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THE CLINTON ECONOMIC PLAN: CONTINGENT PROMISES AND HIDDEN BURDENS

In his acceptance speech at the Democrat's convention, President Clinton promised several tax cuts that, he said, would be pro-growth, "targeted" to deserving groups, and responsible in terms of their revenue costs. He did not talk about his proposed tax increases, almost all of which would be collected at the business level. The majority of the tax requests, both reductions and increases, were included in the budget that the Administration submitted to Congress last March, but the President introduced several additional proposals in June and August.

Although the President declared, "[M]y plan gives Americans tax cuts that will help our economy to grow," most of the provisions would not do that... Few of the Administration's proposed tax cuts would soften tax biases against productive efforts.

The main tax cuts comprise a "middle class tax relief" package consisting of a child credit, tax assistance for higher-education expenses, and expanded individual retirement account (IRA) eligibility. These cuts would expire at the end of the year 2000 unless the budget deficit is lower than the Congressional Budget Office (CBO) expects. The increases the Administration seeks have received much less attention. Individually, they are smaller than the proposed reductions, but they are more numerous.

In evaluating the Administration's proposals, a number of questions should be asked. Are the tax changes the Administration is proposing consistent with sound tax principles? Would the changes facilitate economic growth? Would they tighten or loosen government control over the economy and society? Is narrow targeting a desirable means of implementing tax policy?

Institute for Research on the Economics of Taxation

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Tax Reductions

Most of the Administration's proposed tax reductions are contained in a "middle class bill of rights" that it introduced last March. One provision is a tax credit for taxpayers with pre-teenage children. Another is a tax deduction for higher-education expenses. A third is an increase in the income limit on eligibility for deductible IRA contributions. Two other proposals dating from March, both under the heading of "tax incentives for distressed areas," are to expand enterprise zones and to allow faster write-off of environmental clean-up costs in designated areas. Another proposal is to charge less interest to taxpayers who pay the estate tax owed on a closely-held business in installments. In June, the President sweetened the higher-education incentive with a tax credit. In August, the Administration added two provisions related to home ownership, recommended a tax credit for hiring those on welfare, and suggested a special tax credit for investors in community development banks and venture capital funds.

[A]n Administration "contingency" plan ... could end most of the tax reductions after a few years, although all of the tax increases would continue.

The Administration has emphasized that its proposals would help particular groups "targeted" by the Administration. People with pre-teenage children would pay less tax, and so would people with expenses for higher education. Most homeowners would pay as much tax as before, though, because the home ownership provisions are actually quite limited. Although the President declared, "[M]y plan gives Americans tax cuts that will help our economy to grow,"[1] most of the provisions would not do that. Tax changes can spur economic growth if they remove tax biases that slow growth. Few of the Administration's proposed tax cuts, however, would soften tax biases against productive efforts. The most significant exception is the IRA proposal. Meanwhile, many of the Administration's proposed tax hikes (discussed in a later section) would worsen tax biases, particularly against saving and investment. That would hurt the economy.

A significant complication is an Administration "contingency" plan that could end most of the tax reductions after a few years, although all of the tax increases would continue. The Clinton Administration promised that its tax and spending proposals would reach budget balance, as scored by the CBO, in the year 2002. Because the CBO was scoring the package as staying significantly in the red, the Administration added a contingency plan. Most of the tax reductions proposed in March would expire, according to one Administration explanation, on December 31, 2000, if "the Federal budget deficit is not at least $20 billion below the Congressional Budget Office's (CBO's) [deficit] estimate for the year 2000."[2] In the legislative language that the Administration produced,

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[1] President Clinton, Acceptance Speech to the Democratic National Convention, August 29, 1996.

[2] Office of Management and Budget, *President Clinton's FY 1997 Budget, Analytical Perspectives*, (Washington, DC: Government Printing Office, 1996), p. 36. In view of the CBO's projection of a $105 billion deficit in the year

though, the contingency turns into an unconditional "tax cut sunset", specifying that most of the proposed tax relief "shall not apply for taxable years beginning after December 31, 2000."[3] The contingency plan engenders much uncertainty about the longevity of most of President Clinton's tax-cut proposals; on that basis, Congress's Joint Committee on Taxation (JCT) regards the tax cuts as temporary and scores the Clinton plan as increasing taxes by $42 billion over the 10-year period 1997-2006. (If the contingency is triggered, the Administration also promises large, unspecified reductions in discretionary spending.)

<u>Tax credit for children 12 or younger</u> President Clinton recommends creating a tax credit for pre-teenage children (younger than age 13) of $300 per child in 1997 and 1998, rising to $500 in subsequent years. The credit would be phased out for taxpayers with adjusted gross incomes (AGI) above $60,000; it would be completely phased out at an AGI of $75,000. Also, the credit would end after 4 years, as of December 31, 2000, unless the federal budget deficit is lower than the CBO predicts. The credit would be nonrefundable, meaning that the government would not write someone a check if the person's child credit exceeded the person's tax bill.

The child credit would significantly reduce tax burdens for many taxpayers with pre-teenage children. For example, a taxpayer with two pre-teenage children and a pre-credit tax liability of $3,000 would only owe $2,400 if the credit is $300 and only owe $2,000 if the credit is $500. The credit would not benefit taxpayers without pre-teenage children.

The age and income cutoffs hold down the credit's revenue cost but are troubling. The credit's ostensible purpose is to soften the tax bite on people with child-rearing expenses, and those costs often increase when children become teenagers. Yet, instead of covering the high-expense teenage years, the credit's age cutoff specifically excludes them.

The phase-out generates at least four problems. First, it raises marginal tax rates sharply in the phase-out zone. For a taxpayer with an AGI between $60,000 and $75,000, additional income from work or saving is not only subject to regular income tax but lowers the credit. If the per child credit is $500, the phase-out would elevate a taxpayer's marginal tax rate by 3.3% ($500 taken back over a $15,000 AGI range) for each eligible child. That would push a taxpayer in the 28% tax bracket to marginal tax rate of 31.3% if there is one eligible child, 34.7% if there are two eligible children, and 38% if there are three eligible children. For taxpayers in the phase-out range, these amplified marginal tax rates would intensify tax biases against work and saving. Second, if people are deemed worthy of a tax credit on the basis of having pre-teenage children, why should people who have qualifying children be denied the credit solely because of an unrelated factor, their level of income?

2000, the CBO interprets this to mean that the contingency plan would kick in if the year 2000 deficit is more than $85 billion. (See Congressional Budget Office, *The Economic And Budget Outlook: Fiscal Years 1997-2006* (Washington, DC: Government Printing Office, 1996), esp. Chapter 3.

[3] CCH, Federal Tax Guide Reports, CCH Special 1, March 28, 1996, reprint of *Revenue Reconciliation Bill of 1996*, Revenue Proposals Contained in President Clinton's Budget Plan and Treasury Department Explanation, as Released on March 19, 1996.

Third, the phase-out is a reminder of how readily soak-the-rich tax provisions become soak-the-middle-class tax provisions. A couple with an AGI of $60,000 would begin to lose the credit if one or both increases his or her earnings by even a modest amount. Fourth, the phase-out is a complication that works against the goal of tax simplification.

The income tax harbors biases against work and saving by reducing the after-tax reward for work relative to leisure and the after-tax reward for saving relative to consumption. These biases distort people's decisions, resulting in less productivity, lower incomes, fewer opportunities, and slower economic growth. The child credit would generally not moderate these biases.

For instance, suppose a husband and wife each earn $25,000, giving them an AGI of $50,000. Also assume they file jointly, claim the standard deduction, and have 2 pre-teenage children. Based on the 1996 personal exemption, standard deduction, and rate brackets, they would have a taxable income of $33,100, which puts them in the 15% rate bracket, with a tax liability of $4,965. If the $500 per child credit were already on the books, that would reduce their tax bill by $1,000 to $3,965. Now suppose the couple have an opportunity to earn an extra $1,000 through added work or saving. At a 15% tax rate, their tax liability would increase by $150; it would be $5,115 before the credit and $4,115 after the credit. While the credit would lower the couple's total tax bill, it would not lessen the tax bite at the margin; the couple could still keep only $850 of the additional income. Thus, tax biases against productive activities would be as strong as before.

While the [child] credit would lower the couple's total tax bill, it would not lessen the tax bite at the margin... Tax biases against productive activities would be as strong as before. Indeed ... if the couple had a somewhat higher income ... the phase-out of the credit would substantially increase the tax biases they face.

Indeed, as explained above, if the couple had a somewhat higher income and were in the phase-out range, the phase-out of the credit would substantially increase the tax biases they face. Suppose the husband and wife each earn $30,000, giving them an AGI of $60,000. That would make their taxable income $43,100, which puts them in the 28% rate bracket, with a tax liability of $6,855. If the $500 per child credit were now on the books, it would reduce their tax bill by $1,000 to $5,855. Once again, suppose the couple have an opportunity to earn an extra $1,000 through added work or saving. That would increase their AGI to $61,000 and their tax bill before the child credit to $7,135. Because their AGI now exceeds $60,000, they are in the credit's phase-out range, and their credit per child would fall to $466.67 ($933.33 total). After subtracting the credit, their tax bill would be $6,201.67. With the $1,000 of extra income, their tax bill has risen by $346.67, allowing them to keep only $653.33 — a marginal tax rate of 34.7%. Of that, 28% is due to the regular tax and 6.7% to losing part of the credit as their income rises. Thus, for this couple, the child credit has actually increased the tax bite at the margin, intensifying tax biases against productive activities.

<u>IRA Eligibility</u> Under current law, the deductibility of IRA contributions begins phasing out over a $10,000 range, starting at an AGI of $40,000 for joint filers ($25,000 for single filers). Individuals, regardless of their incomes, can make nondeductible IRA contributions; contributions to these IRAs are made with after-tax dollars, but the annual earnings of the accounts are tax-deferred until the savings are withdrawn. Nondeductible IRAs are clearly much less attractive than deductible ones. The Clinton Administration would lift the start of the phase-out to an AGI of $70,000 in 1997 and 1998 and $80,000 in subsequent years ($40,000 and $50,000, respectively, for single filers) and double the size of the phase-out range to $20,000. These amounts and also the $2,000 annual contribution limit on IRAs would be indexed for inflation, starting in the year 2000. Because this provision is subject to the Administration's zero-deficit contingency plan, it could terminate at the end of the year 2000.

Expanding the number of people eligible to use deductible IRAs and adjusting the annual contribution limit to keep pace with inflation are desirable because deductible IRAs help overcome a basic income tax bias against saving. The problem is that if earnings are saved, the government assesses income tax on both the earnings and the returns on the saving, but if the earnings are used for consumption, only the earnings are taxed. By taxing the saving stream multiple times while taxing earnings used for consumption only once, the income tax prods people to save too little and consume at too high a rate. Deductible IRAs partially remove this tax penalty on saving. Because contributions are not taxed while gross IRA distributions are taxed, the saving stream is taxed once, which is the same treatment accorded to earnings used for consumption.[4] With more saving treated evenhandedly, at least with respect to this particular anti-saving bias, people would have an incentive to save and invest more than they would if they obtained no relief from the bias. The additional saving and investment would strengthen the economy: productivity, incomes, international competitiveness, and opportunities for the future would all rise.

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The Administration's proposal would be better if it completely removed the income and maximum contribution limitations instead of merely easing them, but it is superior to current law. Unlike almost all of the other features of the Administration's plan, this one would moderate a tax bias and improve incentives for economic growth. A significant pitfall is that, if these IRA reforms were enacted, they might end after a few years because of the contingency plan.

[4] Equivalently, neutral tax treatment can be achieved by taxing IRA contributions but not taxing distributions. The Clinton proposal would give taxpayers the option of structuring their IRAs that way. Not accounted for in this assessment are the other taxes that bear on income that is saved: the federal corporate income tax, state and local income taxes, transfer — estate and gift — taxes, and others.

Provisions for Home Owners Under current law, people who sell a primary residence may roll over the capital gain if they buy another home of equal or greater value. If they are at least age 55, they may also claim a one-time $125,000 capital gains exclusion on home sales. The President would raise the capital gains exclusion on home sales to $500,000 ($250,000 for single filers) and let taxpayers claim it regardless of age once every two years.

This provision would reduce taxes for some home sellers, but fewer than it might seem because the current-law combination of the rollover and the lifetime exclusion already shield most people selling homes from the capital gains tax. Because the provision would only help a small minority of home owners, the JCT estimates it would have a 6-year revenue cost of less than $3 billion.

This provision raises questions about Administration priorities. Owner-occupied housing is already subject to less severe capital gains tax treatment than other types of assets. From the perspective of directing tax relief to where tax distortions are greatest, owner-occupied housing should be one of the last types of assets to receive (additional) capital gains relief, rather than the only one. This provision would tend to increase the diversion of saving from investment in plant, equipment and other productivity-enhancing investments into residential housing. Another question involves home owners versus renters. Renters pay taxes on their dwellings indirectly: in order to earn an acceptable rate of return on their rental investment properties, landlords charge higher rents than otherwise to cover taxes. Because this provision would not change the tax treatment of rental properties, landlords would not have any new tax savings to pass along to renters. Thus, this provision would not benefit renters. It would differentiate in favor of home ownership versus renting, irrespective of other considerations that may well be more relevant with respect to how housing services are acquired.

Another provision, related to both home ownership and IRAs, would waive the early withdrawal penalty if IRA distributions are used to buy first homes. IRAs are an important means of combating the income tax bias against saving, but numerous restrictions on IRAs deter many people from using them. Relaxing one of those restrictions would allow IRAs to function better as a means of moving towards neutral tax treatment of saving.

Deduction and credit for higher-education costs The Administration recommends creating a deduction of up to $10,000 ($5,000 in 1997 and 1998) for higher-education costs. The deduction would be "above the line", meaning people could claim it even if they take the standard deduction. The deduction would start phasing out once the taxpayer's AGI reaches $100,000 for joint filers ($70,000 for single filers), and it would be subject to the contingency plan. The President also proposes granting a tax credit of up to $1,500 annually for up to 2 years of college. (The deduction and credit could not both be claimed in the same year.) The credit would be refundable, meaning people could claim it even if they paid no tax.

Saying that we must "make 14 years of education the standard for every American," the President described these tax proposals as part of the Administration's "college strategy."[5] With the credit, says the President, "Education at the typical community college will now be free."[6]

These and other targeted tax provisions demonstrate the Administration's intention to use the tax system to encourage or discourage various activities based on whether the Administration likes or dislikes the activities. The use of such inducements opposes the principle of tax neutrality. A tax is neutral if it does not affect people's decisions, that is, if people do not make choices that they would not make otherwise on the basis of tax considerations. An economy operates more efficiently if taxes are neutral than if they create biases for or against particular activities.

Having millions of people attend community colleges because the federal government has made it "free" may not be the best use of the nation's limited resources. There is no free lunch. Someone must pay for the undiminished, possibly increased, costs of supplying all those educations.

It is sometimes argued that taxes should support certain activities if there are compelling social or economic reasons to do so and if the aid cannot be delivered as well through other means. This argument has merit only if the costs of providing the support are also considered. It is not clear that the higher-education deduction and credit meet these demanding requirements. Having millions of people attend community colleges because the federal government has made it "free" may not be the best use of the nation's limited resources. There is no free lunch. Someone must pay for the undiminished, possibly increased, costs of supplying all those educations. The Administration has talked of the benefits of having more people attending college, but it has not discussed the sacrifices that implies elsewhere in the economy and has not weighed the costs of those forgone opportunities against the benefits of its subsidies. Moreover, contrary to the President's one-size-fits-all assertion that everyone should have at least two years of post-secondary education, many people do not want to remain in the classroom past high school and would gain little from doing so. There is a strong dose of elitism in assuming that taking college courses, regardless of the individual and the courses chosen, is always more socially enriching and more effective in terms of accumulating human capital than other ways in which people might spend their time, ranging from on-the-job experience to leisure activities.

The federal government already furnishes much assistance on the spending side to higher education through student loan programs and direct aid to higher-education institutions. Even if further aid is deemed desirable and meets appropriate tests, the Administration has not explained why it cannot be furnished on the spending side, without introducing special tax rules.

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[5] President Clinton, Commencement Address at Princeton University, June 4, 1996.

[6] *Ibid.*

Another caution is that tuition and other higher-education expenses have risen much faster than inflation and many blame the increases, in part, on the increased subsidy afforded by various forms of government assistance. If that is true, the proposed deduction and credit would push up higher-education costs, offsetting much of the supposed benefit to students.

Empowerment zones, enterprise communities, and brownfields Special rules assist businesses that locate in empowerment zones and enterprise communities.[7] With regard to federal taxes, empowerment zones offer an employment and training credit, $20,000 of additional expensing per year on business equipment, and tax-exempt private activity bond financing. Enterprise communities offer tax-exempt private activity bond financing. The Administration now proposes to designate, with some modifications in the special tax rules, 2 additional empowerment zones in urban areas within 180 days and 20 additional empowerment zones (15 urban, 5 rural or Indian reservation) before 1998. The Administration would also designate 80 additional enterprise communities (50 urban, 30 rural or Indian reservation) before 1998.

Empowerment zones and enterprise communities present a complicated picture in terms of tax principles. The special rules regarding expensing and tax-exempt bond financing help correct biases in the regular tax system that discourage saving and investment in the designated areas. In those respects, empowerment zones and enterprise communities are consistent with tax neutrality.

For neutral tax treatment, businesses should be able to deduct investment costs when they incur those costs. Expensing (the immediate write off of investment costs) allows them to do that. When businesses must depreciate their investment costs over many future years, in contrast, the deductible costs are understated in discounted dollars. (For example, if a business spends $1,000 this year on capital equipment but can deduct the cost only over the next 5 years in equal annual deductions, and if the discount rate is 10%, the deduction has a discounted value of only $834, causing the business's costs to be understated and its income overstated by $166 in discounted dollars.) Tax-exempt bonds also address a tax bias. As discussed earlier with regard to IRAs, the income tax normally generates a bias against saving by taxing earnings used for saving multiple times while taxing earnings used for consumption just once. Tax-exempt bonds deal with this problem: bonds are bought with after-tax dollars but the returns on the bonds are not taxed; hence, the saving stream is taxed just once.

From this perspective, empowerment zones and enterprise communities are good tax policy for the eligible communities because they lower artificial tax barriers to saving and investment therein. The resulting increases in investment and entrepreneurial activity will boost productivity,

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[7] The 1993 tax act created 9 empowerment zones and 95 enterprise communities for low-income areas. Two-thirds are in urban areas and are designated by the Secretary of Housing and Urban Development. One-third are in rural areas and are designated by the Secretary of Agriculture. To be eligible for designation, an area must meet detailed criteria regarding population, distress, area, size, and poverty. The secretary making the designation has the power to relax some of the poverty criteria for an enterprise community but not an empowerment zone. The designations of areas as empowerment zones or enterprise communities were made in 1994 and 1995, and each area will generally retain that designation for 10 years.

employment, output, incomes, and opportunities. The economy would be better off, of course, if these rules were extended to everyone. But perhaps the special areas will hasten the adoption of the rules elsewhere by showing the economic benefits of the rules. If so, the benefits to the initially benefitted communities will be diffused. Of course, one should expect these communities to oppose generalizing the tax changes, on the assumption that the more widely available are these tax benefits, the less effective they will be in attracting investments and businesses to the designated communities.

The disadvantage to having designated areas with special rules is that some of the added production and employment in the designated areas does not come from new economic activity but is diverted by the various incentives from other localities where production could be carried on more efficiently. To the extent this occurs, a policy question is whether social and other considerations justify favoring some localities at the expense of others. Unless it can be shown that existing tax laws discriminate against these localities relative to other areas, locality-specific incentives are at odds with the principle of tax neutrality. (This question becomes particularly acute if the selections seem based largely on political motivations, a possibility that should not be ruled out.)

A similar analysis applies to "brownfields." The term is used to refer to environmentally contaminated properties in certain low-income areas. Under current law, taxpayers incurring costs to clean up and monitor contaminated properties may be required to capitalize some of the costs. With the idea that pollution often holds back development in distressed areas, the brownfields provision would facilitate clean-up efforts by allowing the taxpayers to currently deduct certain of those costs if the properties are located on qualified sites.

As with empowerment zones and enterprise communities, this proposal is desirable in that it would permit costs to be recognized for tax purposes when they are incurred. When costs must be capitalized, their discounted value is understated, causing some economically worthwhile investments to be rejected for tax reasons. On the other hand, this provision is subject to some criticism because it could favor certain areas at the expense of others.

<u>Other Tax Reductions</u> Several other Administration proposals would also decrease taxes in special cases. One would lower how much interest the government charges taxpayers who pay in installments the estate tax owed on a closely-held business. Another, which would only apply in designated areas and have the funds flow through state governments, would give a tax credit to employers of people on welfare for at least 18 months. Another would expand the work opportunity tax credit (WOTC). One more would let the Community Development Financial Institution (CDFI) Fund allocate tax credits for investments in community development banks and venture capital funds.

Tax Increases

The tax reductions and some new spending initiatives in the President's plan would be paid for with tax increases. While much of the cuts center on individual taxes and are highly visible, the proposed increases are far more difficult to see because most of them would be assessed at the business level and are highly technical. The common denominator of most of the proposed increases is that they would raise the costs of doing business. The government-generated increases in production costs would then be passed along to individuals in lower profits to investors in businesses, leading to less investment, slower growth in labor's productivity, hence lower wages to employees and higher prices to consumers for goods and services of businesses paying higher taxes.

A few provisions, such as a hike in the capital gains tax (accomplished by restricting the use of a standard method of determining cost basis), would target individual investors. These provisions would also discourage investment.

The [Joint Committee on Taxation] lists approximately 50 [tax increases in the Administration's plan] ... and it estimates that they would comprise an $80 billion tax increase over the period 1997-2002.

With the exceptions of extending the airfare excise tax and superfund excise taxes, most of the provisions are not large in isolation. They are so numerous, however, that their cumulative effect would be large. The JCT lists approximately 50 of them, and it estimates that they would comprise an $80 billion tax increase over the period 1997-2002. (See Appendix for the JCT's listing.) Because of the multitude and technical nature of the tax-increase proposals, it is not practical to discuss and evaluate each of them here. Instead, a representative sample of three are examined in subsequent discussion.

The Administration claims that many of the provisions are merely designed to close corporate tax loopholes. An examination of current law and the proposed changes, however, finds that most of the supposed abuses are consistent with good tax principles. They are generally in the tax code to mitigate tax biases against saving and investment. The main shortcoming of the current-law provisions is not that they are loopholes but that they generally do not go far enough in correcting tax biases against productive activities. If the Administration's corporate "loophole" closers were implemented, the real effects would be to depart further from sound tax principles and to worsen tax biases.[8] Another problem arises because most people would be unaware they were paying these taxes due to the indirect routes via which they would bear the taxes: lower investment returns, lower

[8] These issues are explored in greater detail in Michael Schuyler, "False Charges Of Corporate Welfare Fuel Administration Tax Hike Proposals," *IRET Economic Policy Bulletin* No. 66, June 1996, which examined the "loophole" closers the Administration sought in its March budget submission. (Copies of this Bulletin are available from **IRET** on request.) Several of the revenue raisers analyzed in that paper (eliminating the deductibility of interest costs incurred on corporate owned life insurance, limiting the possessions tax credit, repealing a 1986 rule that had allowed a certain company to use an interest allocation rule available to financial institutions, and restricting the income forecast method of depreciation) became law, with some modifications, during the summer when they were attached as revenue offsets to bills moving through Congress.

employee compensation, and higher consumer prices. The camouflaged nature of the tax hikes would interfere with one of the most important functions of taxes: to show people how much they are paying for government services so they can make better choices about what amount of government they want. The following proposals are examples of the real but hidden character of the tax increases.

Reduce dividends received deduction Under current law, a corporation that owns shares in another corporation may exclude from taxable income a portion of the dividends it receives from the other company. The excludable portion is 70%, 80%, or 100%, depending on whether the ownership stake is less than 20%, between 20% and 80%, or greater than 80%. Complaining that the "70 percent exclusion is too generous for corporations that cannot be considered an alter ego of the distributing corporation," the Administration would cut the 70% exclusion down to 50%.[9]

If the Administration's corporate "loophole" closers were implemented, the real effects would be to depart further from sound tax principles and to worsen tax biases.

The top statutory corporate tax rate is 35%. If not for the dividends received deduction, the effective corporate tax rate would rise far above that when one corporation owns shares in another. Suppose Company B owns shares in Company A. When Company A earns $100, it must pay $35 of income tax, leaving it with $65. If Company A then pays the $65 to Company B as a dividend and if there were no dividends received deduction, Company B would have to pay $22.75 of income tax on the dividend (35% of $65), leaving it with only $42.25 of the original $100. The cumulative income tax rate at the corporate level would be 57.75% ($57.75 of the $100 of earnings paid in corporate income taxes). If another corporation owned shares in B, dividends it received would bear a cumulative tax at the corporate level of 72.54%.

To prevent the effective income tax at the corporate level from exceeding the top statutory rate of 35%, the dividends received deduction should be 100%. Thus, it is already inadequate under current law. No additional income whatsoever is generated as dividends are paid by A to B, B to C, and so on. Nondeductibility is simply an unprincipled device for imposing a far higher tax on corporate earnings than the statutory rate. Corporate "alter egos", on which the Administration claims the issue hinges, is wholly irrelevant to the problem.[10] The reduction in the dividends received deduction the Administration seeks would compound the overtaxation. Further, it would

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[9] CCH, reprint of *Revenue Reconciliation Bill of 1996, op. cit.*

[10] Even if the dividend received deduction were 100%, the government would still be assessing two income taxes on the same earnings. Corporate earnings are taxed at the corporate level. Then, when distributed to individual shareholders as dividends or realized by the individuals as capital gains, the same earnings are taxed again at the individual level by the individual income tax.

do so where the dividends received deduction is already smallest and, thus, the overtaxation problem already worst.

The proposed tax change would be anti-growth because investment is one of the main sources of economic growth and this change would reduce investment. One reason investment would fall is that the higher effective tax rate would make it less attractive. Another reason is companies would have fewer dollars available for reinvestment because a larger share of earnings would, instead, have to be paid in taxes. The proposed change would also affect decisions about inter-corporate ownership. By further cutting the dividends received deduction on small ownership stakes, the government would be telling corporations either not to invest in each other or to make the investments large ones. For market efficiency, the government should be sending no such signals through the tax system.

Reduce the number of years that net operating losses (NOLs) can be carried back Under present law, businesses with NOLs can carry the losses back up to 3 years or forward up to 15 years. With a carryback, a business deducts the current year's loss from income in a previous year, obtaining a refund on the taxes paid for the previous year. With a carryforward, a business waits until there is income in a future year and then deducts the loss from that income, reducing its tax bill in the future year. The Administration asks to shorten the carryback period to just 1 year; it offers to lengthen the carryforward period from 15 to 20 years. The Administration says these changes are desirable because of the "complexity and administrative burden" of carrybacks, adding the statement that the increased use of carryforwards would not be complicated or administratively burdensome.[11]

To prevent the effective income tax at the corporate level from exceeding the top statutory rate of 35%, the dividends received deduction should be 100%... [I]t is already inadequate under current law... The reduction in the dividends received deduction the Administration seeks would compound the overtaxation.

Many businesses suffer losses some years while earning profits other years. The performance of these businesses would be greatly overstated for tax purposes if they were unable to net their losses against their profits. Carrybacks and carryforwards are a means of providing offsets. If carrybacks can be used, they afford full offsets. Suppose, for example, that a business had income last year of $15,000 but a loss this year of $10,000. A carryback allows the business to claim without delay a tax adjustment reflecting the loss. Suppose, however, that the business cannot use a carryback and must carry the loss forward. Because a dollar in the future is worth less than a dollar now, the delay erodes the value of the loss offset. At a discount rate of 10%, the offset to the $10,000 loss would have a present value of only $9,091 if it must be carried forward 1 year, only $8,264 if it must be carried forward 2 years, and just $2,394 if it must be carried forward 15 years.

[11] CCH, reprint of *Revenue Reconciliation Bill of 1996, op. cit.*

By barring many businesses now eligible to carry losses back from doing so, the Administration would prevent many firms trying to weather losses from obtaining prompt tax relief. The delay would cause the discounted value of the offsets to understate the losses. And if a troubled business did not have future income, it could never obtain relief. The proposed extension of the carryforward period from 15 to 20 years would be of almost no help to firms with losses because of discounting and the small likelihood that businesses which could not claim losses within 15 years could claim the loses if they had an extra 5 years. Contrary to the Administration's assertion, restricting the use of carrybacks and requiring more losses to be carried forward would not simplify the tax system.

One result of the Administration's proposal would be to put more pressure on businesses experiencing difficulties. The pressure would be especially great during recessions, when many businesses have disappointing results. Another result is that businesses would be less inclined to invest in anticipation of future opportunities because major investments might lead to current losses that could not soon be offset against income. Still another result is that businesses with NOLs would have a stronger motive than now to merge with profitable firms in order to minimize the delay in utilizing NOLs. All of these consequences are undesirable.

<u>Repeal a rule allowing half of export profits to be treated as income from foreign sources</u> Unlike many nations, the United States taxes its companies on their worldwide incomes. This exposes U.S. taxpayers with income from abroad to the danger that their foreign-source income will be taxed by both the country where it is earned and by the United States. Paying two nations' income taxes on the same income would clearly put U.S. companies trying to do business abroad at a grave competitive disadvantage compared to foreign rivals paying only one income tax. In recognition of the double-tax problem caused by its worldwide taxation, the United States allows taxpayers that have paid foreign taxes on foreign income to claim a credit for those taxes when computing how much U.S. income tax they owe.

A key restriction, however, is that U.S. taxpayers cannot claim foreign tax credits (FTCs) exceeding the U.S. tax they would owe on their foreign-source income if not for the credits. For instance, the maximum FTC a company could claim on $100 of foreign-source income is $35, assuming a 35% U.S. corporate income tax rate. In determining their foreign-source incomes, U.S. taxpayers must allocate their revenues and expenses between U.S. and foreign sources. Rules that force taxpayers to allocate less of their revenues and/or more of their expenses to foreign sources reduce the income that U.S. taxpayers are permitted to categorize as foreign source and, thus, reduce the maximum FTCs they can claim. For instance, if new allocation rules reduced the income categorized as foreign source in the example from $100 to $80, the maximum FTC would fall from $35 to $28. (With $20 less categorized as foreign source, $20 more would be categorized as U.S. source and not eligible for the FTC.)

As it has sought to collect additional revenues over the years, the U.S. government has increasingly tightened the allocation rules, thereby cutting the income taxpayers can classify as foreign source and reducing the maximum amount of foreign taxes on which U.S. taxpayers can claim credits. These and other restrictions often prevent U.S. taxpayers from fully crediting the foreign taxes they have paid on foreign income against their U.S. tax liabilities. Thus, U.S. companies must frequently labor under the double-tax handicap that some of their foreign income is taxed abroad and again by the United States.

One of the tax increases the Administration proposed in August is to eliminate the very long-established export sales source rule and replace it with an activity based rule. Under current law, the sales source rule allows U.S. multinational corporations that export to treat half of their export income as being derived from domestic production and half from foreign sales activity. The Administration would replace this with a rule that attempts to allocate the income based on actual economic activity. In seeking to remove the sales source rule, the Administration is taking the position that the source of sales (in this case, sales abroad) should be irrelevant in determining for tax purposes whether the income from the sales is classified as foreign-source income. If companies were forced to use the activity based rule, some would show drops in how much of their income they could categorize as foreign source. That would diminish the maximum FTCs they could claim. For companies whose foreign taxes exceeded their new (lower) maximums, the FTCs they could claim would decrease, their U.S. taxes would increase, and they would suffer worsened double taxation.

One perverse result of this change is that although it is often thought desirable for U.S. businesses to be vigorous exporters, the increased double taxation would make it more difficult for many of them to remain competitive. Another unfortunate result is that it would induce some companies now selling American-made products to foreign affiliates to move their production offshore; in some cases it would allow them to classify more of their income as foreign source under an activity based rule, permitting the companies to continue crediting their foreign taxes against their U.S. taxes. Obviously, the federal government should not be giving businesses a tax motive to produce abroad if the businesses would otherwise choose to produce in the United States, but that is what the new rule would sometimes do. One more drawback is that the 50% allocation rule is very simple, whereas the Administration's proposed alternative is much more complicated and can be extremely contentious.

Government Spending

President Clinton describes his tax cut proposals as being "responsible" and "paid for within my balanced budget plan."[12] Another part of the plan consists of the tax increases that would largely finance the tax reductions. A third, very important, component of the Administration's budget plan is spending restraint. The Administration's budget documents call for strict curbs on federal spending. Moreover, if the budget contingency plan is triggered, the Administration would have to make large, additional cuts in discretionary spending four years from now. Unless the Administration lives up to its promises regarding spending restraint, its budget will be deeply in the red.

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[12] President Clinton, Democratic National Convention, *op. cit.*

The Administration's actions with respect to federal spending are a serious concern because, so far, the Administration has given little indication that it intends to abide by its pledges regarding spending restraint. In the just concluded session of Congress, the Administration used the threat of Presidential vetoes to demand more funding for many programs, thwarting Congressional efforts to secure greater spending restraint in fiscal year 1997. With the exception of national defense, there was virtually no area where the Administration tried to persuade Congress to approve less spending.

Unless the Administration lives up to its promises regarding spending restraint, its budget will be deeply in the red... [T]he Administration's [budget] plan puts off until later years most of the spending restraint, resulting in easy-to-reach limits for 1997 but much harder-to-reach ones later.

Although the spending amounts approved for fiscal year 1997 stayed within the limits in the Administration's budget plan, that was because the Administration's plan puts off until later years most of the spending restraint, resulting in easy-to-reach limits for 1997 but much harder-to-reach ones later. For example, the CBO estimates that the Administration's plan calls for discretionary spending cuts from the baseline of $4 billion and $6 billion in 1997 and 1998, respectively, but $42 billion, $46 billion, and $38 billion in 2000, 2001, and 2002.[13] Similarly, the CBO estimates that the Administration's budget plan seeks Medicare cuts of $5 billion and $8 billion in 1997 and 1998, but $20 billion, $26 billion, and $31 billion in 2000, 2001, and 2002. For Medicaid, the Administration plan's proposed cuts are $2 billion each in 1997 and 1998, but $10 billion, $16 billion, and $22 billion in 2000, 2001, and 2002. Moreover, if the year 2000 deficit is not at least $20 billion below the CBO's projection, discretionary spending must be cut by an additional $22 billion and $46 billion in 2001 and 2002, according to the CBO's interpretation of the contingency plan.

Many observers are dubious that the Administration has the discipline to comply with the future caps. Indeed, Congressional testimony suggests that the White House may not even intend to try. Some Administration officials say the White House has already urged them to disregard the future-year spending limits in the budget plan. Veterans Affairs Secretary Jesse Brown stated before a Congressional hearing that the President had personally assured him that the future cuts slated for his department would never occur. Similarly, NASA director Goldin said that the White House had told him not to base any decisions on the post-election reductions shown in the President's budget.[14]

In the weeks leading up to the Democratic convention, President Clinton discussed many new spending initiatives. Several of them emerged at the convention, including a "G. I. Bill for American

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[13] CBO, *The Economic And Budget Outlook: FY 1997-2006, op. cit,* p. 58.

[14] Comments of Secretary Brown and Director Goldin are reported in David S. Broder, "Clinton's Budget Game," *The Washington Post*, June 9, 1996, p. C-7.

Workers", government-subsidized health insurance for the unemployed, a student literacy initiative featuring a major expansion of the AmeriCorps program, and more money for the troubled superfund program and other environmental clean-up efforts.[15] Although the requested funding for these programs is initially modest, each of them could readily be enlarged, placing a substantial drain on the U. S. Treasury.

[T]he Administration has often described enthusiastically the benefits of government programs, while saying almost nothing about the costs... Concentrating on the benefit side allows many expensive and intrusive government programs to look artificially good...

The Administration has often described enthusiastically the benefits of government programs, while saying almost nothing about the costs of those programs in terms of the production and consumption they divert from private-market control and the economic distortions they frequently create. In this respect, the Clinton Administration is not unique, of course. Until costs of spending initiatives are identified, however, alleged benefits should be discounted. Concentrating on the benefit side allows many expensive and intrusive government programs to look artificially good. Despite occasional rhetoric that the era of big government is over, the Administration's philosophy seems to be that new government programs and the expansion of existing programs would make this country a better place. In his convention acceptance speech, for instance, President Clinton declared, "[W]e will balance the budget ... in a way that preserves Medicare, Medicaid, education, the environment, the integrity of our pensions, the strength of out people.[16] Rather than offering guidance as to where federal spending ought to be cut to live within the budget plan, this statement, with its suggestion that the key to a strong America is the government, seems to argue that the government should not be pruned very much, if at all.

Are Mr. Clinton's Tax And Spending Promises Credible?

In 1992, Mr. Clinton ran for President with the promise that he would push through a major middle-class tax cut. What he pushed through, instead, was a large tax increase. Mr. Clinton claims that he partially redeemed his pledge by greatly expanding the earned income tax credit (EITC), but that expansion did not lower taxes for most middle-class taxpayers; it was mainly targeted towards lower-income households. The President denies he raised taxes for the middle class, but that ignores the extra 4.3 cents of federal tax on every gallon of gasoline and the stiff tax increase for millions of middle-class social security beneficiaries who had to include more of their benefits in their taxable

[15] President Clinton, *op. cit.* Unlike the original G. I. Bill, which went to people who had helped fight a war, the "new G. I. Bill for American Workers" would be a training grant of up to $2,600 a year for the unemployed and workers the government deems underemployed.

[16] President Clinton, Democratic National Convention, *op. cit.*

incomes. The simple facts of that track record cannot help but inspire doubts about the believability of the President's promises in this election year.

Another cause for suspicion is that the President's budget calls for more spending restraint in future years than the Administration has been willing to accept in any year up to now. This is relevant in examining taxes because if the spending restraint promised for future years in the Administration's budget does not occur, that would increase future federal budget deficits. The higher deficits might prompt the Administration to seek more money on the revenue side by requesting more tax increases or shelving some of the tax cuts it has proposed.

The Administration's contingency plan, both on the tax and spending sides, injects still more doubts. According to the CBO's interpretation of the contingency plan, discretionary spending must be cut by an additional $67 billion in 2001 and 2002 if the year 2000 deficit is not at least $20 billion below the CBO's projection. It would be tempting for the Administration to reduce the odds of triggering that spending contingency by scuttling much of the tax cut. The contingency with respect to tax reductions creates yet more uncertainty. If the tax reductions were enacted into law as they are currently written, it is quite likely that most of them would suddenly disappear after 4 years, at the end of the year 2000. Another consideration is that it would be unprecedented to condition a tax change on how a future year's actual deficit compares with the CBO's projection. Two more likely scenarios with regard to tax reductions are that the contingency would be dropped in favor of an automatic sunset (which is how the Administration's proposed legislative language reads) or that the cuts would be made permanent but kept much smaller than anything the Administration is now discussing by dropping some of the proposals and scaling back others.

Although there are many doubts about whether the Administration would seek the tax reductions it has promised, there are few doubts that it wants the tax increases it has recommended. Similarly, there is little reason to doubt that this Administration would seek additional, new spending programs. If the Administration were returned for a second term, it is questionable that initiatives for a less intrusive, smaller federal government would originate in the executive branch.

Conclusion

While President Clinton often talks about free enterprise and private markets being the main elements of a strong economy and a prosperous people, his tax proposals overlook the market system while emphasizing government control. Under a market-oriented tax plan, the core question would be how to reduce tax distortions and interference with market incentives that cause people to make inefficient decisions for tax reasons.

The Administration's suggested tax cuts, however, are not based on an assessment of tax distortions or how to correct them. Instead, the Administration has identified various groups or activities it would like to reward, and wishes to do so through the tax system. What the Administration would be doing with its tax "targeting", in essence, is trying to pick winners and losers in the economy.

The Administration's proposed revenue raisers also disregard the importance of markets. The overwhelming majority of the Administration's recommended tax hikes would add to existing tax biases against productive activities. In insisting that these changes would not hurt the economy, the Administration is implicitly taking the position that markets do not really matter. By minimizing the role of the market system while giving priority to the government's actions, these policies indicate that the Administration's true stance is one of big government.

On the spending side, the Administration has identified virtually no domestic programs as being beyond the proper scope of government. Indeed, it has consistently sought to expand the government's role, for example, by trying to give the government control over health care in the United States. It is revealing that in the days before the Democratic convention, the President eagerly talked about new things the government could be doing rather than asking whether the government should scale back any of its current activities. The Administration's position regarding spending reinforces the impression that it sees government economic management as being superior to the free market system, despite occasional praise for private enterprise. Because the Administration's spending plans are apt to strain the federal budget, the Administration is likely to look for revenue raisers, leading to fewer tax reductions than President Clinton is now promising and more tax increases.

A less inefficient, more neutral tax system and effective spending constraints would benefit all people in the country, not merely those targeted by the Administration. Unfortunately, the Administration's economic policies, if enacted, would result in more intrusive fiscal and budget policies that would add to the existing government-imposed roadblocks to economic progress.

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APPENDIX

Joint Committee On Taxation's Listing Of The Tax Increases Sought By The Clinton Administration[17]

The JCT has compiled a list of the tax increases the Administration is requesting. Also included below are several revenue raisers that, according to budget rules, are categorized as spending offsets, but are, in effect, taxes. The sheer number — and technical complexity — of the provisions is evident from the list.

Determine basis of substantially identical securities using average-basis method
Require recognition of gain on certain appreciated positions in personal property
Extend pro-rata disallowance of tax-exempt interest expense to all corporations
Deny interest deduction on certain debt instruments
Defer interest on certain convertible debt
Realize gains and losses from certain terminations with respect to property (extinguishment)
Determination of original discount where pooled debt obligations subject to acceleration
Gain recognition for certain extraordinary dividends
Recognition of gain in certain section 355 transactions
Tax treatment of redemptions involving related corporations
Treat conversion of large corporations into S corporations as complete liquidations
Reduce 70% dividends received deduction) to 50%
Modify holding period applicable to dividends received deduction
Treat certain preferred stock as "boot"
Further restrict like-kind exchanges involving foreign property
Modify loss carryback and carryforward periods
Repeal percentage depletion for certain non-fuel minerals mined on federal lands
Expand subpart F provisions regarding income from notional principal contracts and stock lending transactions
Modify foreign tax credit carryback and carryforward periods
Modify foreign tax credit rules applicable to dual capacity taxpayers
Terminate suspense accounts for family farm corporations required to use accrual accounting
Repeal lower-of-cost-or market method of accounting for inventories
Repeal components-of-cost method of accounting for inventories
Increase penalties for failure to file correct information returns
Repeal exemption of withholding on gambling winnings from bingo and keno where proceeds exceed $5,000
Require reporting of payments to corporations rendering federal services to federal agencies
Expand requirement that involuntarily converted property be replaced with property acquired from an unrelated person
Extend superfund excise taxes through 9-30-06
Extend superfund AMT
Extend the oil spill tax through 9-30-02 and increase the cap on unobligated balances in the trust fund
Extend "LUST" excise taxes through 9-30-06
Extend airway and airport trust fund excise taxes through 9-20-06
Treat kerosine as diesel fuel for excise tax purposes
Extend the FUTA surcharge
Require monthly deposits for FUTA taxes
Deny rollover or exclusion of gain on sale of principal residence which is attributable to depreciation deductions
Increase merger filing fees
Replace sales source rules with activity based rule
Tighten the substantial understatement penalty
Impose $225 per flight fee on business aircraft
Deny dividends received deduction for preferred stock with certain non-stock characteristics
Shorten extension of the credit for producing alternative fuel from biomass or coal facilities

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[17] See Joint Committee on Taxation, "Estimated Budget Effects Of The Revenue Provisions In The President's Fiscal Year 1997 Budget Proposal, Released On March 19, 1996, And The President's Proposals, Released On August 29, 1996 (Does Not Include Provisions Enacted After March 19, 1996)," Dated September 16, 1996, Reprinted in *Daily Tax Report*, September 23, 1996. The JCT's list excludes several tax hikes the Administration asked for in March that were subsequently enacted, with modifications.