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TOWARDS A BETTER TAX SYSTEM: THE BUSH PLAN

In his campaign for the Presidency, Texas Governor George W. Bush has placed tax reform at the top of his economic agenda. Gov. Bush argues that federal taxes are too high and too distortionary. He and his advisors have developed a plan that would achieve major improvements in both areas.

The centerpiece of Gov. Bush's plan is cutting the individual income tax's marginal rate brackets. He recommends replacing the current five brackets of 15%, 28%, 31%, 36%, and 39.6% with four brackets of 10%, 15%, 25%, and 33%. Another key element of the plan is starting to reform the tax-and-spend Social Security system by permitting workers to redirect into personal retirement accounts part of what they now pay in Social Security taxes. Many of the plan's provisions would lower marginal tax rates indirectly by changing how taxable income is measured. A few provisions would not affect marginal tax rates; Gov. Bush included them mainly for social policy reasons. <u>All</u> parts of the plan would lower people's federal tax bills.

> ***Texas Governor George W. Bush ... argues that federal taxes are too high and too distortionary. He and his advisors have developed a plan that would achieve major improvements in both areas.***

In arguing that the government is taxing away from people too much of the money they have earned through their productive efforts, Gov. Bush observes that taxes have climbed to a peacetime record share of people's production and incomes (an estimated 20.6% in 2000).[1] Gov. Bush also expresses concern that unless the extra taxes are speedily returned to the American people, they will fuel bigger government: historically, the federal government quickly spends all the revenues it receives.

Gov. Bush objects not just to the level of U.S. taxes but to the economic distortions they create. The income tax sharply reduces saving and investment through multiple taxation (several layers of

[1] See Congressional Budget Office, *The Budget And Economic Outlook: An Update*, July 2000, accessed at www.cbo.gov.

Institute for Research on the Economics of Taxation

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income tax on the same income stream) that results in much higher tax rates on income used for saving and investment than on income used for consumption. The tax system also discourages work effort by decreasing the reward for work relative to that for leisure. These tax biases weaken the economy and reduce people's incomes and future opportunities. Tax distortions have two sources: problems with the tax base and high statutory tax rates. (The former refers to what is taxed; the latter refers to the rate at which it is taxed.) The Bush plan would lower the tax rate structure. Several of its elements would attack defects in the tax base.

Gov. Bush and his advisors claim that by cutting overall taxes and easing biases in the tax base that hurt production and the generation of income, their tax reform plan can simultaneously leave more income in the hands of the people who earn it, get the money out of Washington before it is spent on bigger government, spur economic growth, and reduce the odds of a recession in the near future. An analysis of the plan finds that it is well designed to deliver on its promises.

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A shortcoming of the Bush plan is that it is incremental; it would smooth down some of the rough edges of the current tax system but would not fundamentally restructure the system. Fortunately, the reforms that Mr. Bush advocates proceed in the correct direction and could become the foundation for additional improvements. Gov. Bush and his economic advisors have said they would have liked to do more but were held back by cautious budget assumptions and hope the plan now on the table proves to be only a starting point. The multi-trillion dollar rise in expected future federal budget surpluses since Mr. Bush first unveiled his tax relief plan last December may provide them with that opportunity.

Why The Tax System Is Broken And Needs To Be Fixed

Taxes distort relative prices, making many productive activities less rewarding to the producer than they are to society. The result of those tax-created disincentives is that the economy operates below its potential: productivity, earnings, and living standards are lower than they need to be and the expansion of economic opportunities over time is slower than otherwise.

One key bias is against work effort. Because people must pay income and payroll taxes on their earnings from work but are not subject to those taxes on the enjoyment they derive from leisure, they tend to work less than otherwise, and the tax-induced decline in work effort means less output and reduced incomes.

Powerful tax biases discourage saving and investment. These biases are extremely harmful because saving and investment are major contributors to productivity and incomes. The basic income tax bias against saving is that while income tax is assessed just once on earnings used for immediate consumption (income tax is collected on the earnings but income tax is not collected on the consumption purchases and the enjoyment they provide), income tax is assessed on earnings which are saved and again on the returns to the already-taxed saving (interest, dividends, capital gains). Because the income tax takes one bite out of consumption but multiple bites out of saving, it elevates the cumulative income tax rate on saving above that on consumption.[2] That tax differential, which lowers the after-tax reward for saving compared to the after-tax reward for consumption, encourages people to spend more today and save less for the future. On top of this basic income tax bias, the corporate income tax is a separate, third layer of income tax, which falls on individuals' investments in corporate equity. For people who save diligently and successfully, the estate and gift tax produces a fourth layer of tax bias against saving and investment. (Most of the saving in estates has already been subject to the income tax, often multiple times. On tax-deferred assets like deductible IRAs and employer-provided pensions, income tax will be collected from the heirs.)

Part of the solution is to cut statutory tax rates. Reducing marginal tax rates would immediately lessen the severity of tax biases (provided the government does not counteract lower rates with the types of unprincipled revenue offsets that were featured in the 1986 tax act). Because the strength of tax biases increases rapidly as the marginal tax rate rises, the largest productivity gains would come from cutting the highest tax rates.

Reform of the tax base is also essential. To correct the basic income tax bias against saving, either (1) tax should be deferred on saving but gross returns to saving should be fully taxed (the deductible IRA and tax-deferred pension approach) or (2) saving should be fully taxed but returns

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[2] To illustrate this basic income tax bias, consider a simplified example in which a person has just earned $100 of wages and is deciding whether to save the money or shop for clothing with it. In the first case, assume there are no taxes and that the market interest rate is 10%. The person can either buy $100 of clothing with the earnings or save the money to provide a $10 return in every future year. In the next case assume the government imposes a 40% income tax (almost the same rate as the federal income tax's top statutory rate) which it applies only to the initial earnings. In this case, the person is left with $60, which can be used either to buy $60 of clothing or a $6 annual return in future years, with no tax on the $6 of annual interest. Although the rewards are reduced (which discourages work), they fall equally regardless of the saving-consumption choice, which means the tax is unbiased between saving and consumption. In both the preceding cases, one needs to sacrifice $10 of current consumption to obtain a $1 annual return in future years ($60/$6). (The result would be the same, and saving-consumption neutrality preserved, if tax is deferred on saving and the returns to saving are taxed. In that event the full $100 could be saved, it would yield $10 annually before tax, and the tax would reduce the annual return to $6.) In the ordinary income tax, however, a tax bias against saving occurs because both the initial earnings are taxed (reducing them to $60 in this case) and the returns to saving are taxed (reducing them to $3.60 in this case). The double tax depresses the reward for saving relative to that for consumption; equivalently, the double tax raises the cost of saving in terms of forgone consumption. With the double tax, one needs to sacrifice $16.67 of current consumption to obtain a $1 annual return in future years ($60/$3.60). In this case the cost of saving has jumped 67% in terms of foregone current consumption (from 10 to 1 to 16.67 to 1).

to saving should not be taxed (the Roth IRA and municipal bond approach). To remove the additional tax biases against saving and investment, the corporate and individual income taxes should be integrated (the same income should not be taxed at both the corporate and individual levels), and the death tax should be abolished. With these steps, saving and consumption would be put on the same tax footing: earnings that are saved would be taxed the same number of times — once — as earnings used for immediate consumption and at the same cumulative tax rate. Such a system is called "saving-consumption neutral". Tax neutrality is an important objective of fundamental tax reform.

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Thoroughly revising the tax base to remove its anti-saving, anti-investment biases would require fundamental tax restructuring, and would yield the largest pro-productivity, pro-income, pro-growth payoff. A number of fundamental tax restructuring plans have been offered, including the flat tax, a national retail sales tax, and the USA (Nunn-Domenici) tax. One of the most straightforward neutral tax systems is a simple cash flow tax. (Perhaps the purest example of a cash flow tax is the Inflow-Outflow Tax designed by Dr. Norman B. Ture, who was the founder of IRET. A precis of his plan is available from IRET on request.) Mr. Bush's plan is not fundamental tax restructuring, but many of its provisions would move in that direction.

The Provisions In The Bush Tax Plan

Gov. Bush is calling for many changes in the tax system. Last December, he released a plan containing a core set of recommended tax reforms.[3] Since then, he has recommended that workers be allowed to reduce their Social Security taxes in order to contribute to personal retirement accounts and suggested a number of additional tax-relief measures, most of which would take the form of targeted tax credits. The table on the next page lists Gov. Bush's core tax plan and his other proposals.

In the remainder of this section, the core proposals and a majority of the others are briefly described and then evaluated from the perspective of whether they would reduce tax biases. In many cases, opportunities for extending and improving the proposals are suggested.

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[3] George W. Bush, "A Tax Cut With A Purpose," Bush For President Campaign, December 1, 1999, accessed at www.georgewbush.com.

Governor Bush's Tax Proposals
Core Tax Plan And Other Proposals

- Personal Retirement Accounts As Part Of Social Security Reform
- Cuts In Individual Income Tax's Rate Brackets (new brackets of 10%, 15%, 25%, and 33%)*
- Exclusion Of 10% Of Lower-Earning Spouse's Income From Tax Base To Reduce Marriage Penalty*
- Repeal Of The Estate, Gift, And Generations Skipping Transfer Taxes (The Death Tax)*
- The Child Credit*
  - Double The Child Tax Credit (from $500 to $1,000)
  - Increase The Income Threshold At Which It Begins Phasing Out
- Eliminate the Social Security Earnings Test (Part of this became law several months after Gov. Bush issued his proposal.)*
- Charitable Deduction Proposals*
  - Establish An Above-The-Line Charitable Deduction For Non-Itemizers
  - Do Not Count Withdrawals From Deductible IRAs As Income If Funds Contributed To Charity
  - Raise Cap On Corporate Charitable Deduction To 15% Of Income (Currently 10%)
- Liberalize Education Savings Accounts (Increase the contribution limit from $500 to $5,000 annually and allow the accounts to be used for schooling prior to college.)*
- Create Farm And Ranch Risk Management Accounts (Tax Deferred "Rainy-Day" Accounts)
- Make The R&D Tax Credit Permanent*
- Place Five-Year Moratorium On New Internet Taxation
- Health-Care-Related Tax Proposals
  - Establish Family Health Credit (This tax credit would pay 90% of the cost of a health insurance policy, up to $2,000 yearly, for a family without government or employer-provided health coverage that is making less than $30,000.)
  - Expand Medical Saving Accounts (MSAs)
  - Allow Year-To-Year Rollover Of Up To $500 In Flexible Spending Accounts (FSAs)
  - Establish An Above-The-Line Deduction For 100% Of Cost Of Long-Term Care Insurance
  - Extra Dependent Exemption To Taxpayers Who Care For An Elderly Relative In Their Homes
- Make The Expensing Of Brownfields Cleanup Costs Permanent
- Various Tax Incentives For Energy Production
- Permit 50% Capital Gains Exclusion When Land Sold For Conservation Purposes
- Individual Development Accounts (Tax credits to financial institutions if they match a small amount of annual saving by low-income wage earners.)
- Low-Income Housing Tax Credit (Tax credit, distributed by state agencies, to investors for building low-income housing in low-income communities.)
- Special Tax Deduction For Teachers (Above-the-line deduction for up to $400 of out-of-pocket expenditures on classroom supplies.)
- Tax Incentive For People With Disabilities To Telework

** Part of Core Tax Plan.*
The core tax proposals are described in George W. Bush, "A Tax Cut With A Purpose," Bush For President Campaign, December 1, 1999. That and the other proposals were accessed at www.georgewbush.com.

Personal Retirement Accounts As Part Of Social Security Reform

Description of Proposal. Gov. Bush would give workers the option of redirecting into the new personal retirement accounts 2 percentage points or so of the wages that they and their employers must now pay the government in Social Security tax.[4] Gov. Bush promises that there would be no reduction in Social Security benefits for current retirees and near retirees. This promise is credible because the Social Security Trust Funds will have ample income to pay full benefits to current retirees and near retirees even if 2 percentage points of the present tax is redirected to personal retirement accounts.[5]

The Social Security System, with its trust funds, gives the illusion of being a saving plan, but it is not. It is, in reality, a tax-and-transfer system... Personal retirement accounts, in contrast, would be real saving... A system based on real saving can afford to pay higher returns than a tax-and-transfer system because the added saving speeds the county's growth and increases its wealth.

Analysis. This is among the most significant proposals in the Bush plan. The Social Security System, with its trust funds, gives the illusion of being a saving plan, but it is not. It is, in reality, a tax-and-transfer system. Retirees do not receive benefits from their previous saving; that money was spent long ago to pay past retirees or on unrelated programs. Today's retirees' benefits come from payroll taxes collected from current workers. The government maintains accounting entries which it calls Social Security Trust Funds, but they are not real saving; they are IOUs from

[4] Social Security has three trust funds: Old Age and Survivors Insurance (OASI), Disability Insurance (DI), and Hospital Insurance (HI). The personal retirement accounts would provide an alternative, for those who choose it, to part of OASI. The Social Security tax is 15.3% of wages (combined employer and employee shares). OASI's share of that is 10.6% of wages. For workers who select the personal retirement account option, their OASI tax would, in effect, fall from 10.6% to 8.6% of wages, and 2% of their wages would go into their personal accounts.

[5] For estimated income and expenditures of the OASI Trust Fund, see *The 2000 Annual Report Of The Board Of Trustees Of The Federal Old-Age And Survivors Insurance And Disability Trust Funds*, p. 79, accessed at www.ssa.gov. Over the period 2001-2009, this trust fund's surplus, as estimated by its Trustees, will be almost twice as large as the amount needed to finance the proposed personal accounts. The most pro-growth way to fund the personal accounts, however, would be to cut wasteful and inefficient government spending.

In the long term, Social Security is projected to run enormous deficits under current law. In return for cutting the payroll tax by 2 percentage points, the personal accounts could help with long-run financing in two respects. First, most plans along these lines would require that workers who choose to participate agree, as a quid pro quo, to accept lower Social Security checks following retirement. That would reduce Social Security's long-run costs. Second, productivity would be higher and the economy would be larger because a real saving system would have replaced part of a tax-and-transfer system, and it is easier to pay benefits to retirees when the overall economic pie is bigger. In dealing with the Social Security program's distant deficits, personal accounts are a better policy choice than raising the payroll tax. Gov. Bush vows he would not increase the payroll tax.

one part of the government to another. In the future, when Social Security benefits exceed Social Security taxes, the only financing options, in the absence of reform, will be to raise payroll taxes on future workers, cut benefits for future retirees, cut other government spending, borrow, or print money, just as if the trust funds did not exist.

Personal retirement accounts, in contrast, would be real saving. They would not be going to other individuals or to the government to spend. They could be used to increase the nation's investments in plant, equipment, buildings, mines, and farms, boosting production and income. There would be real assets in the personal accounts, and they would be the personal property of the contributing workers. As personal property, the accounts would have two clear advantages over Social Security. The government could not take them away, and people who wished to leave any unspent balances to their heirs could do so. A third and bigger advantage is that the accounts would provide higher returns than Social Security. A system based on real saving can afford to pay higher returns than a tax-and-transfer system because the added saving speeds the county's growth and increases its wealth. Many workers would eagerly redirect some of their wages from Social Security taxes into these personal accounts if given the choice because of the greater security and higher returns.

Another problem with the present tax-and-transfer Social Security system is that the payroll tax discourages work effort by reducing the after-tax reward for work, and the promise of retirement and medical benefits decreases the need to work and save for retirement. Properly designed personal retirement accounts, which people would regard as their property and part of their reward for work and which would involve a de facto cut in the payroll tax, would soften this anti-work bias, further increasing the wealth-creation effect of the new accounts.

In addition to personal retirement accounts, Gov. Bush advocates, as do many members of both parties, a Social Security "lock box" to "wall off the Social Security surplus from the rest of the budget."[6] Presumably, some of the funds within the "lock box" would be used to help finance the personal retirement accounts, because they qualify as Social Security reform. The remainder would stay under government control and supposedly be used to pay down the federal debt faster than otherwise. Merely creating a lock box is inferior to establishing personal retirement accounts, however, because as long as funds remain under government control, the government will have great difficulty resisting the urge to spend the funds. Also, whereas personal retirement accounts encourage greater work effort by lowering the effective marginal tax rate on labor, a lock box, by itself, does not. In fact, the artificial distinction between the Social Security surplus and other budget surpluses is not a legitimate concept. Using a part of the Social Security surplus to reduce the tax burden on capital investment would do more to strengthen the economy than paying down the national debt.

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[6] George W. Bush, "A Tax Cut With A Purpose," *op. cit.*

Gov. Bush has not yet fleshed out all the details of his proposed personal retirement accounts. Those details are crucial in order to be sure the plan is well constructed and lives up to its potential. Several precautions are desirable to guarantee that workers recognize the accounts are their property and to prevent the government from gaining control over the accounts and spending the money elsewhere: the accounts should be legally designated from the start as contributors' individual property; to emphasize who owns the accounts and to make them of maximum value to contributors, contributors should be allowed at least limited choice regarding how their funds are invested; the funds should be managed by contributors or by professional private-sector financial institutions, and should not involve federal ownership or control of corporations; and payments from the accounts should be based on how much individuals contribute and how much their contributions subsequently grow. One way in which Gov. Bush could strengthen and improve the proposal would be by allowing workers to redirect more than 2% of their wages from the Social Security tax to their personal accounts. That would provide more saving, better work incentives, and greater retirement security.

Gov. Bush would lower individual marginal income tax rates... This is the most significant pro-productivity, pro-growth reform of the individual income tax in the Bush plan... The marginal tax rate is the tax rate on a taxpayer's final dollars of income and on the next dollars of income the taxpayer might earn by working longer or saving and investing more. Consequently, it is the marginal tax rate that influences people to change their saving, investment, and work behavior.

Cut Individual Income Tax's Rate Brackets

<u>Description of Proposal</u>. Gov. Bush would lower individual marginal income tax rates. Currently the individual income tax has five rate brackets: 15%, 28%, 31%, 36%, and 39.6%. Gov. Bush would replace them with four rate brackets: 10%, 15%, 25%, and 33%. He would cut part of the 15% bracket to 10% (the first $6,000 for singles and $12,000 for couples). The 10% rate would produce large percentage cuts in the tax bills of people with small, positive taxable incomes. He would replace the 28% and 31% brackets with a 25% bracket. Higher up the rate scale, he would eliminate the two rate brackets added by the 1993 tax increase — the 36% rate and the 39.6% "millionaires' surtax" rate (which actually kicks in at less than $300,000) — and establish a new top rate of 33%.

<u>Analysis</u>. This is the most significant pro-productivity, pro-growth reform of the individual income tax in the Bush plan. In order to promote growth, taxes have to be cut at the margin. This provision would reduce marginal tax rates substantially. The marginal tax rate is the tax rate on a taxpayer's final dollars of income and on the next dollars of income the taxpayer might earn by

working longer or saving and investing more. Consequently, it is the marginal tax rate that influences people to change their saving, investment, and work behavior.

If this provision becomes law, a taxpayer's after-tax income at the margin would rise by 5.9% if the taxpayer is currently in the bottom quarter of the 15% bracket, by 0% if the taxpayer is currently in the top three-quarters of the 15% bracket, by 4.2% if the taxpayer is currently in the 28% bracket, by 8.7% if the taxpayer is currently in the 31% bracket, by 4.7% if the taxpayer is currently in the 36% bracket, and by 10.9% if the taxpayer is currently in the 39.6% bracket. (The increase in after-tax income at the margin would be larger on wages subject to the payroll tax.) These increases in after-tax rewards would encourage people to save, invest, and work more. The potential economic benefits are large.

The Bush plan would provide marriage penalty relief by excluding from a couple's taxable income 10% of the lower-earning spouse's income... [This] relief is directed towards the couples most likely to suffer a marriage penalty ... helping to counteract an anti-work bias produced by the income tax.

This provision could be improved if the rate brackets were cut further. For example, the top rate prior to the 1993 tax increase was 31%. Because tax biases are strongest where marginal tax rates are highest (the people who are most apt to be influenced by tax effects are those who confront the biggest tax-induced distortions in relative prices), cutting the top rate to 31% or less would give a strong additional boost to the economy's productivity and growth. Consideration should also be given to reducing the tax bracket for the people now in the top three-quarters of the 15% bracket. Unless these people have their income tax liability wiped out by the combination of the doubled child credit (see below) and the lower tax rate on their first few thousand dollars of income, their marginal tax rate would not be altered by the Bush plan in its current form.

Marriage Penalty Relief

Description of Proposal. The Bush plan would provide marriage penalty relief by excluding from a couple's taxable income 10% of the lower-earning spouse's income. The 10% exclusion would apply to the first $30,000 earned by the lower-income spouse. This would restore marriage-penalty relief added to the tax code in 1981 but repealed as a revenue raiser in 1986.

Analysis. Many couples experience a so-called marriage penalty: higher taxes as a couple than if single. Almost as many couples enjoy a marriage bonus: lower taxes as a couple than if single. The couples most likely to experience a marriage penalty are those in which both spouses work, especially if their incomes are close to equal. One virtue of the provision in the Bush plan is that its relief is directed towards the couples most likely to suffer a marriage penalty. It is better in this respect than a different plan that Congress passed this year (H.R. 4810) but the President blocked with a veto.[7] The Bush provision is crafted to increase work incentives, helping to counteract an anti-work bias produced by the income tax. Provided the lower-earning spouse makes no more than $30,000, the exclusion would produce a 10% cut in the lower-earning spouse's marginal tax rate (e.g., from 31% to 27.9%), raising the spouse's after-tax wage at the margin. This should have a significant positive impact on labor participation because second earners are usually very sensitive to after-tax wages.

The salutary incentive effect of the Bush proposal could be strengthened by setting a higher cap so that it would apply to the marginal tax rate of more second earners. If the Bush plan used the Reagan-era cap of $30,000 but adjusted it for inflation, the cap would be over $50,000 today, and if it factored in real income growth, the cap would be higher still.

Repeal the Estate, Gift, and Generations Skipping Transfer Taxes (The Death Tax)

Description of Proposal. This proposal would reduce and eventually repeal the death tax. The phaseout period would be nearly a decade.

Gov. Bush's effort to abolish the death tax is good tax policy. He could improve his plan, though, by calling for the tax's immediate repeal ... [to] speed up the gains in productivity, tax simplification, and even government revenues.

Analysis. Abolishing the death tax would generate major efficiency gains. The death tax strongly discourages saving and investment because it retaxes at extremely high marginal rates savings that have already been taxed, usually multiple times. The death tax's top statutory rate is 55%; a "bubble" can push its marginal rate to 60%; and when the Generation Skipping Transfer Tax is tripped, the marginal tax rate can rise to about 80%. Two of the simplest ways to avoid this tax on savings left to heirs is to save less and consume more during life and to work less in order to earn less income to save. The death tax also harms productivity by financially weakening and often destroying small businesses and family farms when they pass from one generation to the next. According to one study, if the death tax had been repealed in 1993, the nation's total output of goods and services would be about $80 billion greater this year than it is with the tax and the cumulative increase in output over the period 1993-2000 would have been $380 billion.[8]

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[7] H.R. 4810 would have made the standard deduction twice as large and the 15% bracket twice as wide for married couples filing jointly as for single filers.

[8] Richard E. Wagner, *Federal Transfer Taxation: A Study In Social Cost* (Washington, DC: Institute For Research On The Economics Of Taxation and The Center For The Study Of Taxation, 1993).

Eliminating the death tax would also simplify the tax system. The death tax return is very complicated to prepare. Moreover, anticipation of the tax pushes many people into estate-tax planning, which is extremely time consuming, cumbersome, and expensive.

Ironically, the death tax probably loses money for the government: other taxes tend to fall by more than the death tax collects because of the effects of estate-tax planning and the weaker economy caused by the death-tax-induced economic inefficiencies. Congress voted in 1999 to gradually repeal the death tax. It voted again this year to gradually repeal the tax (H.R. 8). However, the President vetoed both efforts.

Gov. Bush's effort to abolish the death tax is good tax policy. He could improve his plan, though, by calling for the tax's immediate repeal. Eliminating the tax promptly would speed up the gains in productivity, tax simplification, and even government revenues.

Double the Child Tax Credit and Increase the Income at which It Begins Phasing Out

Description of Proposal. This proposal would double the recently enacted child credit from $500 to $1,000. It would also increase the income threshold at which the credit begins phasing out to $200,000. (The phase out currently begins at $75,000 for singles and $110,000 for couples.)

Analysis. For most people a doubled child credit would not lower their marginal tax rates. (A person making an extra dollar would owe just as much tax on that dollar whether the child credit is $500 or $1,000.) Thus, in most cases the higher credit would not improve incentives to work, save, or invest. Efforts to increase the child credit are primarily driven by social policy, not tax neutrality or simplification.

For one group, however, the doubled child credit would enhance incentives. The combination of the doubled child credit and the new 10% rate bracket would zero out the income tax liabilities of several million working poor and near-poor families who are now in the 15% income tax bracket. Although these people are in a low tax bracket, many of them experience a high effective marginal tax rate because they are in the income range in which the Earned Income Tax Credit (EITC) is phased out. The EITC has become such a large tax credit that its phaseout with rising income produces a huge marginal tax rate spike: 15.98% for people with one eligible child and 21.06% for people with 2 or more eligible children.[9] Thus, a person in the 15% bracket who is also in the EITC phaseout range has an effective marginal income tax rate of 30.98% if there is 1 eligible child and 36.06% if there are 2 or more eligible children. When one adds payroll tax (combined employee and employer shares, with adjustment for deductibility of employer share) to these rates,

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[9] For instance, a person with 2 eligible children can receive up to $3,888 from the EITC this year. In the EITC's phase-out range, the government reduces that by 21.06¢ for every extra dollar of income the person earns. Thus, an extra dollar of income in the EITC phaseout range costs the person 21.06¢ of EITC, in addition to regular tax.

one sees an effective marginal tax rate of approximately 44% if there is 1 eligible child and approximately 49% if there are 2 or more eligible children. These marginal rates discourage additional work effort by many of the poor and near poor. The families whose income tax is zeroed out by the doubled child credit and the new 10% rate bracket would enjoy a 15 percentage point drop in their marginal tax rates.[10] (They would still experience the marginal rate spike due to the EITC phaseout. Not much can be done about the EITC's rate spike unless the EITC is made smaller, it is not phased out, or the phase out begins at a high income that is not reached by most taxpayers. The EITC phaseout's marginal rate spike is large and extends over a long income range because the EITC is large. A bigger EITC, which is sometimes discussed, would make the phase-out problem worse.)

Efforts to increase the child credit are primarily driven by social policy, not tax neutrality or simplification. For one group, however, the doubled child credit would enhance incentives. The combination of the doubled child credit and the new 10% rate bracket would zero out the income tax liabilities of several million working poor and near-poor families who are now in the 15% income tax bracket.

Mr. Bush would also modify the child credit by increasing the AGI threshold at which it begins phasing out to $200,000. With the rollback, the phaseout would affect far fewer taxpayers, and that makes excellent economic sense. The phaseout aggravates tax distortions because it boosts the effective marginal tax rate by 5 percentage points for taxpayers in the phaseout range, adds complexity to the already overly complicated tax system, and discriminates among taxpayers with children by denying some of them — those who pay the highest taxes — a provision available to other taxpayers with children. The increase in the phaseout threshold would be an improvement over current law, but it would be still better not to recapture the credit at all.

The fact that a doubled child credit would remove millions of people from the income tax rolls does raise one policy concern. People who do not pay the federal government's main tax may regard government services as free goods, since they would be excused from paying most of the bills. If a large block of such voters developed, they could become a powerful constituency pushing for bigger government.

Eliminate the Social Security Earnings Test

Description of Proposal. The Social Security Earnings Test reduced checks for Social Security recipients between the ages of 62 and 70 who earned above certain amounts. Several

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[10] The story is more complicated for some families with 3 or more children because of the Additional Child Tax Credit. That is not discussed here.

months after Gov. Bush issued his proposal to eliminate the earnings test, legislation passed by Congress and signed by the President (H.R. 5) repealed the Social Security earnings test for seniors at and above the government-designated "normal retirement age" (now 65 but rising to 67). The earnings test remains in place, however, for Social Security recipients between 62 and the "normal retirement age".

Analysis. The earnings test that remains on the books strongly discourages work effort by Social Security recipients between 62 and the "normal retirement age" because it takes away $1 of benefits for every $2 of labor income earned above an exempt amount ($10,080 in 2000). In the phase-out range, that is a 50% effective marginal tax rate, which is in addition to all other taxes.[11] When the loss of benefits is combined with the federal income and payroll taxes, a worker's effective marginal tax rate can climb as high as 88.9% if the person is in the income tax's 15% bracket and as high as 109.3% if the person is in the income tax's 28% bracket, with several more percentage points added by state and local income taxes.[12] The earnings test is tantamount to a federal edict to seniors to stop working.

[T]he earnings test should be repealed for workers between age 62 and the government-designated "normal retirement age".

Repeal of the earnings test for Social Security recipients at and above the "normal retirement age" was a large step in the right direction. In order that the earnings test no longer push productive seniors out of the work force, the rest of the Bush proposal still needs to be enacted: the earnings test should be repealed for workers between age 62 and the government-designated "normal retirement age".

Charitable Deduction for Non-Itemizers

Description of Proposal. The Bush plan has three provisions regarding charitable deductions. Only the chief one is discussed here. Under current law, charitable donations are a category of

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[11] Benefits lost due to the earnings test are supposedly recovered in later years because the beneficiary is given a "delayed retirement credit" for the time period in which benefits are lost. When benefits are resumed, the monthly benefit is higher, and if the person lives long enough, the lost benefits will be recovered. Risk-averse seniors do not regard this recovery as a sure thing (if they know of it at all), and the test is a clear disincentive to work.

[12] The highest marginal tax rates occur for taxpayers who are in the income range where income tax on their Social Security benefits is being phased in. Extra wages then not only reduce Social Security benefits due to the earnings test but also increase Social Security benefits subject to income tax. For a step-by-step explanation of how the effective marginal tax rates are derived, see Stephen J. Entin, "Statement before the House Ways And Means Committee," Hearing On The Senior Citizens' Equity Act: Reforming Taxation Of Social Security Benefits, January 19, 1995, esp. fn 1.

itemized deductions, and taxpayers who itemize can claim them. The standard deduction is in lieu of itemized deductions, including the charitable deduction. Thus, individuals who choose the standard deduction as an alternative to itemization cannot also claim a charitable deduction. The Bush plan would change this by establishing an above-the-line charitable deduction for non-itemizers. In effect, the charitable deduction would become separate from and in addition to the standard deduction.

Analysis. This proposal must be judged on social policy grounds. Economic principles do not provide guidance on whether the charitable deduction should be part of or in addition to the standard deduction. The choice will generally not affect the severity of tax biases against work, saving, and investment.

Expand Education Savings Accounts

Description of Proposal. The Bush proposal would increase the contribution limit on Education Savings Accounts from $500 to $5,000 annually. It would also allow these Education IRAs to be used for grades K to 12, not just for college.

The Bush proposal would increase the contribution limit on Education Savings Accounts from $500 to $5,000 annually... Education IRAs are saving neutral because they tax the saving stream only once... Allowing people to save more for education expenses without incurring a tax penalty is sound policy.

Analysis. Education IRAs are saving neutral because they tax the saving stream only once. (Like Roth IRAs, contributions are not deductible, but distributions are not taxed, if certain conditions are met.) Hence, their expansion would lessen the income tax bias against saving. Allowing people to save more for education expenses without incurring a tax penalty is sound policy. It is especially valuable due to the contribution a good education makes to a economic productivity and personal fulfillment. Permitting people to use these saving-neutral accounts to meet education expenses in grades K to 12 is also wise tax policy because all levels of education are important and all saving should receive neutral tax treatment.

This and the next provision are the only ones in the Bush plan expanding saving-neutral accounts. While both are good ideas, the Bush plan could be improved if it relaxed arbitrary government restrictions on a wider range of saving-neutral accounts, such as IRAs, 401(k)s, and defined-benefit pensions. An excellent starting point would be H.R. 1102, the Comprehensive Retirement Security And Pension Reform Act Of 2000, which the House passed but whose fate with the Senate and the President is uncertain at this time. Another excellent starting point would be the Family Security Accounts (FSAs) proposed by Senator John McCain. Individuals could contribute up to $3,000 annually ($6,000 for couples) to these IRA-like accounts. Tax would be deferred on contributions and assessed on gross distributions. People could withdraw funds from FSAs without penalty, for any purpose, provided only that the funds had been invested for at least 1 year. FSAs would combat tax inefficiency by expanding the amount people could save and the purposes for which they save without being subject to the tax system's anti-saving bias. FSAs would particularly benefit low-income savers who often cannot afford to save separately for retirement and emergencies. Rather than risk a tax penalty on an emergency withdrawal from an IRA or pension, they leave their money in ordinary saving accounts and lose the benefit of tax-deferred compounding. FSAs would eliminate this concern and extend the benefit of tax deferral to the people most in need of it.

Create Farm and Ranch Risk Management Accounts

Description of Proposal. Farmers and ranchers could place a percentage of their net income in good years into tax-deferred risk management accounts to help tide them through lean years.

Analysis. Like IRAs, tax-deferred pensions, and Education Savings Accounts, these new accounts would extend neutral tax treatment to additional amounts of saving and investment. Any expansion of neutral tax treatment of saving and investment is welcome because, ideally, all saving would receive neutral treatment. The specific rationale behind this targeted proposal is that farmers and ranchers have unusually variable incomes and an unusually high need for precautionary saving.

This provision could be made better by making it less targeted and broadening it to cover more savers and more income. Many people should be engaging in rainy-day saving to reduce their risks from a variety of sources, including being in an occupation where income is highly variable, having expenses that fluctuate from year to year, and guarding against emergencies. The government tax penalty should not be discouraging these people from saving prudently. But saving for any other reason is socially and personally beneficial as well, and is deserving of neutral, unbiased treatment.

Make the R&D Tax Credit Permanent

Description of Proposal. The R&D Credit is a temporary credit. It was last renewed at the end of 1999 (after several months in limbo) and is scheduled to expire again in 2004. Gov. Bush seeks to make the R&D credit permanent.

Analysis. Although the R&D credit is usually regarded as a "tax expenditure", there is much evidence that it is money well spent. Econometric studies have generally found that for every dollar the credit costs the government in taxes, it returns considerably more than a dollar in economic benefits. The explanation is that R&D spending often brings substantial spillover benefits to the rest of the economy that are not fully captured by those who do the research. R&D is also a risky undertaking, and a risk-averse population may tend to invest less in such activities than is justified by the actual level of risk. As a result, businesses tend to carry out too little R&D. The credit encourages them to do more, which lifts R&D closer to its socially optimal level. There is strong bipartisan support for retaining the credit.

Gov. Bush is correct to call for a permanent R&D credit. Since the positive spillover effects that justify the credit are permanent, the credit should also be permanent.

Given these facts, Gov. Bush is correct to call for a permanent R&D credit. Since the positive spillover effects that justify the credit are permanent, the credit should also be permanent. The credit's temporary status under current law generates uncertainty about the tax status of future R&D, which hinders business planning and impairs the credit's ability to stimulate R&D.

Moratorium on Internet Taxes

Description of Proposal. Gov. Bush proposes to extend the moratorium on multiple and discriminatory taxes on e-commerce for at least 5 years. There is also a moratorium on new taxes on Internet access. Gov. Bush favors permanently prohibiting Internet-access taxes.

Analysis. There are two different issues here: (1) taxing sales made over the Internet and (2) taxing access to the Internet. The moratorium on taxing e-commerce applies only to taxes that are multiple and discriminatory; nondiscriminatory taxation of e-commerce is permissible. The purpose of the moratorium is to insure that the Internet's development is not slowed by differentially heavy taxes on e-commerce. This is a prudent safeguard for a new technology that has the potential to be a major source of economic growth; the moratorium should be extended. Indeed, it could be argued that the federal government should enact a permanent ban on multiple and discriminatory e-commerce taxes.[13]

[13] An issue sometimes confused with the moratorium is whether states and localities can require sellers with no legal nexus in the jurisdiction to collect the jurisdiction's so-called "use" taxes (sales taxes on out-of-jurisdiction purchases by local residents). The Supreme Court has ruled in cases involving mail order sales that states and localities do not have this power. (The key cases are *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *National Bellas Hess, Inc. V. Dept. of Revenue of State of Illinois*, 386 U.S. 753 (1967).) These rulings also prevent states and localities from forcing e-commerce firms with no legal nexus in the jurisdiction to collect use taxes on sales made to the jurisdiction's residents. Current law, however, does not prevent a state or locality from seeking to collect use taxes from residents who buy products through a mail order catalog, over the Internet, or in some other way from a remote seller, although use taxes have proven difficult to enforce.

The other issue is taxing Internet access. Examples of access fees are the numerous federal, state, and local taxes assessed on telephone service, which have proliferated in recent years. Access fees are really selective excise taxes and are undesirable for three reasons: they are distortionary, complicated, and largely hidden. They should not be imposed on Internet service (and should be repealed on telephone service).

Gov. Bush's position on Internet taxation makes good sense. This spring, the majority of the Advisory Commission on Electronic Commerce also reached the conclusions that the moratorium on multiple and discriminatory e-commerce taxes should be extended for 5 years and that Internet access should never be taxed.[14]

Health-Insurance-Related Tax Proposals

Description of Proposals. Gov. Bush offers four proposals for using the tax system to help subsidize the cost of health insurance in a reasonable and cost-conscious manner. One proposal would expand Medical Saving Accounts (MSAs) by relaxing some stringent government restrictions that have limited their use. Another provision would let workers carry over from one year to the next up to $500 in their health Flexible Spending Accounts (FSAs). A third, more expensive proposal would create a refundable tax credit, called the Family Health Credit (FHC), that the uninsured and those not covered by a government plan could use to help buy a basic health insurance policy. The Bush campaign describes all three proposals as "providing access to affordable health care." A fourth proposal would permit an above-the-line deduction for 100% of the cost of long-term care insurance.

> ***Gov. Bush offers four proposals for using the tax system to help subsidize the cost of health insurance in a reasonable and cost-conscious manner... [S]ome health care reformers have sought, within the context of a tax-free fringe benefit, to modify the design of employer-provided health insurance so as to motivate people to pay more attention to costs, while finding a way to extend the incentive to carry insurance to those currently lacking it.***

Analysis. Since World War II, when it was used as a means of attracting workers to the war effort, employer-provided health insurance has received favorable tax treatment compared to most other forms of compensation. It has been declared a tax-free fringe benefit, with no tax on either premiums or claim payments. A partial deduction for health insurance has been extended to the self-

[14] Advisory Commission On Electronic Commerce, "Advisory Commission On Electronic Commerce Report To Congress," April 2000, reprinted in Bureau Of National Affairs, *Daily Tax Report*, April 13, 2000, pp. L-1 to L-30.

employed. No tax break is available for employees whose employers do not offer the health insurance fringe.

The tax subsidy has encouraged employees to request and employers to provide a larger portion of worker compensation in the form of high-cost, high-benefit health insurance than they otherwise would. Health insurance reduces the chance of people becoming impoverished and requiring public assistance. However, these expensive policies shift the bulk of medical outlays onto third party payers, with only low deductibles and copayments by the employees. This makes people with employer-provided health insurance relatively inattentive to prices when selecting health care services, because insurance picks up so much of the tab for additional outlays. Thus, the tax subsidy has encouraged additional, sometimes wasteful spending, and has driven up the cost of health care (exclusive of the subsidy), particularly for the uninsured and for government programs assisting the poor and the elderly.

In an ideal world, the employer-paid health insurance premium would be treated either as any other ordinary worker compensation (taxable when earned) or as tax-neutral saving (with a deduction for the premium and a tax on the benefit payments). The revenue saved by the Treasury from eliminating the subsidy should be used to lower tax rates. Individuals would then rely a bit more on direct cash payments to health care providers and a bit less on third party payments for health care, with no price distortions. This approach, however, has little political appeal. Accordingly, some health care reformers have sought, within the context of a tax-free fringe benefit, to modify the design of employer-provided health insurance so as to motivate people to pay more attention to costs, while finding a way to extend the incentive to carry insurance to those currently lacking it.

One proposal would expand Medical Saving Accounts (MSAs)... MSA's have three chief advantages over conventional employer-provided health insurance: they provide more choice for the covered workers, they motivate consumers to be price conscious when shopping for medical services, and they reduce administrative costs by encouraging a higher deductible with direct cash payments by patients to doctors for routine outlays without filing claims.

MSA extension. MSAs allow an employer or employee to put a limited amount of compensation tax free into a saving account to cover the premium on a high deductible (catastrophic) insurance policy and to pay out-of-pocket medical outlays under the deductible or copayment. If the funds are spent on health care, they remain free of tax. Any money saved by the worker by accepting a higher deductible or exercising care in purchasing services remains in the tax-deferred account and is available for later use on health needs, giving account holders an incentive to consume carefully. Consequently, MSA's have three chief advantages over conventional employer-provided health insurance: they provide more choice for the covered workers, they motivate consumers to be price conscious when shopping for medical services, and they reduce administrative costs by encouraging a higher deductible with direct cash payments by patients to doctors for routine outlays without filing claims.

The MSA statute provides for only a temporary experiment, allowing only a limited number of policies, barring joint contributions by employers and employees, and mandating a higher deductible than some participants would like. Gov. Bush's proposal would make MSAs permanent, remove the cap on the number of policies and let more employers offer them, permit both employer and employee contributions, and lower the extremely high minimum deductible that has scared many workers away from MSAs.

One drawback to MSAs is that users have trouble taking out contributions that turn out not to be needed for health care. Under current law, any funds removed from the accounts other than for qualified health care spending are subject to ordinary income tax and a special 15% tax penalty if the account holder is less than Medicare age (65) or is not disabled. If 65 or over or disabled, there is ordinary tax but no penalty. These rules result in a partial use-it-or-lose-it situation that encourages wasteful consumption of health care. To counter such effects, any reform should provide for more flexibility in the use of MSA money. A rollover of some amount of MSA savings into ordinary IRAs beyond a certain age or dollar value without the penalty tax should be available. Account holders should be allowed to use MSA funds to pay for Medicare B premiums and medigap policies. There should be no requirement that unused MSA funds begin to be withdrawn by a certain age (as is imposed on ordinary IRAs). It is to be hoped that any reform of the MSA program will address these issues.

Health FSAs. Health FSAs are a tax-free employer-provided fringe benefit that gives workers limited funds to cover various out-of-pocket health care expenditures. Under present law, anything remaining in a worker's FSA at the end of the year reverts to the employer. Recipients likely to use all of the money on out-of pocket expenses have an incentive to watch their spending to make it go as far as possible. However, for those with fewer medical care needs, this use-it-or-lose-it requirement encourages wasteful end-of-year spending, such as the purchase of extra pairs of eyeglasses, too frequent check-ups, and unnecessary elective procedures.

Gov. Bush would correct that pro-spending bias and make FSAs more useful to workers by permitting them to roll over up to $500 of unspent FSA balances to the next year. To be truly effective, however, the rollover should be uncapped and should permit some use of FSAs for non-medical uses at some point in the recipient's life, with no more than an ordinary tax imposed; otherwise, the use-it-or-lose-it problem will merely be deferred, not eliminated.

Family Health Credit. The proposed Family Health Credit (FHC) would offer the uninsured a tax credit of 90% toward the cost of a basic policy, with the credit capped at $2,000. (The maximum credit would be reached on a policy costing $2,222.) This plan would put uninsured people on a more equal tax footing with people who enjoy tax-sheltered employer-provided health coverage or deductions for insurance for the self-employed by giving a tax subsidy to the uninsured.

While the more equal treatment is only fair, the expanded tax subsidy would subject more health spending to tax-related price and consumption distortions. Nonetheless, FHCs may head off even more heavy-handed types of government interference in the health care market. FHCs would lower the cost of basic health care to the poor while giving them a policy that would probably include a deductible and copayment. The cap on the credit would eliminate the incentive at the margin to buy ever-more generous policies. There would be greater price consciousness than under a traditional government spending or regulatory program. FHCs would be better, for example, than expanding Medicaid or slapping federal price controls on medical services, or Vice President Gore's unlimited 25% credit for insurance premiums. Such steps would impose little price awareness and could lower the quality of care and slow advances in treatment by motivating Washington to ration care or squeeze providers.

The proposed Family Health Credit (FHC)... would lower the cost of basic health care to the poor while giving them a policy that would probably include a deductible and copayment... There would be greater price consciousness than under a traditional government spending or regulatory program. FHCs would be better, for example, than expanding Medicaid or slapping federal price controls on medical services, or Vice President Gore's unlimited 25% credit for insurance premiums. Such steps would impose little price awareness and could lower the quality of care and slow advances in treatment by motivating Washington to ration care or squeeze providers.

Disadvantages of FHCs are that they would be expensive, would be a new tax-subsidy program, and that their phaseout with rising income would create a large spike in people's marginal tax rates. In one example the Bush campaign provides, the FHC's phaseout would boost a family's marginal tax rate by 6.67 percentage points as their income increases from $30,000 to $50,000.[15] FHCs would be improved if the phase-out were scrapped or modified so that the marginal rate spike were not so great. It is also important that FHCs be constructed so that, insofar as possible, they not subsidize health care spending at the margin. Reaching a decision regarding the merits of FHCs will require a careful look at the specifics of the program as it is submitted to Congress.

Long-term care deduction. The proposed 100% above-the-line deduction for individual purchases of long-term care insurance is very narrowly targeted to only one type of insurance and

[15] See "The New Prosperity Initiative," Fact Sheet, George W. Bush For President, April 11, 2000, accessed at www.georgewbush.com.

health care outlay. At present, individuals can claim long-term care premiums as part of the medical deduction along with other medical outlays, but only if they itemize their deductions and if the medical outlays exceed 7.5% of adjusted gross income. The proposal would encourage some additional use of long-term care insurance. And, as noted above, health insurance reduces the chance that people will become impoverished and require public assistance. However, why do long-term care premiums deserve better tax treatment than other medical outlays, or better treatment than saving, including saving for retirement? Once the premiums for such a policy are paid, the only way that an individual can benefit from the policy is to require the care, which leads to moral hazard. There should be more reliance on a general expansion of neutral tax treatment for saving, which would boost incomes and assets available all purposes, including retirement needs and long-term care, with fewer targeted provisions.

Make the Expensing of Brownfields Cleanup Costs Permanent

Description of Proposal. Taxpayers may expense (write off in the year incurred) certain costs of cleaning up brownfields (contaminated industrial sites), but the tax provision allowing them to do so is scheduled to expire at the end of 2001. Without it, taxpayers would have to depreciate cleanup costs over 39 years. The Bush plan would make the expensing provision permanent.

Analysis. Although the brownfields provision might seem like a tax subsidy, it is not. For the full value of investment costs to be reflected accurately on tax returns, they should be claimed in the year incurred. Expensing does that. In contrast, depreciation causes investment costs to be understated, income overstated, and taxes to be too high in present value terms. That tax bias discourages investment. Another advantage of expensing is that it is simple, whereas depreciation is paperwork intensive. Ideally, all investment should be expensed.

A Feasible Tax Plan

In order to increase voters' confidence that the Bush plan is credible and can be enacted if Mr. Bush is elected President, Mr. Bush and his advisors used a succession of cautious budget assumptions when developing Mr. Bush's core tax plan. Those cautious assumptions have built a large margin of safety into the plan's numbers.

! They assumed a long-run real economic growth rate of only 2.7%, even though real growth has averaged 3.9% over the last 5 years, 3.0% during the last decade and 3.1% over the last 30 years. If future economic growth is merely average, tax revenues and government budget surpluses will be vastly higher than the numbers they used when designing their plan.

! They assumed tax collections will fall as a share of the economy even without tax cuts. They note that if the share of taxes in the economy remains constant, the amount available for tax relief will rise "by between $20 billion and $40 billion per year over the next five years."[16] In fact, even at modest growth rates, taxes tend to rise as a share of the economy as real income growth pushes taxpayers into higher tax brackets (so called real-income bracket creep).

! Many of the plan's proposed tax changes would bolster the economy's productivity, leading to more output and growth. Higher output and income would have a strong positive feedback on tax collections. Nevertheless, Gov. Bush and his advisors used a static revenue assumption that entirely ignores tax-relief-induced growth and the positive revenue feedback. If the Bush plan is enacted, the economy's dynamic favorable response should offset between a quarter and a third of the static revenue cost.

Mr. Bush and his advisors used a succession of cautious budget assumptions when developing Mr. Bush's core tax plan... They assumed a long-run real economic growth rate of only 2.7%... Many of the plan's proposed tax changes would bolster the economy's productivity, leading to more output and growth... [Behavioral effects] will produce some positive revenue feedback.

! Gov. Bush and his advisors explain that they further overstated the budget cost of tax relief by ignoring the behavioral effect whereby "taxpayers ... shift more income into taxable forms" when effective marginal tax rates decline.[17] In reality, that behavior effect will produce some positive revenue feedback.

! Gov. Bush and his advisors also assumed that government spending would grow more rapidly than the Congressional Budget Office (CBO) was then projecting and built higher federal outlays into their model. This is the only area in which they may have been too optimistic; they may have underestimated the rise in federal spending.

! Finally, they provided added budget room in the core package by calling for non-Social-Security tax relief of only $483 billion over 5 years even though their extraordinarily cautious estimate of the non-Social-Security surplus for the same period was $100 billion larger.

Official government projections of federal revenues and surpluses confirm that Mr. Bush's core tax plan would fit easily within the federal budget. Since last year, the CBO has repeatedly revised upward its baseline surplus projections to better reflect the strength of the economy and the pace of tax revenues. In July, the CBO released its latest current policy baseline projections.

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[16] George W. Bush, "A Tax Cut With A Purpose," *op. cit.*

[17] *Ibid*.

Assuming that discretionary spending stays within its statutory caps through 2002 and grows at the rate of inflation thereafter, the CBO projects that the federal budget surplus for the 10-year period 2001-2009 will be $5.2 trillion, and that the non-Social-Security portion of the surplus, by itself, will be $2.9 trillion.[18] Compared to last year, the projected baseline federal budget surplus for this 10-year period has increased by $2.3 trillion and the projected baseline surplus for the non-Social-Security portion of the surplus has increased by $1.9 trillion.[19,20] In relation to these federal budget surplus projections, Gov. Bush's tax-relief package actually looks modest.

Some might attempt to refute these findings by claiming that many government spending programs are inadequately funded, that various new ones should be created, and that once those needs are attended to there will be no surplus left. But that is an argument for a different use of the surplus — bigger government — not an argument that the surplus is not large enough to cover the proposed tax cut. In fact, the projected baseline surplus is more than sufficient to finance the Bush plan, assuming that at least limited control is maintained over federal spending.

Opportunities For Improvement

The amount of tax relief that Governor Bush and his advisors are proposing has been sharply limited by their decisions to use extremely cautious budget assumptions, to fund tax relief only from the surplus, and to finance non-Social-Security tax relief only from the on-budget surplus.

When Gov. Bush's core tax plan was first released in late 1999, some of his advisors said they expected that the government would soon revise upward its revenue and surplus projections, and they hoped those higher numbers would allow them to expand the plan. The upward revisions they predicted have come to pass and have been dramatic. Some of this added budget room would be used up by the various tax credits and other initiatives Gov. Bush has put forward this year. But

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[18] See Congressional Budget Office, *The Budget And Economic Outlook: An Update*, July 2000, accessed at www.cbo.gov.

[19] See *Ibid*. and Congressional Budget Office, *The Economic And Budget Outlook: An Update*, July 1, 1999, both accessed at www.cbo.gov.

[20] The Clinton Administration and Congress have repeatedly exceeded the discretionary spending caps. In response to that lack of spending discipline, the CBO offers two other baselines. One assumes discretionary spending is frozen at the stepped-up level enacted for 2000. Using that baseline, the CBO projects that the federal budget surplus for the 10-year period 2001-2009 will be $5.1 trillion, and that the non-Social-Security portion of the surplus, by itself, will be $2.8 trillion. The other baseline assumes discretionary spending grows at the rate of inflation after 2000. Using that baseline, the CBO projects that the federal budget surplus for the 10-year period 2001-2009 will be $4.1 trillion, and that the non-Social-Security portion of the surplus, by itself, will be $1.8 trillion. Although this last set of numbers factors in $1 trillion of additional federal spending above the caps, the total projected budget surplus for the 10-year period is still $1.2 trillion higher than the "caps intact" surplus projected last year and the projected non-Social-Security portion of the surplus for the 10-year period is $0.9 trillion higher than it was last year. Again, the finding is that last year's budget surplus projections left ample room for Gov. Bush's tax plan and this year's projections provide even more room.

the budget picture has brightened so enormously that, if Mr. Bush is elected President, he can seek powerful, additional reforms when he presents his tax plan to Congress while staying within his self-imposed financing constraints.

The current U.S. tax system has such harsh and damaging biases against saving, investment, and work effort that many reforms are desirable. The remainder of this section highlights several of them. The list is not meant to be exhaustive; the tax system, unfortunately, has so many defects that an inventory of all possible, constructive changes would be very long indeed. The list, instead, shows some of the most promising options for building on the Bush plan in order to reduce tax biases. Every item that follows is consistent with the direction of the Bush plan; every one of them would support greater productivity, better job opportunities, and faster growth. Several of the items were mentioned earlier in discussing how the proposals now in the Bush plan could be extended.

[Since] Gov. Bush's core tax plan was first released in late 1999 ... the budget picture has brightened so enormously that, if Mr. Bush is elected President, he can seek powerful, additional reforms when he presents his tax plan to Congress while staying within his self-imposed financing constraints.

Speed growth of voluntary personal retirement accounts. Gov. Bush recommends that workers be allowed to redirect 2% or so of their wages from the Social Security tax to new personal retirement accounts. This excellent idea could be made even better. People should be allowed to contribute a higher percentage of their wages to the new accounts, if they want.

Repeal the death tax now. Gov. Bush recommends gradually reducing and by the end of the decade eliminating the Estate, Gift, and Generation Skipping Transfer Taxes. The highly distortionary, extremely complicated death tax should be repealed at once; it should not remain on the books for the better part of a decade.

Broad-based expansion of saving-neutral accounts (deductible IRAs, Roth IRAs, tax-deferred pensions, Education IRAs, etc.). Gov. Bush's plan includes some targeted provisions expanding saving-neutral accounts. These are helpful provisions, but a broad expansion of tax-neutral saving accounts would be much more beneficial. Narrowly drawn provisions are not the best approach when confronting a generalized income tax bias against saving which is not confined to one occupation or one reason for saving but punishes all saving. Besides complicating the tax code with special rules, targeted provisions leave the bias as strong as ever in too many areas.

Allow businesses to expense the costs of production assets. In most cases, the tax code prohibits a business from deducting the cost of a production asset when it actually incurs the cost. Instead, the business is forced to claim the deduction slowly, over a depreciation period ranging from

3 to 50 years depending on the type of asset. This delay stacks the deck so that investment costs are understated in present value terms. Since income is a net concept — revenues minus expenses — the delay causes income and, thus, income tax to be significantly overstated in real terms. That deters businesses from investing as much as they should. It especially discourages businesses from investing in assets to which the government has assigned long write-off periods. By hurting investment and depressing the capital stock, the use of depreciation holds back productivity, output, and incomes. Many studies indicate that about one-third of the gains from added capital go to capital owners and about two-thirds go to labor (more capital enhances workers' productivity and that boosts wages). Capital owners bear some of the loss resulting from the tax bias but workers bear most of it in the form of lower wages and incomes.

[S]ome of the most promising options for building on the Bush plan in order to reduce tax biases [are the following reforms]... Speed growth of voluntary personal retirement accounts... Repeal the death tax now... [Enact a] broad-based expansion of saving-neutral accounts... Allow businesses to expense the costs of production assets... Abolish the Individual and Corporate Alternative Minimum Taxes (AMT)... Eliminate phaseouts whenever possible.

The best remedy is expensing: allowing businesses to deduct the cost of capital expenditures at the time they make the expenditures. The cost of investments in production assets would then be portrayed accurately for tax purposes. An additional advantage of expensing is simplicity, compared to the enormous amount of tax paperwork generated by the current system of delayed, multi-year write-offs. Expensing is an especially effective investment stimulus because it would direct the tax relief at new investments. It would not change the tax treatment of assets that are already in place. Gov. Bush has taken a small step in this direction by recommending that the tax provision which permits the expensing of brownfields cleanup costs be made permanent. Much more should be done.

If desired, the government's near-term revenue loss could be minimized by allowing a multi-year pattern of write-offs equal in present value to expensing. One example is a "neutral cost recovery system" (NCRS), which, in effect, gives interest on the deferred portion of write-offs to maintain their real present value. This idea has been championed in recent years by Rep. Nick Smith (R-MI). An approach that would reduce but not eliminate the anti-investment tax bias caused by the delay in deducting costs is to shorten depreciation periods. In 1999, Senator John Ashcroft (R-MO) endorsed this approach when he proposed a 25% cut in asset lives as part of a larger package of tax reforms. Another option is to expand the limited number of cases in current law in which taxpayers may expense their investment costs.

Abolish the Individual and Corporate Alternative Minimum Taxes (AMT). The AMT is, in effect, a parallel income tax whose rules are inconsistent with those of the regular income tax.

The AMT forces individuals and businesses with large amounts of otherwise legal and justified deductions or business expenses to lose or defer the use of such write-offs in order to accelerate Treasury tax collections. Taxpayers owe the government either the regular income tax or the AMT, whichever is larger. Once collected mostly from businesses and wealthy individuals, the AMT is now trapping hundreds of thousands — soon millions — of middle class individuals because of its lack of inflation indexing. A study distributed by the U.S. Treasury reports, "By 2010, under current law, almost 16 percent of all taxpayers will be subject to the AMT. Most ... will be added to the AMT simply because they have many dependents, live in high-tax states, or are heads of household."[21] Moreover, any plan that provides regular-income-tax relief without dealing with the AMT would actually intensify AMT-related problems. The reason is that as tax reform lowers regular income tax liabilities, huge numbers of additional taxpayers could be forced into the AMT. The AMT was never justified, but few voters realized that until now because the AMT did not directly affect them. The individual and corporate AMTs are by their nature complicated, distortionary, and arbitrary. The individual and corporate AMTs should be repealed.

By creating a tax climate less hostile to productive activities, the Bush plan would promote long-run productivity and growth, and during its implementation would give the economy an extra lift to help prolong the current expansion.

Eliminate phaseouts whenever possible. Phaseouts refer to the loss by taxpayers of deductions, exemptions, or credits with rising income. The Bush plan currently proposes to rollback one phaseout: it would raise the income threshold at which taxpayers begin losing the child tax credit. Although many phaseouts have been added to the tax code in the last two decades, they are bad tax policy: they are complicated, often arbitrary, and they worsen tax biases because within their phaseout zones they create large spikes in marginal tax rates. Most phaseout provisions now in the tax code should be repealed.

Conclusion

Gov. Bush's tax reform plan is commendable. It would achieve its stated objectives of lowering people's tax burdens and easing tax disincentives against work, saving, and investment. Its two most important provisions are across the-board-cuts in statutory tax rates and personal retirement accounts to replace part of the ailing Social Security system. By creating a tax climate

[21] Robert Rebelein and Jerry Tempalski, "Who Pays The Individual AMT?" U.S. Treasury Department, Office of Tax Analysis, *OTA Paper* 87, June 2000.

less hostile to productive activities, the Bush plan would promote long-run productivity and growth, and during its implementation would give the economy an extra lift to help prolong the current expansion. Although the Bush plan is less sweeping than the 1981 tax act that formed one of the legs of the Reagan revolution nearly a generation ago, it would, if enacted, be arguably the most pro-taxpayer legislation signed into law since then.

Fundamental tax restructuring is needed to remove deep-seated biases in the tax base against saving, investment, and work effort. The Bush plan, in comparison, leaves most of the current tax system in place while trying to alleviate some of its worst flaws. Fortunately, the provisions in the Bush plan move in the direction of a better defined, more neutral tax base, and further constructive steps could readily be added.

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