and a larger economy. The first two effects expand the base of the capital gains tax; the third effect expands the bases of all taxes in the economy. (Official government revenue estimates grudgingly allow for a bit of the first effect but ignore the other two.)

This feature of the Dole plan is a major step toward more nearly neutral tax treatment of saving and consumption. Ideally, the tax on capital gains should be eliminated, not just reduced. It may well be, however, that basic tax restructuring is the appropriate vehicle for that reform.

The Dole proposal would defer the full reduction of the capital gains tax rate until 1998, according to the JCT's description. Only part of the rate cut would apply to assets sold in 1997. That would complicate tax computations for tax year 1997. Moreover, it would induce people to delay selling appreciated assets until after 1997.

Capital gains on homes are already taxed less severely than gains on other capital assets. Home owners can often roll over gains realized on the sale of their homes and, if they are at least age 55, they can claim a lifetime exclusion for $125,000 of gains. Given these features, doubling the lifetime exclusion, which is included in the Dole plan's capital gains provision, is a low economic priority, notwithstanding its political appeal.

<u>Repeal 1993 tax increase on social security benefits</u> Prior to 1993, social security recipients with "provisional income" above $32,000 for joint filers ($25,000 for single filers) were required to include up to 50% of their social security benefits in their taxable incomes.[7] The 1993 tax increase added a second tier: social security recipients with "provisional income" above $44,000 for joint filers ($34,000 for single filers) have had to include up to 85% of their social security benefits in taxable income. The Dole plan would promptly repeal this 1993 tax increase.

Because of how the taxable amount of social security benefits is computed, the tax is actually triggered by, and falls on, non-social security income such as interest, capital gains, earnings from a business, or wages from a job. In the 50% phase-in range, an extra dollar of non-social security income is effectively taxed at 150% of the normal rate. (The extra $1.00 of non-social security income increases taxable income by $1.50: the $1.00 itself and $0.50 of social security benefits.) In the 85% phase-in range, the marginal tax rate is effectively 185% of normal. Because single filers

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[7] Provisional income is defined as AGI plus tax-exempt interest plus certain foreign-source income plus one-half of social security benefits.

in the 85% phase-in range (which starts at a "modified AGI" of $34,000) will usually have a regular marginal tax rate of 28%, this raises their true marginal tax rate to a whopping 51.8%.

These greatly amplified marginal tax rates are a heavy government-imposed penalty on senior citizens who had the prudence to provide themselves with non-government sources of income. As such, the tax also sends a perverse message to younger people. It discourages them from saving to provide their own non-government retirement incomes: saving now to generate income in retirement is less attractive because the government will tax away a large share of the income. Moreover, because of this tax penalty, many seniors who would otherwise work are dissuaded from doing so, depriving the economy of their often valuable job skills.[8] Although public policy makers may often state that people should save more for their retirement years, the tax code sends exactly the opposite message.[9]

By repealing the [1993 tax increase on social security beneficiaries] ... the Dole plan would ... not only improve the financial security of senior citizens, but ... prompt increases in work and saving that would strengthen the economy.

By repealing the 85% tier as of 1997, the Dole plan would lower one of the highest penalties for working and saving now in the tax code. Repeal would not only improve the financial security of senior citizens, but by reducing tax penalties on productive activities, it would prompt increases in work and saving that would strengthen the economy. Of course, from an economic efficiency perspective, it would be better if the tax treatment of social security benefits were revised to conform more closely with that provided to private retirement income.

Many social security recipients would also argue that taxing their benefits is unfair. They paid income tax on their social security contributions. Taxing them on their benefits without first subtracting out what they contributed means the government is taxing them at both ends. Moreover, although the benefits tax was sold politically as being directed at the wealthy, it begins at such low incomes that most people paying the tax are squarely in the middle class. (The tax provides a good lesson that soak-the-rich rhetoric is often used to sugar-coat taxes on the middle class.) These

[8] Earlier this year, Congress eased another government-created deterrent to work by seniors: the earnings test, which reduces social security benefits to individuals between ages 65 and 69 if they earn labor compensation above a certain amount. See Stephen J. Entin, Testimony before the Subcommittee on Social Security of the Committee on Ways and Means, Hearing on the Senior Citizens' Equity Act, January 9, 1995 and Stephen J. Entin, Testimony before the Committee on Ways and Means, Hearing on the Senior Citizens' Equity Act, January 19, 1995.

[9] Many of these points are explored more fully in A. James Meigs, "The Medicare Catastrophic Coverage Act: A Case for Repeal (Part III)," *IRET Policy Bulletin* No. 38 (Washington, DC: Institute for Research on the Economics of Taxation, 1989); and Stephen J. Entin, Budget Package Threatens Saving, Growth," *IRET Policy Bulletin* No. 61 (Washington, DC: Institute for Research on the Economics of Taxation, 1993).

arguments apply to the pre-1993 tax as well as the 1993 increase, but repealing the 1993 increase is an excellent first step.

American Dream Savings Accounts (ADSAs) Under present law, individuals' eligibility to deduct individual retirement account (IRA) contributions begins phasing out at an AGI of only $40,000 ($25,000 for single filers). Alternatively, individuals may make nondeductible contributions to their IRAs. Nondeductible contributions to IRAs are taxed, and withdrawals of earnings are also taxed, but earnings are not taxed while they remain in the account. Contributors to nondeductible IRAs face heavy record keeping requirements.

The Dole plan would replace nondeductible IRAs with "American Dream Savings Accounts" (ADSAs). Contributions to ADSAs would not be deductible but distributions would not be taxed. Eligibility to use these new IRAs would not be phased out as individuals' reached middle-class incomes. The maximum amount an individual could contribute each year to an ADSA would be $2,000, reduced by any contributions that year to a deductible IRA. There would be an early withdrawal penalty: distributions from ADSAs would be taxed and also subject to a 10% penalty unless the individual had 1) maintained funds in any ADSA for at least 5 years and 2) either reached age 59½ or withdrawn the money for a "special purpose" (buying a first home, paying large medical bills, paying higher education costs, or using the funds to meet expenses while unemployed).[10] From 1997 to 2000, individuals could roll over funds from existing IRAs into ADSAs by paying ordinary tax (spread over 4 years) on the transfers.

IRAs are an elegant way to avoid the anti-saving bias an income tax creates when it taxes income used for saving more heavily than income used for consumption. In a deductible IRA saving is only taxed once because contributions are not taxed but distributions are taxed. An alternative which also puts saving on the same footing as consumption is to tax contributions but not distributions. This is how ADSAs would operate.

ADSAs would not subsidize saving but would impose the same tax burden on a dollar of income that is saved as on a dollar of income that is used for consumption. This move toward tax neutrality would increase the volume of saving because people would save more if the tax code did not penalize them so much for doing so. The added saving and the additions to capital it would finance would strengthen the economy.

Deductible IRAs and ADSAs are algebraically equivalent in terms of their present values and their discounted cost over time to the U.S. Treasury (assuming tax rates are the same when people contribute and take distributions.) In federal revenue estimates, however, ADSAs appear less costly to the Treasury than deductible IRAs because the government gets its tax dollars up front within the budget window. That revenue consideration may explain why the Dole plan includes ADSAs instead of lifting the income limitation on deductible IRA contributions.

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[10] If an individual withdrew funds from an ADSA for a "special purpose" within 5 years of first opening an ADSA, the withdrawal would be taxed but not subject to the 10% penalty.

Given that ADSAs treat saving evenhandedly with consumption, it is unfortunate that for revenue reasons the Dole plan places so many restrictions on ADSAs. An individual's maximum ADSA contribution would be limited to $2,000 yearly, reduced by any deductible IRA contributions. (According to the JCT's explanation, this yearly cap would be indexed for inflation. Hence, the ADSA cap would retain its real value over time, unlike the cap on deductible IRAs which has steadily lost value because it is not adjusted for inflation.) ADSAs would also be subject to an early withdrawal penalty. That penalty would discourage some people from using ADSAs. From the perspective of sound tax principles, the penalty is inappropriate because the purpose of ADSAs should not be to lock in people's savings but to allow people to choose between saving and consumption without the tax system pushing them one way or the other. A small plus is that the Dole plan would soften or waive the tax penalty for several "special purpose" types of withdrawals.

[Mr. Dole's] economic plan also seeks to reduce government regulation, reform the tort system, and curb government spending.

Increase the estate tax exemption for certain family-owned businesses Current law exempts from the estate and gift tax the first $600,000 of otherwise taxable transfers. The Dole plan would phase in over 10 years an additional exemption, reaching $1,000,000 in 2006, for qualifying family-owned businesses that comprise more than 50% of a decedent's estate. A business would not qualify unless the family owns a large share of it and materially participates. Further, part of the exemption would be revoked unless the heirs continue for a number of years to materially participate in the business.

The estate and gift tax is a levy on accumulated saving. Because much of that saving has been taxed, often repeatedly, during life, the estate and gift tax compounds the tax system's bias against saving.[11] Beyond resulting in less saving, it encourages people whose estates might be subject to the tax to engage in elaborate and costly tax planning. Starting at a marginal rate of 37% on taxable estates as small as $600,000, this levy, which has often been excused as falling on the super rich, reminds us once again that supposed soak-the-rich taxes are often paid by a much broader swath of the population.

The sale of family businesses to raise the funds needed to pay the estate tax is often cited as an unwholesome result of the tax. The Dole plan would reduce the frequency with which this happens. The gradualness of the phase-in, however, would diminish the provision's near-term impact.

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[11] For a discussion of the impact of estate and gift taxes on the cost of saving compared with that of consumption uses of income, see Richard E. Wagner, *Federal Transfer Taxation: A Study In Social Cost*, *IRET Fiscal Issues* No. 8 (Washington, DC: Institute for Research on the Economics of Taxation and the Center for the Study of Taxation, 1993). As the title of the study suggests, Wagner makes a telling case that these taxes cost the economy far more than any revenue or other benefits they may be deemed to afford.

The proposal is very narrow and selective in the relief it would provide. The estate and gift tax has a strong anti-saving bias regardless of the composition of the assets in the estate. Providing relief to the heirs of some family businesses is better than doing nothing, but it would be simpler, more consistent with solid tax principles, and more beneficial to the economy to abolish this special tax on accumulated wealth, or at least raise the exemption amount for everyone.

Credit for poverty-relief charitable giving Current law does not allow individuals who claim the standard deduction (nonitemizers) to take a separate deduction for charitable contributions. The Dole plan would grant nonitemizers a short-lived nonrefundable credit for 50% of their contributions in cash to qualifying poverty-relief charities.[12] The credit, however, would be capped at $100 for joint filers ($50 for single filers) in 1997, making it a 50% credit on the first $200 ($100 for single filers) of qualifying contributions. In 1998, the credit would be capped at $200 for joint filers ($100 for single filers). After those two years, the credit would expire. According to the JCT's explanation, the credit would only be available to nonitemizers (those who claim the standard deduction.)

The idea behind this credit is that privately supported charities that collect voluntary contributions from individuals often achieve better results in helping the needy than does the government through its means-tested spending programs. Given that it has spent trillions of dollars over the decades on poverty programs, this argument continues, the government should forgo a few billion dollars in taxes to encourage private giving that is likely to attain more long-term success in helping people out of poverty.

The sharp limits on the credit hold down its revenue cost, but they also limit the encouragement the credit would otherwise offer people to contribute more to poverty-relief charities. Moreover, insofar as the credit holds promise for achieving its goal of engaging private organizations in relieving poverty, one must wonder why the credit would be available for only two years.

Provisions related to higher education Under current law, interest on student loans is not tax deductible. The Dole plan would allow an above-the-line deduction (useable by both itemizers and nonitemizers) for interest paid on qualified student loans during the first 60 months that repayments are required. The deduction would phase out at "modified AGIs" above $65,000 for joint filers ($45,000 for single filers). Further, the Dole plan would extend permanently the exclusion from income of employer-provided educational assistance, both at the undergraduate and graduate levels. The Dole plan would also grant an income tax exemption to distributions from qualified state tuition plans for higher education expenses. And it would let individuals establish "education investment accounts" for higher education expenses; nondeductible contributions would be limited to the amount of the child credit, and, following rules similar to those of the proposed ADSAs, distributions would not be taxed. The Dole plan would waive the 10% penalty on withdrawals from

[12] Among the eligibility requirements a charity would have to meet is that at least 85% of its annual expenditures are for "poverty program expenses."

IRAs and qualified pension plans if the funds are used for higher education expenses. (The Dole plan's ADSAs would offer a similar waiver.)

One argument in favor of sheltering some part of higher education costs from tax is that people obtain education in order to earn more income over their lives, and the increased income will be taxed when it is realized. In conformity with the principle that taxable income should be measured net of the expenses incurred in generating that income, these education costs should be netted out. In other words, investment in human capital should be treated for tax purposes like investment in physical capital. A major weakness in this argument, though, is that people's investments in human capital do not consist solely of higher education. Much of that investment accumulates from the time a person is born and throughout a person's life in the form of a wide variety of experiences. Singling out college expenses for favorable tax treatment implies, contrary to fact, that higher education is the unique component of investment in human capital.

Acceptable income taxation should seek to place investment in human capital on the same tax footing as investment in physical capital. Meeting this difficult challenge calls for more heroic tax innovations than are offered in the Dole plan.

Other Components of Mr. Dole's Economic Program

Tax proposals are the central element of a broader economic strategy proposed by Mr. Dole. His economic plan also seeks to reduce government regulation, reform the tort system, and curb government spending. A unifying theme is the proposition that the government has become overly large and intrusive, infringing on people's liberties and slowing the economy.

Federal regulations impose high costs on the economy by dictating what products may and may not be produced and how various products are produced. A small portion of regulatory costs appear on-budget in the expenditures of federal regulatory agencies. The overwhelming majority of regulatory costs, however, result from the inefficient use of production inputs caused by government restrictions.

Government regulations can be thought of as implicit taxes on the private use of productive resources, with very much the same impairment of the market's performance. Thus, regulatory reform, if it proves effective, is analogous to trimming taxes; it has the potential to yield economic benefits and, in addition, to protect individual liberty.

It is difficult to predict whether Mr. Dole's regulatory initiatives, which include a cost-benefit test for new regulations and periodic reexamination of regulations, are strong enough to moderate the regulatory drag substantially, but regulatory costs are so high that even relatively small improvements could add considerably to the nation's output.[13] A note of caution is that because

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[13] Conceptually, the real costs of regulations are the values of forgone output resulting from government-imposed constraints on how resources are used. Estimating these costs poses enormous conceptual and measurement problems.

regulatory agencies are created and ultimately derive their authority from laws passed by Congress, regulatory costs are more likely to rise than fall if Congress keeps passing laws expanding the reach of regulators over private producers and consumers.

Along with regulatory reform, the Dole plan would modify the tort system. The Dole plan reflects the view, shared by many, that lawsuits have become so expensive and unpredictable that they often discourage production and innovation. The plan would put several types of limits on damage awards. If the position of Mr. Dole and many others is correct, these lawsuit reforms could make the tort system fairer and reduce its costliness.

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Mr. Dole also argues that government spending should be trimmed. Describing both taxes and government spending programs as potential threats to freedom, he warned in his acceptance speech at the Republican convention that taxes take away from people "the right to enjoy the fruits of one's own time and labor." Government spending programs, he declared, also transfer control of spending power from the people to those running the government, letting "the party of government...satisfy its priorities with the sweat of your brow." He portrayed government spending programs as often motivated not by compassion or morality, but by the arrogance and interests of those running the government, who "think that what you would do with your own money would be morally and practically less admirable than what they would do with it." Mr. Dole also said in that speech, "[I]t is time to recognize that we have surrendered too much of our economic liberty."

Mr. Dole and his advisers have also expressed the belief that many government programs are ineffectual or, worse, counterproductive and that many more government programs are overly expensive for what they deliver. When government spending programs take production inputs that would have been employed more productively in the private sector or when government spending programs distort how the private sector uses production inputs, the result is a weaker, less efficient economy that provides less output, less income, and lower real wages. By releasing resources to

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The conventional measure, focused on the costs of compliance and enforcement, is subject to methodological criticisms and extremely imprecise. The Administration guesses that regulatory compliance and enforcement costs are $600 billion annually. One recent study estimated that compliance and enforcement costs and negative effects of regulations on productivity far exceed $1 trillion annually. See Richard K. Vedder, "Federal Regulation's Impact on the Productivity Slowdown: A Trillion-Dollar Drag," (St. Louis, MO: Center for the Study of American Business, 1996). For comparison, gross domestic product (GDP) is approximately $7.6 trillion annually, and the individual income tax collects about $650 billion.

more efficient uses in the market-directed private sector, a downsizing of government could generate increases in output, productivity, employment, and real wages.

Although Mr. Dole has delivered a principled case in favor of a smaller government, the spending cuts he has actually proposed do not seem to address the question of what sorts of activities the government should undertake. The only programs, agencies, or departments specifically mentioned for downsizing are the Commerce and Energy Departments. Mr. Dole does not explain why cutting these departments should be central elements in redefining the role of government.

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The cuts in the Commerce and Energy Departments are part of $110 billion that would come from checks on non-defense discretionary spending. Other savings in that broad category are described only in the most general terms: "eliminating wasteful spending...and cutting bloated overhead, personnel, and administrative costs."[14] Instead of focusing on what government does and whether it should be engaged in those activities, much of the Dole rhetoric promises to run government programs more cost effectively. Collectively, these spending proposals are sufficiently vague and *ad hoc* as to invite the suspicion that the real motivation is simply to keep Mr. Dole's economic plan in budget balance.

An additional $55 billion of savings would come from a variety of spending and other changes, "including the aggressive use of the line-item veto, closing corporate loopholes, interest savings through lower deficits, and reforming other government programs."[15] Again, the description does not identify what should be cut back or place the reductions in the context of reducing the social and economic control presently exerted by those in government. As for the notion that revenues can be gotten at little economic cost by closing corporate "loopholes," it diverts scrutiny from spending programs and is plain wrong. Relative to a neutral tax system, corporate taxes are too high, not too low. Most so-called corporate tax "loopholes" are not tax subsidies; they moderate, but do not fully correct, biases against saving and investment. Thus, closing them would worsen tax inefficiencies. A better setting for revamping the corporate income tax and determining whether loopholes exist would be the tax restructuring that Mr. Dole says will follow the tax relief package.

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[14] Dole/Kemp '96, "Backgrounder: How the Dole/Kemp Plan Will Cut Taxes And Balance the Budget," August 27, 1996. An earlier document had indicated that $32 billion should be cut from the Energy Department's budget and $15 billion from the Commerce Department's budget. (Bob Dole for President, *op. cit.*)

[15] Dole/Kemp '96, *op. cit.*

Measured against his analytical case for a smaller government, Mr. Dole's proposed checks on government spending are not only vague and unfocused but also very modest compared to the government's total size. So-called mandatory programs, the largest components of which are Social Security, Medicare, and Medicaid, now account for 65% of non-interest federal spending, and the growth trends of these programs are ominous. Yet, Mr. Dole has said that Social Security and Medicare, the two largest "entitlements", are "off the table," and he has avoided specifying possible cuts in any other mandatory spending programs.

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The Dole Plan and the Federal Budget Deficit

The tax cuts in Mr. Dole's economic program would reduce federal revenues, but he contends that the cuts are fully financed. Consequently, declares Mr. Dole, enactment of his program would not set back the timetable for balancing the federal budget. The latest Congressional Budget Resolution calls for a balanced budget by 2002.

In explaining how their target can still be met, Mr. Dole's advisers note that the Congressional Budget Resolution leaves room for a tax cut of $122 billion. Additional spending cuts and other changes are counted on for another $165 billion. Auctioning rights to part of the broadcast spectrum is estimated to bring in $34 billion. Another $80 billion comes from assuming that factors which caused an unanticipated rise in tax collections this year will continue in part in future years. Finally, the faster economic growth expected to result from the proposed tax reductions is estimated to produce $147 billion in additional tax revenues. Together, these amounts, if they are accurate, will fully offset the revenue loss.

Many eminent economists judge the growth and revenue feedback assumptions to be very reasonable. Among the economists who back the dynamic assumptions are Nobel laureate Milton Friedman, Nobel laureate Gary Becker, Harvard Professor Martin Feldstein, Stanford Professor Michael Boskin, Harvard Professor Robert Barro, and Stanford Professor (and leading Dole economic adviser) John Taylor. Professor Becker declares that the Dole plan "is a bold one and a doable one that can raise the growth rate of the economy...to well over 3 percent."[16] This is not to say that every economist agrees with the Dole plan's economic assumptions, but it does indicate that those assumptions have analytical support and are plausible.

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[16] Clay Chandler, "Some Economists Laud Dole Tax Cut Proposal," *The Washington Post*, August 7, 1996, p. A15.

Both history and common sense, however, tell us not to place great weight on budget projections. Estimation models are sufficiently imprecise and economic surprises sufficiently frequent that actual budget results often differ substantially from earlier projections. Instead, the evaluation of the Dole plan should be primarily in terms of its likely economic effects and whether it would achieve its goals. A balanced budget is desirable, and the Dole numbers appear consistent with that objective, but no one can guarantee the net budget outcomes that that plan, or any other major economic plan, would produce. If the Dole plan is enacted and indications later arose that the budget would fall short of balance, further adjustments, such as additional spending revisions, could then be made. The Dole plan should not be rejected because of uncertainties about the federal budget deficit in the year 2002.

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Tax Restructuring

Saying that his tax relief package is only "step one," Mr. Dole and his advisers declare, "[R]estoring America to its full economic potential requires a fundamental overhaul of the tax system."[17] To accomplish that, they envision a fundamentally restructured tax system that would be "lower, flatter, fairer, simpler, and more savings oriented" than the present one.[18]

Constructive tax restructuring calls for fundamental changes in how the tax base is defined. The Dole plan, however, takes only modest steps toward achieving a better defined tax base.

Because the Dole tax plan is largely devoid of any such improvements in the tax base, its enactment would not facilitate the tax restructuring effort. Indeed, the near-term plan might actually lower the odds that tax restructuring would occur. The time and effort spent on Mr. Dole's current proposals would divert attention from fundamental tax overhaul. And, if these proposals became law, there might be a tendency to wait several years to see the results before turning to the bigger challenge of restructuring the tax system. Also, the revenue cost of the more limited plan would make tax restructuring harder to finance. Moreover, by easing some tax problems, passage of the limited plan might make tax restructuring seem less urgent. Unfortunately, settling for the limited tax changes Mr. Dole has proposed would also limit the gains to the economy.

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[17] Bob Dole for President, "Restoring the American Dream," *op. cit.*

[18] *Ibid.*

Freeing the Economy Versus Managing the Economy

Bob Dole and his advisers emphasize the growth dividend that they expect from his tax plan and broader economic strategy. They present two very different explanations, though, regarding what they are trying to do. One explanation centers on reducing government interference in the economy and has a solid foundation. The Dole campaign declares, "Each of Bob Dole's initiatives...draws on the simple proposition that the American people, not government, are the true guardians of our freedom and prosperity."[19] Implicit in this is recognition that the growth dividend would come from reducing artificial growth impediments that government has created.

Both history and common sense ... tell us not to place great weight on budget projections... Instead, the evaluation of the Dole plan should be primarily in terms of its likely economic effects and whether it would achieve its goals.

Another statement gives a different impression, however. "Growth must be the central goal of U.S. economic policy...America can do better if we set ambitious, but reachable, growth goals for our country and then implement the policies necessary to achieve them." [emphasis in original][20] If this is trying to say that those in government should recognize the enormous costs when their policies slow the economy and should redesign federal policies so that the government is not such an economic drag, it is on target. What the statement sounds like, however, is that the government should set a growth target for the nation (the Dole campaign mentions 3.5%), design a plan for reaching that target, and then impose that government plan upon the nation. It suggests, perhaps through imprecise phrasing, government economic planning.

If people, responding to the signals of a free market system, make economic choices that would produce a growth rate of 1% (or 3% or 5%), it is difficult to identify on what basis public policy makers should contradict the people's choices.

Again, the Dole plan is on solid footing if it does not aspire to impose from above a higher growth rate than people's preferences would generate but simply recognizes that government interference is slowing the economy. The logic of the economic game plan should not be to tell people how to work, save, and produce or what growth rate they should aim for; it is simply to reduce government interference so that people's preferences can come closer to being fulfilled. The resulting expansion of freedom and the market system is what would provide the growth dividend.

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[19] *Ibid.*

[20] *Ibid.*

Conclusion

The basic theme of Mr. Dole's tax plan and broader economic strategy, which includes spending reductions and regulatory and lawsuit reforms, is sound: government activities frequently hurt people rather than helping them; much of the damage occurs when the government distorts people's incentives and when it diverts production inputs into areas it favors. Thus, Mr. Dole's smaller-government message — the government could do more good if it did less, if taxes and spending were both lower — is a principled one. Although his tax plan would be stronger if it moved directly to fundamental tax restructuring, it would, in its present form, still allow the economy to be more efficient and dynamic, leading to greater prosperity for the American people.

Michael Schuyler
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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.