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THE GORE TAX PLAN: REDISTRIBUTION, NOT REFORM

Introduction

Vice President Al Gore proposes tax cuts that he claims will be worth $500 billion over the next 10 years. The Vice President describes his tax program as targeted, meaning it would not reduce taxes across the board but would cut taxes for activities or groups he believes the government should assist. The majority of his tax-reduction proposals involve tax credits, including several refundable credits. (People can claim refundable tax credits whether or not they owe tax.)

The highly targeted nature of the Gore tax cuts and their structuring as refundable credits has raised several serious questions. Are these proposals really tax cuts or are they disguised spending increases? How much of the population would qualify? Would the proposals increase economic activity and income, or would they merely redistribute, or worse, reduce income and employment?

The highly targeted nature of the Gore tax cuts and their structuring as refundable credits has raised several serious questions. Are these proposals really tax cuts or are they disguised spending increases? How much of the population would qualify? Would the proposals increase economic activity and income, or would they merely redistribute, or worse, reduce income and employment?

The economic consequences of tax changes are best predicted by looking at the degree to which the tax changes increase or reduce incentives at the margin to produce additional income. That is, will a tax change reduce marginal tax rates or instances of double taxation, or correct mismeasurement of taxable income, in a manner that would increase the after-tax reward to additional production? If so, the proposal will increase work, saving or investment, and raise economic output and employment; if not, not.

The Gore tax plan contains virtually no net marginal incentives to increase work, saving or investment, and would do nothing to promote growth. It contains many tax increases on saving and investment that would retard those activities. Where money would flow from the Treasury to taxpayers, it would generally do so in a manner that more resembles a spending program than a tax

Institute for Research on the Economics of Taxation

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reduction, and that either has nothing to do with the amount of economic effort put forth by the taxpayer, or may even decline the harder the taxpayer works. Even the Gore saving incentive plan is primarily an income redistribution scheme that keeps taxes at the margin higher than necessary on all taxpayers in order to provide largely lump sum transfers from mostly middle- and upper-income taxpayers to some primarily lower-income people. It would be the biggest income redistribution program in history. The Gore tax plan would retard growth compared to any reasonable alternative use of the surplus.

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How Big A Net Tax Cut?

The Vice President revealed after Labor Day that his plan also includes significant tax increases.[1] According to Mr. Gore, he would lower some taxes by $575 billion but raise other taxes by $96 billion, for a net tax cut of $480 billion over the 10-year period 2001 to 2010. Whereas the Vice President has extensively discussed his tax-cut recommendations, he identifies the proposed tax increases only as efforts to "close corporate tax shelters and unwarranted loopholes."[2] A footnote points to the Clinton-Gore Administration's Fiscal Year 2001 budget documents[3], where the proposed tax hikes are found to be a list of 80 revenue raisers, most on business and most very complicated. Moreover, a close examination of Mr. Gore's overall budget plan brings to light additional tax increases of $82 billion. Mr. Gore places these tax increases under the labels "reduce youth smoking" and "other revenue offsets"[4], and he neglects to subtract them from the alleged size of the tax cut. They also come directly from the Clinton-Gore Administration's budget, where they are among a set of proposals described as "other provisions that affect receipts."[5] The three largest of these items

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[1] See Gore/Lieberman, Inc., *Prosperity For America's Families: The Gore-Lieberman Economic Plan*, September 2000, esp. pp. 179-185, accessed at www.algore2000.com.

[2] *Ibid.*, pp. 180-181.

[3] U.S. Office Of Management And Budget, *Mid-Session Review, Budget Of The United States Government, Fiscal Year 2001*, June 2000, Table 16, accessed at www.whitehouse.gov/omb.

[4] Gore/Lieberman, Inc., *Prosperity For America's Families*, *op. cit.*, p. 184.

[5] OMB, *Mid-Session Budget Review*, *op. cit.*, Table 16.

are $66 billion from further increases in cigarette taxes, $9 billion from higher air travel taxes, and $8 billion from reinstatement of the Superfund excise taxes. With this second group of tax increases, the revenue offsets rise to $178 billion ($96 billion + $82 billion) and the 10-year net tax cut shrinks to $398 billion — not the $480 billion the Vice President claims.

The Vice President revealed after Labor Day that his plan also includes significant tax increases... [T]he 10-year net tax cut shrinks to $398 billion — not the $480 billion the Vice President claims.... [Furthermore] several hundred billion dollars of what Mr. Gore calls tax cuts ... should not be counted as tax cuts at all but as spending increases.

Although net tax reductions of slightly under $400 billion may seem large, they are actually very small relative both to federal revenues and to projected federal budget surpluses. Over the decade, the reductions would average $40 billion a year, which would amount to just 1.5% of total federal revenues during the period. As a share of federal budget surpluses, the Vice President's tax package would represent only about 8% of the surpluses that the Congressional Budget Office (CBO) projects for the years 2001-2010.[6] That is, under Vice President Gore's plan, more than 90% of the projected budget surpluses would not be used to provide tax relief. In reality, even these numbers overstate the tax reductions. Several hundred billion dollars of what Mr. Gore calls tax cuts would, in fact, be government checks — the refundable portion of various credits — to people who have no income tax liabilities. Under federal budgeting rules, those checks should not be counted as tax cuts at all but as spending increases.[7] And of the fraction of purported tax cuts that are officially tax cuts, many of them are closer in function to spending programs than tax relief.

The tax increases are also small compared to Vice President Gore's spending proposals. According to Mr. Gore's numbers, he would increase federal spending by about $900 billion through

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[6] See Congressional Budget Office, *The Budget And Economic Outlook: An Update*, July 2000, accessed at www.cbo.gov. The CBO now provides several baselines because of uncertainty about the willingness of the White House and the Congress to abide by the caps on discretionary spending that they agreed to as part of the Balanced Budget Act of 1997. If the caps hold through 2002 with discretionary spending thereafter growing at the rate of inflation, Mr. Gore's tax plan would be less than 7% of the $5.8 trillion of projected federal budget surpluses for the period 2001-2010. If the caps are ignored and discretionary spending grows at the rate of inflation after 2000, Mr. Gore's plan would be less than 9% of the projected budget surplus for the period 2001-2010. Mr. Gore calls for a much larger percentage of the projected budget surplus to go towards increased federal spending.

[7] A study by the Senate Budget Committee, majority staff, estimates that the net tax reductions in Mr. Gore's plan would be actually be about $300 billion over 10 years. That estimate was prepared by taking the Administration's budget proposals, which the Vice President was assumed to endorse, and adding his additional proposals. The tax-cut estimate excludes items the Vice President calls tax decreases but that Budget Committee experts believe to be spending increases. (Senate Budget Committee, Majority Staff, "Analysis of Vice President Gore's Proposals," September 2000, pp. 1-4, accessed at www.senate.gov/~budget.)

the year 2010.[8] This implies that for every $1 by which he cut taxes, he would raise government spending by $2.25. Some independent evaluations of his spending proposals, however, see a much higher price tag. For example, a National Taxpayers Union line-by-line budget analysis estimates that the 10-year cost of Mr. Gore's announced spending proposals would be $2.7 trillion (substantially exceeding the projected on-budget surplus).[9] Based on that estimate of the spending increases, for every $1 by which Mr. Gore cut taxes, he would raise government spending by $6.75. And if several of the "tax cuts" in the Gore plan are more correctly classified as spending increases, the tilt towards higher spending rather than lower taxes becomes even greater.

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Mr. Gore's tax proposals are an extension of those of the Clinton-Gore Administration. The tax increases come verbatim from the Administration's budget request. The tax decreases closely follow earlier Administration proposals. For example, the Vice President's proposed Retirement Savings Plus Accounts are a slightly reworked version of the Administration's proposed Universal Savings Accounts. His tax credits for higher education and vocational education would expand upon the Administration's Hope Scholarship Credit and Lifetime Learning Credit. His recommendation that people between 55 and 65 be given a 25% premium credit to help them buy into Medicare adds a twist to the Administration's previously rejected attempt to lower the age at which people can enter the government's financially ailing Medicare program.

Mr. Gore's proposals, like those of the Administration, reject broad-based tax relief, give preference to targeted tax cuts, emphasize redistribution of income through the tax system, and rely heavily on tax credits.[10] Because they would be confined to particular groups and behaviors that the Vice President believes should be assisted, it has been estimated that they would reduce the

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[8] Robert J. Samuelson, "Gore The Conservative," *The Washington Post*, August 15, 2000, p. A23.

[9] Tom McClusky, "A Chicken In Every Pot and Ten Thousand Lawyers In Every Garage," Update to NTUF Issue Brief 127, National Taxpayers Union Foundation, September 7, 2000, accessed at www.ntu.org

[10] By way of comparison, Governor George W. Bush's proposed tax cuts are larger, broad-based, would lower the tax bills of most taxpayers, and would significantly lower marginal income and payroll tax rates. He is calling for no tax increases. (For an evaluation of Governor Bush's tax recommendations, see Michael Schuyler and Stephen J. Entin, "Towards A Better Tax System: The Bush Plan," *IRET Policy Bulletin*, No. 81, Institute For Research On The Economics Of Taxation, August 30, 2000. For a concise overview of the numbers in the two major Presidential candidates' tax and spending plans, see Robert J. Samuelson, "Gore The Conservative," *op. cit.*)

liabilities of less than 50% of taxpayers.[11] The number of taxpayers who would receive tax relief depends critically on how many people are assumed to participate in the Retirement Savings Plus program. For several tens of millions of taxpayers, it is the only part of the proposal for which they may qualify.

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Having determined that Mr. Gore's tax cuts would be selective and, on net, surprisingly small, the central question in the remainder of this study will be whether his changes, if enacted, would strengthen the economy by advancing the principles of tax neutrality and simplicity. Tax biases against work, saving, and investment hold down productivity and growth, reducing people's incomes, living standards, and future opportunities; more neutral treatment of saving and investment relative to consumption, and work relative to leisure, would raise incomes for everyone. The heavy costs of tax paperwork inflict another deadweight loss on the population. It will be found, regrettably, that damaging anti-productivity tax biases would be at least as much of a problem under Mr. Gore's plan as they are now. The Gore plan would not cut tax rates at the margin; in many cases, it would raise them. The complexity of the Gore plan's tax increases and targeted tax reductions would add to, rather than ease, the paperwork costs of the tax system. Measured against these principles, the Gore plan would be a missed opportunity, instead of a clear improvement over current law.

The Need For Tax Reform

The Gore tax plan fails to address the serious problems of the current tax system.

Because of a sharp rise in income tax collections in recent years, the federal government is taxing away from Americans a greater share of their production and incomes than it has ever done before in peacetime. According to the Congressional Budget Office (CBO), federal taxes will hit a record 20.6% of gross domestic product this year.[12] The increase in tax collections is caused in part

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[11] "Truth On Tax Cuts," *Wall Street Journal*, editorial, September 5, 2000, p. A34.

[12] See CBO, *The Budget And Economic Outlook: An Update, op. cit.*. Only at the height of World War II — a global conflict in which this nation's survival was at stake — when federal tax collections hit 20.9% of GDP in 1944, did federal taxes briefly rise slightly above the share of GDP they are taking right now. See Office Of Management And Budget, *Budget Of The United States Government: Fiscal Year 2001: Historical Tables* (Washington, DC: Government Printing Office, 2000), Table 1.3.

by "real bracket creep": as incomes rise due to real economic growth, the progressive rate schedule pushes more people into higher marginal tax rate brackets.

As high as tax collections are, the full costs of the tax system to the public are much greater than the revenues collected. An additional cost of the tax system is the "excess burden" it imposes by reducing production and slowing economic growth by diminishing the rewards for productive activities. One key tax bias is against work effort. Because people must pay income and payroll taxes on their earnings from work but are not liable for those taxes on the enjoyment they obtain from leisure, they work less than otherwise, and the tax-induced decline in work effort reduces people's output and their incomes. Several powerful tax biases discourage saving and investment. The tax treatment of saving decreases the ability and willingness of people to save for emergencies, education, homebuying, retirement, and other purposes. The ordinary income tax is heavily biased against saving and in favor of consumption uses of income. Income is taxed when first earned. If the after-tax income is used for consumption, the goods and services obtained are generally free of additional federal income tax, except for a few selective excise taxes. If the after-tax income is saved, however, the returns on the saving (interest, dividends, rents, non-incorporated business profits, etc.) are taxed again. This is the fundamental bias of the income tax against saving. In addition to this basic bias, the tax system piles on a third layer of tax on income that is saved in the form of the corporate income tax and a fourth layer in the form of the federal Estate, Gift, and Generation Skipping Transfer Taxes (the Death Tax)[13], compounding the problem. These multiple layers of tax on saving and capital increase the cost of saving, leading to a smaller stock of capital than would otherwise prevail. A smaller capital stock hurts productivity, which means less production and lower real wages and employment.

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These biases can be eased by cutting statutory marginal tax rates. Reducing marginal tax rates would 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. It is especially important to lower marginal tax rates because real bracket creep has pushed many people higher up the rate bracket scale.

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[13] 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.

In addition to marginal tax rate reductions, however, reform of the tax base is also needed, particularly to address tax biases against saving and investment. A neutral tax code would not penalize saving relative to consumption. There are two ways to make the taxation of saving and consumption neutral. Either income that is saved should be exempt from tax (as with deductible IRAs and tax-deferred pensions) and the earnings of the saving and the principal taxed upon withdrawal, or the amounts saved should be taxed when earned but the earnings should be tax exempt (as with Roth IRAs and tax-exempt securities).[14] 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.

[F]ederal taxes will hit a record 20.6% of gross domestic product this year... As high as tax collections are, the full costs of the tax system to the public are much greater than the revenues collected. An additional cost of the tax system is the "excess burden" it imposes by reducing production and slowing economic growth by diminishing the rewards for productive activities... The current tax system also imposes large, indirect costs on people through its huge paperwork demands.

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. (The purest example of a cash flow tax may be 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.)

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

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

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

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

The current tax system also imposes large, indirect costs on people through its huge paperwork demands. To cope with the tax system's ferocious complexity, households and businesses must spend large blocks of their time on tax matters and hire skilled and expensive armies of accountants, lawyers, and recordkeepers, which diverts valuable resources away from the production of useful goods and services.

The most complicated provisions of the tax code involve saving and investment: the capital gains tax, the corporate income tax, the estate tax, the taxation of foreign source income, depreciation, etc. A person with only wage income has a fairly simple tax return. Reform of the tax base, designed to end or at least decrease the multiple, arbitrary, and often inconsistent taxation of saving and investment, holds the greatest promise for simplifying the tax code. Two additional and growing sources of complexity in recent years that also require correction are sharp increases in the number of tax credits (each with its own detailed set of rules) and in the number of phaseout provisions under which taxpayers lose various deductions, exemptions, or credits as their incomes rise.

Vice President Gore, however, scarcely mentions these problems when discussing what he hopes to accomplish with his tax program. As explained more fully in the next section, his tax package would, on the whole, do little to correct the federal tax system's shortcomings to promote faster growth of output, income, or employment.

Vice President Gore's Tax Proposals

Vice President Gore's tax package contains about 85 tax increases and approximately three dozen targeted tax cuts. Table 1 lists several of the proposals to raise taxes and most of the tax cuts. In the remainder of this section, an overview is provided of the tax increases in the Gore plan and several of the major tax reductions are discussed in detail. The provisions are primarily evaluated from the perspective of whether they would reduce (or aggravate) tax biases and complexities.

Vice President Gore's tax package contains about 85 tax increases and approximately three dozen targeted tax cuts... [W]hile most of the revenue raisers would worsen tax distortions and complexities, few of the tax cut provisions deal with the areas of the tax code most commonly regarded as distortionary, complicated, unfair, or otherwise in need of improvement.

A notable feature of the Gore package is that while most of the revenue raisers would worsen tax distortions and complexities, few of the tax cut provisions deal with the areas of the tax code most commonly regarded as distortionary, complicated, unfair, or otherwise in need of improvement. The only elements of the package responding to traditional calls for pro-growth tax reform and relief are those concerning the marriage penalty, the estate tax, and the R&D credit. With the marriage penalty and the estate tax, the Vice President's proposed relief would be quite limited. The Gore campaign indirectly acknowledges that normal tax reform and relief are not the Vice President's focus when it divides the tax proposals into eight categories that emphasize supporting particular groups and encouraging certain activities: "Help working families care for children and aging parents ...Reward work and family ... Help families afford health care ... Improve education and training ... Make retirement more secure by encouraging saving ... Empower communities ... Clean up the environment ... [and] Encourage the development of new technologies."[15] Based on these categories, one could easily mistake the package for a set of spending initiatives rather than tax reductions.

Tax Increases

As can be seen from table 1, most of the revenue raisers in Mr. Gore's plan, with the significant exception of higher cigarette taxes, would increase taxes on business activities and other forms of saving and investing. Most would be collected at the business level. And most involve arcane, difficult to understand areas of the tax code. Although these common properties may perhaps offer political advantages, they are disturbing on economic grounds.

> ***[M]ost of the revenue raisers in Mr. Gore's plan, with the significant exception of higher cigarette taxes, would increase taxes on business activities and other forms of saving and investing... [T]he result would be harsher tax biases, less saving and investment, and more tax-induced damage to the economy.***

The proposals would increase taxes on saving and investment, but the federal government already overtaxes those activities. If the proposals become law, the result would be harsher tax biases, less saving and investment, and more tax-induced damage to the economy. To be sure, the response of the Clinton-Gore Administration is that all its requested revenue raisers target tax loopholes. But while the tax code may have some loopholes regarding saving and investment, they are very few. During the 1980s and 1990s, a succession of Administrations and Congresses pored over the tax code looking for revenue raisers, both to increase government tax collections and to finance reductions in taxes at the individual level. Most tax-code provisions that looked like loopholes and did not have compelling economic or other policy justifications were axed long ago. A partial explanation for why the Clinton-Gore Administration claims saving and investment are often undertaxed is that it regards multiple taxation of saving and investment as the right way to tax them. In other words, the Administration's benchmark is a tax system strongly biased against saving and investment. From that perspective, it tends to view as a loophole any provision that softens the multiple taxation and moves in the direction of neutral treatment of saving relative to consumption.

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[15] Gore 2000, "Al Gore's Issues: Budget And Taxes, Agenda, Cutting Taxes For America's Families," accessed at www.algore2000.com.

Table 1
Vice President Gore's Tax Proposals

Tax Increases

- Increase cigarette excise taxes
- Increase air travel excise taxes
- Reinstate Superfund excise taxes
- Limit benefits of corporate tax shelter transactions: increase disclosure of certain transactions, modify substantial understatement penalty for corporate tax shelters, etc.
- Modify corporate-owned life insurance (COLI) rules
- Tax receipt of tracking stock in certain distributions and exchanges as the receipt of property
- Repeal lower-of-cost-or-market inventory accounting method
- Modify rules for capitalizing policy acquisition costs of life insurance companies
- Subject investment income of trade associations to tax
- Tax receipt of tracking stock in certain distributions and exchanges as the receipt of property
- Eliminate non-business valuation discounts
- Modify deposit requirement for FUTA
- Reinstate oil spill liability trust fund tax
- Replace sales-source rules
- Etc. (approximately 70 other proposals)

Tax Cuts[1]

- Create "Retirement Savings Plus Accounts" that would be in addition to Social Security, with government tax credits matching up to 300% of individuals' contributions.
- Limited Estate Tax relief for some family-owned businesses and farms
- Limited Marriage Penalty tax relief for non-itemizers (twice the standard deduction for couples as for singles)
- Make the R&D Credit permanent and partially refundable
- Tax credits and savings plans for higher-education and vocational training costs
  - Create "College Opportunity Tax Cut" (28% tax credit on up to $10,000 of family's higher-education and vocational training costs)
  - Create "401(j) Life-Long Learning Accounts" for higher-education and vocational training costs
  - "National Tuition Savings Plan" to help link different states' college savings and prepaid tuition plans
  - Offer employers a tax credit of up to $6,000 for each worker they train in "information technology and other technology skills"
- 25% refundable tax credit on health insurance premiums to the following groups
  - families above 250% of poverty level who enroll their uninsured children in CHIP (attached to proposed expansion of government's Children's Health Insurance Program)
  - Parents of CHIP- or Medicaid-eligible children who buy into CHIP for themselves (attached to proposed expansion of children's program to adults)
  - People ages 55 to 65 who buy into Medicare (attached to proposed expansion of Medicare to people ages 55 to 65)

Tax Cuts[1], cont.

- Small businesses that purchase health insurance for their employees through health-insurance purchasing coalitions
- Individuals without employer-provided health insurance who purchase individual policies

• Expand Child and Dependent Care Tax Credit (increase tax credit's matching rate, make refundable, and provide $500 credit for "assumed [job-related] child care expenses" of stay-at-home parents of babies)

• Create "After-School Tax Credit" (up to 50% matching rate, refundable)

• $3,000 tax credit for individuals with long-term care needs

• $1,000 tax credit for disabled individuals who work

• Expand Earned Income Tax Credit (EITC)

• Tax credits to subsidize school construction by state and local governments (state and local governments would issue bonds on which the federal government paid lenders tax credits in lieu of state and local governments paying interest)

• Tax credit for small businesses to offer employee pensions (50% tax credit for first three years of qualified contributions to employees' pensions)

• Expand Empowerment Zones

• Expand Low-Income Housing Tax Credit

• "New Markets Initiative" tax credit for "capital investments in economically distressed communities"

• Make the Expensing of Brownfields cleanup costs permanent

• Technology Bonds to subsidize technology initiatives by state and local governments (state and local governments would issue bonds on which the federal government paid lenders tax credits in lieu of state and local governments paying interest)

• Tax deduction for individual and corporate contributions to Vice President's proposed Democracy Endowment (funding for his campaign finance reform proposal)

• "Tax cuts for conservation" (land owners could reduce certain taxes by limiting land development) / Increased royalties on hard-rock mining on federal lands as revenue offset to these tax cuts and other parts of the "Lands Legacy and Livable Communities Initiatives"

• "Better America Bonds" (tax credits to subsidize certain state and local spending on parks and conservation)

• Assorted tax credits for reduced energy use and less pollution: Tax credit of up to $6,000 for energy efficient cars and SUVs; Tax credit of up to $4,000 for purchase of energy-efficient heavy pickup truck, up to $5,000 for purchase of energy-efficient delivery truck, and up to $15,000 for purchase of energy-efficient 18-wheeler; Tax credit for energy-efficient building equipment (20% credit for heat pumps, water heaters, etc.); Tax credit of up to $2,000 for owner of energy-efficient new home, up to $1,000 for energy-efficient retrofitted home; Expand tax credit for solar energy systems; Tax credit to consumers for buying reduced-pollution electric power; Expand and extend tax credit for electricity production from wind, biomass, and landfill methane; Faster depreciation for distributed power property

[1] As explained in the text, a number of these changes, which Vice President Gore presents as tax cuts, would officially be classified as spending increases.

Information on Vice President Gore's tax proposals accessed at www.algore2000.com.

The fact that most of the higher taxes would be collected at the business level may give the impression that people would not pay them. The truth, however, is that businesses are merely legal arrangements created and used by people. While taxes can be collected at the business level, it is always people who bear "business" taxes. People pay the taxes as owners (lower profits), workers (lower wages), and consumers (higher prices and reduced supplies).

The extremely technical nature of most of the proposed tax increases is also a concern. Most would require new, complicated tax tests in areas of the tax code that are already very complicated. Instead of simplifying the tax code, they would add new rules to interpret, more paperwork to be compiled, and additional tax traps for the unwary.

These tax increases would not be a good idea even if the federal budget were in deficit. The are certainly not appropriate at a time of record surpluses.

Many of the provisions have obvious drawbacks. For example, the proposal to reinstate the oil spill liability trust fund tax would add five cents a barrel to the production cost of oil and put further upward pressure on the price of oil at a time when oil prices are already very high. The proposal regarding FUTA deposits, which would require employers to remit FUTA taxes more frequently to the government, would permanently increase the paperwork costs businesses incur when they employ workers so that the government could slightly accelerate when it receives tax revenues. The proposed change in the sales-source rules would hurt many U.S. firms trying to export goods and services. The proposed corporate-tax-shelter restrictions would, some fear, shift too much discretionary power to the Treasury and IRS, and have a chilling effect on legitimate business activities. The proposed reinstatement of the Superfund taxes would increase business costs, have little relation to pollution, and decrease leverage for reforming the widely criticized Superfund program.

The large proposed hike in cigarette taxes is troubling because smokers are already heavily taxed. Several careful studies have concluded that they pay substantially more in taxes than any costs they impose on society.[16] Moreover, the burden on smokers is increasing rapidly because of previously enacted tax increases and because tobacco companies are being forced to raise prices to pay for the settlement they negotiated with the states' attorneys general. Mr. Gore's proposal, if enacted, would have the effect of compelling smokers to become more of a cash cow for financing general government spending. Another problem with this proposal is that the tax hike would be based in part on the prevalence of illegal underage smoking, which is very hard to measure and is illegal to boot. One objection is that the government might exaggerate underage smoking given the financial incentive it would create to do so, but a deeper problem is that the government should not reward itself at the expense of taxpayers because it fails to enforce the law properly.

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[16] See Stephen J. Entin, "There's No Excuse For A Higher Cigarette Tax," *IRET Policy Bulletin*, No. 72, April 1998.

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Retirement Savings Plus Accounts

Description of Proposal. This proposal is a modified version of an earlier Clinton Administration plan (which the Administration called Universal Savings Accounts). The proposal is extremely complicated. It would establish a new class of saving accounts, called Retirement Savings Plus Accounts (RSPs). Certain individuals could contribute to the new accounts, and their contributions would be matched to varying degrees by the government in a complicated formula. Maximum contribution amounts and the government's matching rate would depend on individual income. Among those who would not be eligible are: individuals with less than $5,000 in wages, dependents on another person's tax return, people under age 18 or over age 70½, and full-time college students. These restrictions would exclude very low wage earners, most students, and most retirees from participation.

An individual making up to $15,000 could contribute up to $500 yearly, and the government would match that at a 300% rate, paying up to $1,500, resulting in combined individual-government deposits of up to $2,000 yearly. For an individual making between $15,000 and $30,000, the individual could contribute up to $1,000, and the government's matching rate would drop to 100%, paying up to $1,000, keeping maximum combined yearly contributions at $2,000. For an individual making between $30,000 and $50,000, the individual could contribute up to $1,000, and the government's matching rate would drop to 33.3%, paying up to $500, again keeping maximum combined yearly contributions at $2,000. It is not clear whether individuals making over $50,000 could participate. In all cases, the dollar limits would be doubled for a couple filing jointly. For example, a couple making up to $30,000 could contribute up to $1,000 yearly and receive in the account up to $3,000 from Uncle Sam.

The government match would be provided through a tax credit. It is not clear whether the tax credit would go to the individual to be deposited at the financial institution or whether the institution would advance the funds and then receive a tax credit from the government in reimbursement. Under the latter procedure, the financial institution would need to be able to contact the government to learn the person's contribution limit and the matching rate.

The plan would be phased in over 10 years, with half-sized contributions through 2006, three-quarter sized limits in 2007 and 2008, and full contributions in 2009 and 2010. Contribution limits would rise at the inflation rate after 2010. The Gore campaign's descriptions of the expected real value of the accounts are in real 2010 dollars.[17]

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[17] Gore/Lieberman, Inc., *Prosperity For America's Families*, *op. cit.*, pp. 52-63.

Contributions to the proposed RSPs would be tax deferred and all withdrawals would be taxed (similar to deductible IRAs and 401(k) plans). Early withdrawals would be subject to a penalty, but no penalty would be assessed on early withdrawals for a new home, education costs, or catastrophic medical expenses, provided that the funds had been in the account for at least 5 years. As the plan has evolved in the Clinton Administration, the accounts would probably be owned by individuals and managed by private-sector financial institutions, but the government would probably limit the investment choices and might require that the accounts be converted to annuities upon retirement.

The Gore retirement savings-plus program would be the biggest income redistribution program in history. Over a worker's lifetime, it would be more skewed and would redistribute more income than Social Security.

Analysis. The Gore retirement savings-plus program would be the biggest income redistribution program in history. Over a worker's lifetime, it would be more skewed and would redistribute more income than Social Security. Giving low-income workers a modest federal match for a few years as they begin to save, to cover management and administrative fees of personal accounts and to teach thrift, would not be unreasonable. It would be especially valuable if it were done as part of a reform of Social Security, which is facing insolvency in a few years. Unfortunately, the Gore plan takes a different route, involving lifetime transfers of enormous size that would do nothing to remedy the problems facing Social Security.

Although Vice President Gore lists the RSPs as the largest item in his tax plan, amounting to about 40% of the net tax reduction, the matching credits, which would comprise most of the proposal's cost, would in reality not be tax relief. They would actually be a new entitlement program, albeit one that made people use tax form 1040 as the application form for receiving government benefits. The reason is that the credits would bear no relation to the correct measurement of taxable income or tax liability; they would be pure subsidies. Indeed, the refundable portion of the matching credits would automatically count as a government spending program according to the government's official budgeting rules. Disguising the payments as a tax program, though, creates the appearance that the Vice President's tax relief package is larger than it truly is and his spending package smaller.

Mr. Gore's retirement saving-plus program would bestow huge subsidies on low-income individuals and, to a lesser extent, on lower-middle-income individuals who participated. Once the program was phased in, a couple who began contributing at age 20, contributed the maximum amount every year, and qualified for the maximum government match, would receive government subsidies from this one program totalling $1.7 million in nominal dollars (counting both government contributions and interest on those contributions) by the time they reached age 65![18] Middle-income and upper-income taxpayers would pay for the bulk of these new subsidies through their tax dollars. With middle-income and upper-income taxpayers receiving small or zero government matches on their saving, they would unequivocally be worse off as a result of this program.

The Gore campaign projects that once the program is fully phased in (after 2010), a low-income single worker earning $23,000 would accumulate, over 35 years, after-inflation savings of $202,000 (in 2010 dollars) under the plan. Three-quarters of that, or $151,000, would be the result of the government contribution, which is really tax transfers from other taxpayers. The annuity that the Gore proposal estimates that the saver could obtain after 35 years is $12,345 per year, a bit larger than the worker's projected Social Security benefit of $12,097. The sum would exceed the worker's pre-retirement income!

In fact, the calculations presented in the plan appear to be understating the case. Paying down the 35 year accumulated account with interest over a normal life expectancy with inflation adjustments should yield the saver an annual real income about a third larger than the annuity shown, and could exceed $16,000, if the assumed pre-retirement rate of return were assumed after retirement.[19] Also, a working lifetime is nearer 45 years; the real value of the single person's account would be nearer $365,000 and the real transfer from taxpayers nearer $275,000. Over a 45 year working life, the annual real draw after retirement could exceed $29,000, or 2.4 times the worker's Social Security benefit, and would, by itself, exceed the worker's pre-retirement income.

All these figures would be doubled for a married couple. They would receive real transfers of $550,000 over a full working lifetime, and build up accounts worth $730,000 in real 2010 dollars. Their annuity of nearly $58,000 would be 2.4 to 3 times their retirement benefits from Social Security (depending on whether they earn separate Social Security benefits or use the spousal benefit).

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[18] This calculation uses a 5.3% real rate of return and a 2.5% inflation rate. The rate of return is taken from the Gore campaign, which describes it as a "conservative assumption" (Gore/Lieberman, Inc., *Prosperity For America's Families*, *op. cit.*, p. 58). The inflation rate is the long-term inflation rate assumed by the CBO, and is used to adjust the contribution limits for inflation. We are indebted to Carlos Bonilla of the House Budget Committee staff for pointing out the size of the subsidy and observing that an example provided by the Gore campaign shows a much smaller dollar amount because, contrary to standard budget practice, it does not express the amount in nominal dollars but in net-of-inflation dollars. In year 2010 dollars, the subsidy in this example would be $549,300.

[19] Apparently, the Gore calculation assumes a very hefty annuity premium, knocking down the return available from an insurance company relative to amounts the individual could draw down on his or her own. Individuals might do better to self-insure against living well beyond the average expected lifetime with other saving for the excess years, or rely on their Social Security for that time frame. Annuity insurers charge a premium to cover possible variations in mortality among their particular clients and to guard against the tendency for only the healthiest people to buy annuities. Even so, with tens of millions of taxpayers getting the RSPs, a possible requirement for everyone to annuitize, and a competitive market for annuities, there should be no need for retirees to lose a quarter of the "fair" annuity value to premiums.

There are two key points to take from this analysis. First, the Gore plan would transfer, mainly from other taxpayers, more than a quarter of a million real dollars to low-income single workers, and more than half a million real dollars to low-income couples, doing three-quarters of their saving for retirement for them with comparatively little effort on their part. To pay for the transfer, it would keep tax rates higher than they need to be on all workers and income tax payers, including very low earners, retirees, and student/dependents who are not eligible for the savings program. The higher-than-needed tax rates would depress employment, saving and incomes across the board.

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Second, over a full working lifetime, the Gore campaign is showing that, for less than the current Social Security retirement payroll tax rate of 10.4 percent, low-income workers or couples who invest in private securities can get back 2.4 to 3 times what Social Security can provide, even with the "tilt" in that program for low earners. This is a stark indictment of the current low rates of return in the Social Security System, and raises a key question: Why is this an add-on program to Social Security instead of a replacement? Why not scale back Social Security (and avoid future payroll tax increases), and allow workers to put some of their own payroll tax (perhaps a greater percent for low-income workers than high-income workers) into a personal account invested in private securities? There would be no need for this massive transfer program, retirement income would be higher, and there would be lower tax rates rather than higher ones, encouraging employment and real saving.

The Gore campaign claims the proposal would have a 10-year cost of $200 billion. Once the program is fully phased in, the cost would supposedly be $35 billion annually.[20] But based on the size of the match and the number of people eligible to participate, others question that figure and claim the cost would be much higher. For example, Senate Budget Committee analysts calculate that if 50% of the lowest-income people participate (a figure mentioned by Alan Blinder, a leading Gore advisor) and if 70% of other eligible workers participate (consistent with 401(k) participation rates), the 10-year cost once the program is fully phased in would be about $750 billion, or about $75 billion a year.[21] If everyone took advantage of these very high matches, the 10-year cost would exceed $1 trillion, or over $100 billion annually. Even with a further assumption that no one would contribute more than 5% of income, Senate Budget Committee analysts calculate that the 10-year cost would still be about $500 billion.

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[20] Reported by Glenn Kessler, "Gore To Detail Retirement Savings Plan," *The Washington Post*, June 19, 2000, p. A1.

[21] Senate Budget Committee, "Analysis of Vice President Gore's Proposals," *op. cit.*, esp. pp. 1-8.

Either the program would cost far more than advertised, or Vice President Gore and his advisors are assuming the plan's various restrictions and contribution requirements would keep participation rates very low. This is an important question, because for millions of taxpayers, the retirement saving plan is the only feature of the Gore tax proposal for which they might qualify.

Looking only at the amount of saving building up in the accounts as a result of the individual and government contributions, it might seem as though the RSP accounts would increase national saving. However, one cannot analyze a tax or spending provision, such as the retirement saving proposal, in a vacuum. There is always an alternative use of the revenue which must be considered.

The contributions of low income individuals who do no saving now would be new saving, unless they borrowed to make the deposits, or repaid debt more slowly. However, some if not most of the individual contributions to the accounts by middle and upper income participants would be saving that they were doing anyway, especially where such savers could use other saving to "max out" in the new accounts, after which they would have no incentive at the margin to add to total saving.

The government matching contributions cannot be regarded as adding to national saving. Even at first glance, they would come out of the projected federal surplus, which is already counted as part of national saving. In fact, the taxes kept artificially high to generate the surplus are probably depressing private saving by more than the marginal revenue they are raising. Cutting marginal tax rates or expanding IRA treatment of saving (with a greater impact "at the margin" than the RSP) could expand private saving by as much or more than the RSP.

The government match is the heart of the RSP proposal, but the way the match is structured creates a succession of difficult problems. The low levels of saving that can earn federal matching funds, in each of the three steps, and the zero match for high income earners, mean that many savers would easily "max out" on their contributions and federal matching sums. For them, there would be no incentive at the margin to add more to their annual saving. The matching funds would simply be lump- sum transfers providing no economic incentive.

The phase-down of the government match with rising income would discourage many low-income and lower-middle-income people from working past a certain income. For example, suppose a couple makes $30,000, contributes $1,000 to their RSP account, and receives a $3,000 government match. A few extra hours of work would push the couple's income above $30,000 and reduce their government match from $3,000 to $2,000, costing them $1,000. Working harder just would not pay for this couple and many other lower-income Americans if the proposal becomes law.[22] Similarly,

[22] Alternatively, suppose Mr. Gore were to replace the income "cliffs" in his current proposal with income ranges of several thousand dollars over which the matching rate was phased down. Suppose in the example he decided to reduce the matching rate over, say the $10,000 between $30,000 and $40,000. That would create, in effect, a marginal tax rate

(continued...)

the program would discourage people from saving as much as they do currently outside of the government-subsidized accounts. They would have less need to save because the government would be doing so much of it for them, and they would be concerned that interest income on saving outside of the RSP accounts would sharply reduce their RSP subsidy if it pushed them over one of the income thresholds in the match formula.

Vice President Gore's RSP proposal would not increase saving, it would redistribute and reduce income and reduce the total quantity of saving in the process. A better way to boost national saving would be through real tax reforms that both let people keep more of what they earn and moderate the anti-saving biases now in the tax code.

The fixation on getting equal dollar amounts into the retirement accounts for the sake of fairness (by means of a declining federal match and rising personal contribution) may stem from a basic misconception of what constitutes evenhanded. In the discussion by Mr. Gore and his advisers of RSPs, they charge that saving-neutral accounts like IRAs and tax-deferred pensions are subsidies to savers and that the subsidy rises with one's tax rate, so that it is greatest for people in the highest tax brackets.[23] They then argue that the government should match these alleged subsidies by creating subsidies for people who have low tax rates and save little now. If current law actually did subsidize savers, the principled policy would be to roll back those subsidies, not to create more subsidies. However, the truth is that, outside of IRAs, 401(k)s, and other saving-neutral accounts, the current tax system penalizes saving, and the tax penalty increases with the tax rate. The pension treatment only restores neutrality. It is only by taking the tax penalty on saving as the norm that Mr. Gore and his advisors reach the doubly wrong conclusion that saving-neutral accounts are subsidies and that the savers who are the most overtaxed by the usual multiple taxation of saving obtain the biggest subsidies. The proposed RSPs, in short, are built on a premise that is exactly the opposite of the truth.

Another sort of problem is that the matching rate would be so high, especially at lower incomes, that it would make fraud lucrative and probably difficult to stop. Also, the high matching rate would tempt many individuals who do not want to save to "game the system" either by borrowing to contribute, reducing other saving, or getting their up-to-300% government match and soon withdrawing the money. The government could be expected to issue rules to discourage such behavior (the Gore proposal contains some already), but the rules would be complicated and, given

[22](...continued)
spike of 10% (the government subsidy would fall by $1,000 over a $10,000 income range), again a powerful disincentive against additional work.

[23] Gore/Lieberman, Inc., *Prosperity For America's Families*, *op. cit.*, pp. 53-55.

the high matching rate, need to be very strict to be effective, which would make the accounts less attractive.

Ironically, Mr. Gore's sweeping, expensive income redistribution program would fail to help many of the low-income people at whom it is aimed. The problem is that many low-income people would find it difficult to participate, either because they would not feel they had the extra cash needed to contribute or because the account's complexities and various restrictions would scare them away. Indeed, workers earning less than $5,000 in wages would actually be prohibited from participating.

Another drawback to Mr. Gore's proposed saving-entitlement program is that it would do nothing to simplify the tax system and reduce its high paperwork costs. It would have the opposite effect, adding many new complexities to the tax system. In contrast, real tax reform could achieve significant tax simplification and give people back billions of dollars now lost to tax paperwork.

The Vice President says that the proposed RSPs should not be confused with personal retirement accounts. Personal retirement accounts, which are gaining increasing bipartisan support, refer to proposals to replace part of the Social Security system with personally owned retirement accounts. Mr. Gore claims his proposed RSPs would be separate from and in addition to Social Security. They would not, he says, replace any part of Social Security, and on occasion his campaign has referred to the proposed RSP accounts as "Social Security Plus". According to him, there is no need for Social Security reform: a simple, painless juggling of how the government keeps its books would, he claims, "save Social Security ... extending its solvency at least until 2050."[24]

The Vice President's proposed change in the government's Social Security books (discussed below) would mask Social Security's financial problems, but do nothing to correct the problems, and by delaying needed reforms create further problems. Meanwhile, the separate RSP program would actually be making Social Security's problems worse by using up funds that might otherwise be committed to winning the public's acceptance of genuine Social Security reform. If Social Security is not reformed, the payroll tax will have to be boosted by more than 4 percentage points as the baby boom retires to keep the system in balance, and ultimately by more than 6 percentage points later in the century. This would carry the payroll tax to nearly 21.4%. It would have to reach nearly 25% to handle projected Medicare deficits. These, or alternative tax increases or benefit cuts, confront future workers and taxpayers if reform is postponed.

Personal retirement accounts offer a number of advantages over the Vice President's proposed RSPs.[25] For those who choose to enroll (participation would be optional), the personal accounts would yield higher rates of return than does Social Security, and higher total retirement income. The

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[24] "Remarks As Prepared For Delivery By Vice President Al Gore," ABNY Breakfast, April 25, 2000, accessed at www.algore2000.com.

[25] For a discussion of personal retirement accounts, see Michael Schuyler and Stephen J. Entin, "Towards A Better Tax System: The Bush Plan," IRET Bulletin, No. 81, August 30, 2000.

accounts could therefore be an inducement for the public to agree to a voluntary reduction in the growth of future Social Security benefits. Assuming they were used to replace a fraction of future promised Social Security benefits, the personal retirement accounts would ease the load on the financially unsound Social Security system and avoid massive payroll tax increases. The implicit reduction in the payroll tax and higher returns on the wages placed in saving would boost work incentives and employment. Personal retirement accounts would be simpler than RSPs. They would not be a major new government entitlement, but a personally owned alternative to part of Social Security. Unlike RSPs, they would not create tax cliffs and marginal tax rate spikes to discourage low-income individuals from trying to raise their incomes through greater work and saving. Finally, because contributions would come from part of the wages that workers and their employers must now pay the government in Social Security taxes, every worker who wished to participate would automatically have the funds needed to do so.

Social Security

Description of Proposal. Vice President Gore's plan to "save Social Security" is to credit increasing amounts of general revenues — soon reaching hundreds of billions of dollars yearly — to the Social Security Trust Funds. His campaign estimates that inter-governmental transfers would hit $120 billion in the year 2011 and climb to $250 billion yearly after 2015.[26]

The Vice President's proposed change in the government's Social Security books ... would mask Social Security's financial problems, but do nothing to correct the problems, and by delaying needed reforms create further problems. Meanwhile, the separate RSP program would actually be making Social Security's problems worse by using up funds that might otherwise be committed to winning the public's acceptance of genuine Social Security reform.

Analysis. The Social Security System, with its trust funds, looks superficially like a saving plan, in which people contribute funds during their working years and receive back their contributions with interest in their later years. In reality, however, Social Security is a tax-and-transfer system. Workers' Social Security taxes (it is the second largest federal tax, trailing only the individual income tax) are used to pay the system's current beneficiaries. Historically, any excess of receipts over outflows has been spent on unrelated government programs. When today's workers begin drawing benefits in the future, their benefits will come from payroll taxes collected from future workers.

[26] See "Al Gore Proposes New Reforms To Modernize Social Security And Strengthen It For The Future," April 4, 2000, accessed at www.algore2000.com. Technically, the Vice President would have the Treasury compute the extra interest the government would have to pay if, contrary to fact, the federal debt were not being paid down. He would then have the Treasury credit that imputed amount to the Social Security Trust Funds.

The government maintains accounting entries which it calls the Social Security Trust Funds to keep track of revenues credited to the system but spent on other government programs. The Trust Funds are not real saving; they are IOUs issued by one part of the government to another.

Vice President Gore's plan to "save Social Security" is to credit increasing amounts of general revenues — soon reaching hundreds of billions of dollars yearly — to the Social Security Trust Funds... Arbitrarily adding vast new amounts of IOUs to the Social Security Trust Funds might give the illusion that Social Security is financially stronger, but would not help by even one cent in financing Social Security in the future.

The IOUs in the Trust Funds take the form of special Treasury securities. The Treasury pretends to pay interest on those IOUs, and it adds the interest to the Trust Funds as additional IOUs. In 2000, about 60% of the Social Security portion of the budget surplus represents Social Security taxes in excess of Social Security benefits and about 40% is from interest on the IOUs in the Social Security Trust Funds.[27] In the future, when Social Security benefits exceed Social Security taxes and the Social Security System tries to redeem some of its U.S. Treasury IOUs, the government's only financing options, in the absence of reform, will be to raise payroll taxes on future workers, raise other taxes, cut benefits for future retirees, cut other government spending, borrow, or print money, just as if the trust funds did not exist. In Congressional testimony in 1999, even key Gore economic advisor Alan Blinder dismissed the IOU scheme and its "odd scorekeeping rules" as a gimmick. "It amounts to a pledge to provide that much more money for Social Security in the future — somehow. But it does not specify the sources. Thus, by itself, it does not fill any of the funding gap..."[28]

Arbitrarily adding vast new amounts of IOUs to the Social Security Trust Funds might give the illusion that Social Security is financially stronger, but would not help by even one cent in financing Social Security in the future. Instead, the illusion of solvency might delay needed reforms. The longer that corrective actions are postponed, the more disruptive they will need to be. If Social Security reform is rejected and the government's books are juggled as the Vice President suggests, redeeming the extra Social Security IOUs would be anything but painless.

Personal retirement accounts, which would strengthen the system with real saving, would be a better approach. To be fully effective, they should be linked to a trimming of the promised

[27] See Office Of Management And Budget, *Budget Of The United States Government: Fiscal Year 2001, Analytical Perspectives* (Washington, DC: Government Printing Office, 2000), Table 15-5. Of course, none of these IOUs is backed by real saving.

[28] Prof. Alan S. Blinder, House Ways And Means Committee Hearing, The President's Social Security Framework, February 23, 1999, cited in Senate Budget Committee, "Analysis of Vice President Gore's Proposals," *op. cit.*, p. 13.

increases in future Social Security benefits for future retirees. By scaling back future benefit growth by some fraction of the accumulation in personal accounts, Social Security can be brought into balance while leaving future retirees with higher incomes from private securities than they can expect from the Social Security tax/transfer system. If, instead, we disburse the projected budget surpluses without asking the public to accept any alteration in the current Social Security System, we will make Social Security reform nearly impossible, and will have wasted the last chance to avoid ruinous future tax increases.

Marriage Penalty Relief

Description of Proposal. Vice President Gore would increase the standard deduction for a married couple filing jointly to twice that for a single individual.

Analysis. Many couples — usually two-earner couples with incomes of similar sizes — experience a so-called marriage penalty: higher taxes as a couple than if single. Almost as many — usually one-earner couples and two-earner couples with one income much higher than the other — enjoy a marriage bonus: lower taxes as a couple than if single. The marriage penalty occurs because although the standard deduction for a couple is bigger than that for a single filer, it is not twice as big, and although most of the rate brackets for a couple are wider than for a single filer, they are not twice as wide. Consequently, when two earners combine their incomes, they may end up in a higher tax bracket and pay a higher combined tax than if they had remained single.

Under Mr. Gore's proposal, the standard deduction could no longer generate a marriage penalty. Rate brackets would remain as much of a problem as before, however, because Vice President Gore's plan would not change them. The two brackets that now have the smallest spread between single and joint filers are the 36% and 39.6% brackets, both of which were added in 1993. The 36% bracket begins at an income only 22% higher for couples than for singles, and the 39.6% bracket begins at the same income for couples and singles. When Vice President Gore promises "elimination of the current marriage penalty for working couples,"[29] he is evidently defining "working couples" to exclude couples who itemize or whose income places them above the 15% rate bracket.

Raising the standard deduction for couples to twice that for singles would benefit all couples who use the standard deduction, whether they now experience a marriage penalty or a marriage bonus. Ironically, in August, President Clinton cited generalized relief to married couples, whether or not they suffer a marriage penalty, as one of his reasons for vetoing the marriage-tax-relief legislation that Congress passed earlier in the summer.[30] Under Mr. Gore's proposal, married couples who itemize

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[29] Remarks as Prepared for Delivery by Vice President Al Gore, Prosperity And Progress For America, June 13, 2000., accessed at www.algore2000.com.

[30] William J. Clinton, Veto Message To Congress Regarding H.R. 4810, The "Marriage Tax Relief Reconciliation Act Of 2000", August 5, 2000, accessed at www.whitehouse.gov.

their deductions and experience a marriage penalty due to the rate bracket schedule would obtain no marriage-penalty relief.

In most cases this provision would not cut marginal tax rates. 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. For a small percent of couples, the larger standard deduction would move them from the bottom of one rate bracket to the top of the next lower bracket, but for most couples their marginal tax rate — and thus tax disincentives against work, saving, and investment — would stay the same.

When Vice President Gore promises "elimination of the current marriage penalty for working couples," he is evidently defining "working couples" to exclude couples who itemize or whose income places them above the 15% rate bracket.

From the point of view of correcting harmful tax disincentives, a better marriage relief provision is the one that Congress passed this year (H.R. 4810) but that the President blocked with a veto. That bill would have increased the 15% bracket for couples to twice that for singles, in addition to giving couples twice the standard deduction of singles. Still better would be widening all the brackets for couples to twice those for singles. A proposal that concentrates on helping those couples who suffer a marriage penalty and reducing their marginal tax rate is the one that was enacted in 1981, but repealed in 1986, and has again been put forward by Governor George W. Bush. The provision would provide marriage penalty relief by excluding from a couple's taxable income 10% of the lower-earning spouse's first $30,000 of income. If the lower-earning spouse makes $30,000 or less, the exclusion would cut the lower-earning spouse's marginal tax rate by 10% (e.g., from 28% to 25.2%), raising the spouse's after-tax wage at the margin. The proposal would have a significant positive impact on labor participation because second earners are usually very sensitive to after-tax wages.

Increased Estate Tax Exemption For Family-Owned Businesses And Farms

Description of Proposal. Under current law, an estate containing a family-owned business or farm may qualify for an Estate Tax exemption of up to $1.3 million under the Qualified Family-Owned Business Interest exemption (QFOBI). To be eligible, a number of restrictive conditions must be met (the family must control a certain percentage of the business, the business must be at least 50% of the estate, the heirs or their families must continue operating the business for a certain number of years, etc.). Vice President Gore would raise the QFOBI exemption to $2.5 million. (Because the Vice President assumes that two spouses die in succession with their estates planned so that each estate qualifies for the family-owned business exemption, he describes the proposal as increasing the family-owned business exemption from the current $2.6 million to $5 million.) Also, Mr. Gore has said he would expand the estate tax deduction allowed under current law for a qualified conservation easement.

Analysis. This Estate Tax revision would provide no relief to the overwhelming percentage of estates consisting of savings in ordinary financial assets and property. It would be a small step in the right direction in that it would reduce the burdens caused by the Death Tax in some cases involving family businesses. The number helped would be very limited, however, because the numerous tests that must be met in order to claim the QFOBI exemption disqualify many small family-owned businesses and farms. (By contrast, Governor Bush's tax plan calls for gradual repeal of the Death Tax for all estates.)

This Estate Tax revision would provide no relief to the overwhelming percentage of estates consisting of savings in ordinary financial assets and property... The Death Tax ... should be repealed, not trimmed around the edges.

The Death Tax causes such severe problems that it should be repealed, not trimmed around the edges. The death tax reduces saving and investment because it retaxes at extremely high marginal rates savings that have already been taxed, usually multiple times, or that will be subject to income tax in the future. Every cent in an estate is either ordinary saving that has been subject to payroll and/or individual and corporate income taxes, or is tax-deferred IRA or pension saving that will be subject to the heirs' income taxes after distribution from the estate. Similarly, the death tax reduces work effort by the usually extremely productive people who expect to leave taxable estates.

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%. To avoid these staggering marginal tax rates on savings left to heirs, people who might leave taxable estates tend to save less and consume more during life. They also tend to work less in their later years and to retire earlier than otherwise once they have accumulated assets large enough to trigger the tax, because earning more to add to the estate would be nearly futile.

With less saving, investment, and work effort due to the Death Tax, production, incomes, real wages, and living standards are lower than they could be. 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.[31]

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[31]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 extremely complicated to prepare, and anticipation of the tax pushes many people into estate-tax planning, which is itself very time consuming, cumbersome, and expensive.

Ironically, the current Death Tax probably decreases total federal revenues. The tax itself brings in about 1.5% of federal revenues. However, it depresses other taxes by weakening the economy and because the estate-tax planning it motivates tends to shift assets and subsequent income from those assets from people in higher tax brackets to people or organizations that are in lower tax brackets or are tax exempt. Eliminating the tax would be rewarded by gains in productivity, tax simplification, and possibly even government revenues.

Congress voted in 1999 to gradually repeal the death tax, and it again voted for repeal this year (H.R. 8). The President vetoed both efforts.

Permanent R&D Tax Credit

Description of Proposal. The R&D Credit is a temporary credit that was last renewed at the end of 1999 (after several months in limbo) and is scheduled to expire again in 2004. Vice President Gore proposes to make the credit permanent. He also suggests making it partially refundable for small businesses without sufficient tax liabilities to claim it.

Analysis. Although the R&E credit is a "tax expenditure", there is much evidence that it is money well spent. A number of econometric studies have found that the economic gains provided by the credit exceed the taxes it costs the government. The reason is that R&D spending brings substantial spillover benefits to the rest of the economy that are not fully captured by those who do the research. Hence, businesses tend to carry out too little R&D. By encouraging businesses to undertake more R&D spending, the credit raises R&D closer to its socially optimal level.

Because 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.

There is strong bipartisan support for retaining the credit, and Governor Bush also calls for making it permanent (although not refundable).

Tax Credits And Savings Plans for Higher-Education and Vocational Training Costs

Description of Proposals. The tax code currently includes a number of special credits and savings plans for education. Interest on certain U.S. Savings Bonds is excludable from income if used for qualified higher education expenses. The Taxpayer Relief Act Of 1997 established Education IRAs. (Like Roth IRAs, contributions are made with after-tax funds and qualified withdrawals are not taxed.) The same act created a special above-the-line tax deduction (available whether or not the taxpayer itemizes other deductions) for certain interest repayments on qualified student loans. The 1997 act also established two tax credits for higher education and vocational training costs that were strongly supported by the Clinton-Gore Administration: the Hope Scholarship Tax Credit and the Lifetime Learning Tax Credit. There are also a variety of government education assistance programs. The rules governing these tax and spending provisions are complicated, and numerous interactions among the provisions add further complexity. For example, allowable expenses are not the same for all the provisions, using one provision may limit or block the use of another, and taxpayers lose the use of the provisions as their incomes rise, with different phaseout procedures for different provisions.

[T]he College Opportunity Tax Cut is too complicated, but its recognition of education expenses as deductible for tax purposes can be justified... [But] it would be good tax policy to replace the present maze of overlapping, often conflicting tax provisions regarding education costs, as well as Mr. Gore's proposed rules, with a saving-neutral account for education (and ideally other types of saving). To the extent that education expenditures are ... investments in human capital ... they should qualify for a tax deduction.

Vice President Gore suggests adding several new provisions for higher-education and vocational training costs. The College Opportunity Tax Cut, which is based on an Administration proposal, would allow a 28% tax credit for up to $10,000 yearly of a family's higher education and vocational training costs (i.e., up to a $2,800 yearly tax credit for a family). But examples provided by the Gore campaign indicate that the proposal would be used in lieu of other education incentives, not in addition to them; the actual effect for many beneficiaries would be to add only an 8% tax credit to the existing 20% Lifetime Learning Tax Credit. The College Opportunity Tax Cut would be phased out for joint filers with adjusted gross incomes (AGI) between $100,000 and $120,000 (phased out for single filers over the $50,000 to $60,000 AGI range.) A new 401(j) account would allow employers and individuals to establish savings accounts for higher education and vocational training costs of employees and families of employees. The funds in the accounts would not be taxed, and withdrawals would not be taxed either if used for qualified education expenses. Contributions would be limited to $2,500 yearly. These accounts would be phased out for families with incomes above $150,000. A so-called National Tuition Savings plan would "link together existing college savings and prepaid tuition plans ... and use incentives to encourage states that do not have programs to create them" so that funds contributed in one state could more easily be used in another.[32] A fourth proposal would give employers a tax credit of up to $6,000 per worker "for worker training in information technology and other technology skills."[33]

[32] Gore 2000, "Al Gore's Education Blue Book," accessed at www.algore2000.com.

[33] Gore 2000, "Gore Would Help Workers Gain New Skills For New Economy," accessed at www.algore2000.com.

Analysis. Current law in this area is extremely complicated. Mr. Gore's proposals would append new layers of complexity. If consistent, principled tax rules were followed, most of this complexity could be dispensed with. To avoid the basic income tax bias against saving, the saving stream should be taxed at only one point: either defer tax on contributions and tax withdrawals or tax contributions and do not tax withdrawals. Thus, a qualified savings account for education that takes the approach of either a deductible IRA or a Roth IRA is justified. Further, because it is wrong deliberately to perpetuate the anti-saving bias for certain groups of individuals, the saving-neutral education account should not be phased out with rising income (i.e., it should not be denied to middle-class and upper-income taxpayers.) It would be even better on tax-neutrality grounds — as well as simpler — if the government did not limit the account to certain types of saving meeting various Washington-knows-best tests but opened the account to all saving.

With regard to education expenses, a case can be made that they are investments in human capital and, like investments in physical capital, are intended to generate future income. Because income is a net concept (revenues minus costs incurred in producing those revenues), investments need to be deducted in order to measure income accurately. That applies just as much to investments in human capital as those in physical capital. A complication that may warrant some limitation on the deductibility of education costs, however, is that people also have non-income-related motivations for learning, including social prestige and personal enjoyment. Nonetheless, a deduction for some portion of education outlays is theoretically sound. Although a deduction is appropriate, a credit is not. Except by chance, a credit will either be too large (if the credit rate is higher than the person's tax rate) or too small (if the credit rate is lower than the person's tax rate).[34]

In short, it would be good tax policy to replace the present maze of overlapping, often conflicting tax provisions regarding education costs, as well as Mr. Gore's proposed rules, with a saving-neutral account for education (and ideally other types of saving). To the extent that education expenditures are believed to be investments in human capital, not motivated by non-income-related objectives, they should qualify for a tax deduction.

Based on this analysis, the College Opportunity Tax Cut is too complicated, but its recognition of education expenses as deductible for tax purposes can be justified. Provided only one family member is in college, the $10,000 limit on yearly expenses might also be defended as a very rough

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[34] For instance, suppose a person spends $100 on education to generate $150 of revenue and that the person is in the 36% tax bracket. The net income in this case is $50 ($150 revenue - $100 cost), and tax on that $50 of income, assessed at a 36% rate, should be $18. A deduction will produce the correct result. (This example abstracts from the importance of time. Because time has value, an additional requirement is that the cost be deducted when it occurs and the revenue be added to the tax base when received. Allowing costs to be written off when incurred is known as immediate write-off or expensing.) Suppose, however, that the government provides a 20% education credit, instead of a deduction. The person will then compute tax on the $150 of revenue (36% of $150 revenue = $54) and subtract the credit on the $100 cost (20% of $100 cost = $20). The result will be a tax bill of $34 ($54 - $20), which is almost twice as high as the $18 it should be. If the person's tax rate were 15%, the credit remained 20%, and the calculations were repeated, the result would be a $5 subsidy (assuming the person has other income for the credit to offset or the credit is refundable).

adjustment for income-related versus non-income related benefits of an education. But if more than one family member has higher education expenses during the year, Mr. Gore's proposed limit, which is for the entire family, is likely too low; it should be raised. The use of a credit rather than a deduction is troublesome; a deduction would more accurately measure net income (income less the cost of earning income) and provide the correct tax base. Mr. Gore's unstated objective with the credit may be to redistribute income. For taxpayers in the 15% income tax bracket, the 28% credit would provide a 13% tax subsidy for every dollar of qualified expenses (13% tax subsidy = 28% credit rate - 15% tax rate). If it is desired to provide a subsidy, that should be done through an explicit spending program unless it is carefully determined that there are strong advantages to using a tax program. The phaseout, although it also helps redistribute income, is bad tax policy. First, if a principled decision is made to recognize education costs as deductible when determining taxable income, everyone with valid education costs should be eligible. Second, the phaseout would produce a very large marginal tax rate spike over the phaseout range, 14 percentage points on top of the regular marginal tax rate, if the $2,800 credit is phased out over a $20,000 income range.[35, 36] That is a nasty work and saving disincentive. Third, the phaseout calculation would be complicated.

The Vice President's proposed tax credit of up to $6,000 for information technology training is based on the crucial hidden assumption is that too few people are entering the field... [T]he Vice President is assuming that he can pick winners and loses among occupations better than individual workers and the free market system.

Likewise, the proposed 401(j) education savings account can be regarded as a prefunded deduction for higher education and vocational training costs. Based on the prior analysis, that combination can be defended. But the prior analysis also indicates that yearly contributions should not be capped and account eligibility should not be phased out with rising income.

The stated goal of the National Tuition Savings plan is laudable: facilitating portability from one qualified state tuition plan to another. But too little is known at present about the provision's actual details to be able to assess it at this time.

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[35] For example, suppose a couple both work, one earning $70,000 and the other $40,000, to send a child to college. The combination of the regular income tax (this couple and other taxpayers affected by the phaseout would most likely be in the 28% tax bracket), the phaseout spike, and the combined employee and employer shares of the payroll tax (adjusting for the deductibility of the employer share of the payroll tax) would produce an effective marginal tax rate of almost 55%.

[36] Mr. Gore may intend to phase out in sequence the 20% Lifetime Learning Tax Credit and the extra 8% added by the College Opportunity Tax Cut. If so, the marginal rate spike would not be as high but would affect more people over a longer income range.

The Vice President's proposed tax credit of up to $6,000 for information technology training is based on the crucial hidden assumption is that too few people are entering the field, despite the widespread perception that it is an exciting new area with rich job opportunities and despite the presence of many accessible (and widely advertised) training programs. Stated somewhat differently, the Vice President is assuming that he can pick winners and loses among occupations better than individual workers and the free market system. (With the credit's narrow job targeting, Mr. Gore is also assuming he can pick the most important category of technology of the future.) There is no reason to believe the Vice President's assumption is correct. If an appropriate number of people are already obtaining information technology training (and it is a popular field), a government program that encourages more to do so would actually misallocate labor and be harmful rather than beneficial.

Expand The Child And Dependent Care Tax Credit

Description of Proposals. Current law permits taxpayers to claim a credit for child care costs of children under age 13 (and care costs of other qualifying persons), if "the care was provided so you (and your spouse if you were married) could work or look for work."[37] Allowable care expenses are limited to no more than $2,400 for one qualifying child (or other qualifying person) and $4,800 for two or more qualifying persons. The tax credit, which is subtracted from tax liability, is a percent of allowable expenses, with the percent depending on adjusted gross income. The percent is 30% of allowable expenses if AGI on the tax return is below $10,000, falls from 30% to 20% as AGI rises from $10,000 to $28,000; and is 20% if AGI is above $28,000. (The maximum tax credit is 30% of $2,400 = $720 for one qualifying person and 30% of $4,800 = $1,440 for two or more qualifying persons.) Vice President Gore says he would raise the credit, as a percent of allowable expenses, to 50% for families with AGIs below $30,000. (The maximum tax credit would be 50% of $2,400 = $1,200 for one qualifying person and 50% of $4,800 = $2,400 for two or more qualifying persons.) Mr. Gore would phase down the matching rate from 50% to 20% as AGI rises from $30,000 to $60,000. The matching rate would be 20% for everyone with an AGI above $60,000, which would be unchanged from current law.[38] He would also make the credit refundable, meaning the U.S. Treasury would pay the tax filer if the credit exceeds income tax liability. (For example, if the credit is $2,400 and the family's pre-credit income tax is $400, the family would receive a $2,000 government check.) In addition, if a child is under age one, Mr. Gore would give stay-at-home parents a $500 tax credit for "assumed [job-related] child care expenses".

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[37] Internal Revenue Service, "Instructions For Form 2441: Child And Dependent Care Expenses, 1999," accessed at www.irs.gov.

[38] The phasedown is explained in See Gore/Lieberman, Inc., *Prosperity For America's Families, op. cit.*, Chapter 7. Earlier descriptions of the proposal had misleadingly indicated that the phasedown would not begin below an AGI of $60,000. For example, see Gore 2000, "Al Gore's Issues: Children And Families, Agenda," accessed at www.algore2000.com., where it says, "[F]or families earning up to $60,000, Al Gore proposes to increase the maximum level of the CDCTC [Child And Dependent Care Tax Credit] from 30 percent to 50 percent."

Analysis. As explained earlier, income is not gross revenue; it is revenue minus the costs incurred in generating the income. When a person must purchase care for a child or other qualifying individual because the person is working, the cost of the care is a job-related expense and needs to be deducted in order to measure income correctly. For instance, if a single parent needs to buy $5,000 of child care services in order to work, earns $45,000 on the job, and has no other work-related expenses, the person's true (net) income is $40,000. If the child care expense were disallowed, the person's income would be overstated and the person would be overtaxed, thereby discouraging the person from working as much.

Because Mr. Gore's [child-care-credit] proposal would not increase the allowable expense ceilings, as many taxpayers as before would find that they could not claim the child care costs attributable to their marginal hours of work. Those taxpayers would continue to be overtaxed at the margin and they would continue to have a tax reason to work fewer hours.

Current law is deficient in three respects. First, the limits of $2,400 and $4,800 are unrealistically low: workers must often spend much more than that in order to obtain adequate child care. While limits may be appropriate in order to distinguish between reasonable and extravagant child care services, the current limits are blatantly inadequate. They were last increased during the Reagan Administration as part of the Economic Recovery Tax Act Of 1981. Because the limits are so low, many workers receive no tax adjustment on the child care costs made necessary by their last hours of work. Hence, at the margin, their work-related expenses are disallowed, their incomes are exaggerated, and their effective marginal tax rates are higher than their statutory tax rates. Consequently, they tend to work fewer days or shorter hours than if their incomes were measured accurately. Second, the use of a credit rather than a deduction is too generous when the credit rate exceeds the worker's tax rate (workers in the 15% bracket are the main beneficiaries) but too miserly when the credit rate is below the worker's tax rate (workers in the 28% and higher tax brackets are the losers). Third, the phase down of the credit rate is complicated and generates an effective marginal tax rate spike of up to 2.67 percentage points throughout the phase-down income range. (The maximum credit drops from $1,440 to $960 over the $10,000 to $28,000 AGI range.) The appropriate reforms would be to replace the credit with a deduction, raise the expense limits, and not phase down the credit.

Because Mr. Gore's proposal would not increase the allowable expense ceilings, as many taxpayers as before would find that they could not claim the child care costs attributable to their marginal hours of work. Those taxpayers would continue to be overtaxed at the margin and they would continue to have a tax reason to work fewer hours. The higher credit rates would lower the total tax bills (i.e., the average tax rates) of taxpayers with AGIs under $60,000 (the biggest gainers would be those with incomes under $30,000). However, the phase-down would raise marginal tax rates. Thus, the larger credit would encourage people to take a job, but discourage those within the phase-down range from working longer or harder at it. The phase-down would begin at a higher AGI, but it would affect more taxpayers than currently: based on 1997 data, there are about 40% more taxpayers claiming the credit in the $30,000 to $60,000 range than in the $10,000 to $28,000 range.[39] For the taxpayers affected by the phase down, the marginal tax rate spike would also be greater than currently: up to 4.8 percentage points throughout the phase-down income range.

As for Vice President Gore's proposal to make the credit refundable, it is at odds with the principle behind the provision, which is to measure income correctly so that workers are not charged too much income tax. If a worker is paying no income tax, no income tax relief is needed. Providing a government check for those with no income tax liability would turn the credit into a delivery vehicle for a government subsidy. Similarly, Mr. Gore's proposal to give a $500 tax credit to stay-at-home parents who have a child under age one is inconsistent with the principle of adjusting for *job-related expenses* in order to measure income correctly. It, too, would be a tax subsidy.

Health-Insurance-Related Tax Proposals

Description of Proposals. Vice President Gore proposes to offer five groups a refundable tax credit for 25% of health care premiums. He would expand the government's Children's Health Insurance Program (CHIP) by allowing families above 250% of the poverty level to enroll uninsured children in CHIP; those who accepted would receive the refundable tax credit to cover 25% of the government program's premiums. He would also expand CHIP by allowing parents of CHIP- or Medicaid-eligible children to buy into CHIP; again, those who accepted would receive the 25% tax credit. He would expand Medicare by allowing uninsured individuals ages 55 to 65 to buy into Medicare, with the tax credit covering 25% of their Medicare premiums. Small businesses that joined qualified purchasing coalitions would receive the tax credit for 25% of the premiums on the health coverage they provided their workers. Individuals without access to employer-provided health insurance would receive the refundable tax credit for 25% of premiums on individual policies they buy.

Analysis. Since World War II, when it was used as a loophole in government wage controls to attract more workers to the war effort, employer-provided health insurance has been a tax-free fringe benefit, with no tax on either premiums or claim payments. This is favorable tax treatment compared to most other forms of compensation. A partial deduction for health insurance has been extended to the self-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

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[39] See David Campbell and Michael Parisi, "Individual Income Tax Returns, 1997," Internal Revenue Service, *SOI Bulletin*, Fall 1999, Table 2.

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.

Mr. Gore's proposed expansion of government health-financing programs ... would reduce the role of the private sector in favor of less efficient, less responsive government spending programs.

In an ideal world, the employer-paid health insurance premium would be treated either as 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 fewer 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.

Mr. Gore's proposed expansions of CHIPs and Medicare, which would increase the government's control and financing of health care at both ends of the age distribution, are consistent with Mr. Gore's stated goal of nationalizing health care financing in the United States a step at a time, if he cannot do it all at once. (The Clinton-Gore Administration has emphasized the gradual approach, also known as the salami-slice strategy, since its failed attempt in 1993-1994 to nationalize health care financing in America with one stroke.) Increased government involvement with health care financing raises many concerns. Government rules and regulations in its medical programs are complex, rigid, arbitrary, and slow to respond to advances in treatment. That combination often raises costs while lowering the quality of care. In countries where health care has been nationalized — that is, politicized — the emphasis tends to be on frequently-used, low-cost services (appealing to many voters) rather than on less-common, high-cost, life-saving treatments at which the United States is the world leader; waiting lines for expensive treatments are long; and price controls, which reduce service availability and discourage expenditures on research, are common. (Medicare already has de facto price controls and Medicaid has tighter ones, which explains why many doctors decline to see Medicaid patients and why nursing homes are increasingly reluctant to admit seniors with high medical needs.) Thus, a general criticism of Mr. Gore's proposed expansion of government health-financing programs and the attached 25% premium credit is that they would reduce the role of the private sector in favor of less efficient, less responsive government spending programs. A specific criticism of Mr. Gore's proposed Medicare expansion is that the out-of-date Medicare program is already in financial trouble, and adding new coverage would make it worse, particularly because the people aged 55-65 most likely to join would be those with the highest costs.

Because the 25% tax credit ... for people without employer-provided health insurance ... would be open ended, it would cut after-tax premium costs at the margin to 75% of real costs, dampening price consciousness and encouraging overspending. A better approach would be to provide tax-based support for the purchase of a basic policy or medical savings account but to cap the assistance so that it would not distort prices at the margin and not encourage the purchase of overly generous and expensive policies.

With regard to the small-business proposal, small businesses should have the freedom to join coalitions for the purpose of trying in the marketplace to negotiate lower, group rates. Mr. Gore has not released enough details about his proposal, however, to know whether it would simply permit voluntary purchasing coalitions to operate, which is reasonable, or whether the coalitions would be vehicles for imposing market-distorting government mandates on small businesses and health insurance providers. The other part of this proposal is the tax subsidy. Its delivery through a 25% open-ended credit (i.e., the more the policy costs, the more the government pays) is troubling. Because the government would be picking up more of the tab at the margin than it does now, the open-ended credit would worsen the current tax bias favoring high-cost, high-benefit policies; it would lessen the concern of employers and workers about prices.

As for the proposed credit for people without employer-provided health insurance, giving them a tax subsidy similar to that already enjoyed by workers with employer-provided health insurance is only fair, but the expanded tax subsidy would subject more health spending to tax-related price and consumption distortions. Because the 25% tax credit would be open ended, it would cut after-tax premium costs at the margin to 75% of real costs, dampening price consciousness and encouraging overspending.

A better approach would be to provide tax-based support for the purchase of a basic policy or medical savings account but to cap the assistance so that it would not distort prices at the margin and not encourage the purchase of overly generous and expensive policies. The health-insurance proposals of Governor Bush show how this could be accomplished.[40]

Are Mr. Gore's Proposed "Tax Cuts" Really Tax Cuts? How That Distorts The Budget Picture.

As mentioned earlier, many of Vice President Gore's "tax cuts" would officially be classified as spending increases in terms of how the government keeps its books. Those provisions involve new or expanded refundable credits. Government budgeteers consider the refundable portion of a credit to be higher spending instead of a lower tax. The logic is that such "refund" checks are payments the government makes to people that are unrelated to the taxes the government has collected from the people. Among the provisions in the Gore plan involving large refundable credits are Retirement Savings Plus Accounts, health-insurance-premium tax credits, the Child and Dependent Care Tax Credit, the After-School Tax Credit, and the Earned Income Tax Credit.[41] Even when Vice President Gore's proposed tax cuts would meet the official definition of tax cuts, many would be closer in intent to spending programs: rather than measuring income more accurately or adjusting taxes for differences in ability to pay, they would subsidize people for participating in various government programs or for otherwise behaving in ways the Vice President thinks they should.

[M]any of Vice President Gore's "tax cuts" would officially be classified as spending increases in terms of how the government keeps its books... [Many others] would meet the official definition of tax cuts ... [but] be closer in intent to spending programs... Structuring de facto spending programs so that they count as tax cuts ... simultaneously understates the growth of government in the Vice President's program and overstates the tax relief.

Structuring de facto spending programs so that they count as tax cuts has major budget implications. For example, if the government finances a $20 billion program with direct outlays, government spending rises by $20 billion and taxes are unchanged. On the other hand, if the

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[40] One of Mr. Bush's recommendations is to expand tax-favored Medical Savings Accounts (MSAs). MSAs protect individuals from having to pay large medical bills while keeping them alert to prices by having them pay small bills. Because claims are not filed on routine outlays, MSAs also have lower administrative costs than traditional employer-provided policies, meaning that less of each premium dollar is spent on paperwork and more is available to cover actual treatment costs. Mr. Bush also proposes to offer people without government- or employer-provided health insurance a Family Health Credit (FHC). It would be a tax credit of 90 percent, up to $2,000, toward the cost of a basic policy (a premium level of $2,222). Two important advantages of the FHC over Mr. Gore's unlimited 25% credit for insurance premiums are that the FHC would meet more of the cost of basic medical coverage and would avoid creating a tax incentive at the margin to buy too much insurance. See Michael Schuyler and Stephen J. Entin, "Towards A Better Tax System: The Bush Plan," *op. cit.*

[41] To the extent these credits offset tax, government budgeteers would classify them as tax reductions. Only the portion in excess of tax (the refundable portion) would officially go on the spending side.

government makes no direct outlays but instead presents people who participate in the program with $20 billion of tax credits, government spending is unchanged while taxes fall by $20 billion. Thus, the clever use of tax credits — of which there are an abundance in the Gore plan — simultaneously understates the growth of government in the Vice President's program and overstates the tax relief.

Confusing Income Redistribution With Tax Relief

Both major candidates designed their tax packages with an eye on income distribution tables.[42] Mr. Bush observed that in his plan the largest percentage reductions in income taxes would go to lower-income people and that his plan would cut to zero the income tax bills of millions of lower income and middle-income families with children.[43] Mr. Gore went much farther than that by demanding that reductions for people at different income levels be comparable in dollar amounts. Using his criterion, he sharply denounced the Bush plan for proposing much larger dollar reductions for people at high income levels than people at low income levels.

> "I will not go along with a huge tax cut for the wealthy at the expense of everyone else and wreck our good economy in the process. Under the tax plan the other side has proposed, for every ten dollars that goes to the wealthiest one percent, middle class families would get one dime. And lower-income families would get one penny... [T]he average family would get about enough money to buy one extra Diet Coke a day... about 62 cents in change."[44]

Mr. Gore's criterion is misleading, of course, because it ignores the dollar amounts of taxes people already pay, which are vastly greater for upper-middle-income and upper-income people than for lower-middle-income and lower-income people. For example, according to the IRS, income tax filers with AGIs between $15,000 and $20,000 had average income tax bills of $415 in 1997, those with AGIs between $75,000 and $100,000 had average income tax bills of $12,420, and those with AGIs between $200,000 and $500,000 had average income tax bills of $71,000.[45] The top half of

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[42] For an excellent discussion of the conceptual and statistical problems of distribution tables, see Jason J. Fichtner, "A Guide To Tax Policy Analysis: Problems With Distributional Tax Tables," Joint Economic Committee Study, January 2000.

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

[44] Vice President Gore, "Democratic National Convention Speech," August 17, 2000, accessed at www.algore2000.com. The 62 cent amount "for the average family" is deceptive, a story in the *Washington Post* points out, both because "it was not based on the average family's income" and because the subgroup of taxpayers on which it was based "already pay very little in federal income taxes." (Glenn Kessler, "In L.A., Truth-Stretching Was Mostly In Check," *Washington Post*, August 19, 2000, p. A8.)

[45] See David Campbell and Michael Parisi, "Individual Income Tax Returns, 1997," Internal Revenue Service, *SOI Bulletin*, Fall 1999. The dollar amounts are taxes after subtracting the EITC, including its refundable portion.

the income distribution paid over 95% of federal income taxes.[46] To implement Mr. Gore's criterion, it would be necessary to enact relief provisions that do not rise with income and tax liability, to take tax relief away from people as their incomes rise, and/or to give some lower-income people refund checks after their income taxes have been cut to zero. Mr. Gore's package contains all these strategies. Consequently, he would give meager income tax relief to people in the top half of the income distribution relative to the income taxes they are now paying and none "at the margin". Hence, the Gore plan would do little to reform features of the tax code that restrict economic output and growth. Under Mr. Gore's approach, progressivity would sharply increase whenever taxes are cut (and based on the proposals he has supported as Vice President, whenever taxes are increased.)[47]

Mr. Gore's package ... would give meager income tax relief to people in the top half of the income distribution relative to the income taxes they are now paying and none "at the margin". Hence, the Gore plan would do little to reform features of the tax code that restrict economic output and growth.

The fundamental issue is that income distribution is a poor guide against which to test tax reform proposals. A distortionary and complex tax provision does not suddenly become neutral and simple because it affects people in one part of the income distribution more than people in another. The correct principle is to aim tax reform at problems in the tax code, rather than at particular parts of the income distribution. The most biased and complicated tax provisions should be improved, even if they are most often seen on the returns of taxpayers in the upper half of the income distribution.

If the worst tax biases and complexities occur at higher income levels, would correcting them help people farther down the income scale? Looking only at distribution tables, one would get the impression that such reforms would not help the poor and lower-middle class, although those reforms would not hurt them either. Distribution tables are misleading, however, for two reasons. They assume that people's incomes are static and that the economy is static, whereas in the real world both income levels and the economy are dynamic and changing. There is tremendous income mobility in the United States. The odds are good that a person who is in the bottom quintile or two of the income distribution today will be in the top quintile or two several years from now. Thus refusing to address a tax problem because it is mainly seen on the tax returns of people with median or higher incomes will directly hurt many of today's low-income individuals several years from now. Second, the performance of the economy is not independent of the tax system. Bad tax policies reduce

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[46] See David Campbell and Michael Parisi, "Individual Income Tax Rates and Shares,1997," Internal Revenue Service, *SOI Bulletin*, Spring 2000.

[47] Mr. Bush's attempt to direct the largest percentage cuts in income taxes to lower-income taxpayers would also increase the progressivity of the tax rate schedule but would still allow for reduced marginal tax rates on all income earners. See Michael Schuyler and Stephen J. Entin, "Towards A Better Tax System: The Bush Plan," *op. cit.*

productivity and slow the growth of output and wages. Correcting those problems allows the economy to be more productive and grow more rapidly. That raises wages throughout the income distribution. Here also, refusing to address bad tax policies because they do not occur in the "right" part of the income distribution will hurt low-income individuals.

A distortionary and complex tax provision does not suddenly become neutral and simple because it affects people in one part of the income distribution more than people in another. The correct principle is to aim tax reform at problems in the tax code, rather than at particular parts of the income distribution.

Waiting For The Other Shoe To Drop: Higher Taxes Needed To Implement Mr. Gore's Agenda

The tax package on which the Vice President is campaigning would, on net, reduce taxes, despite the $178 billion of revenue raisers that Mr. Gore has quietly included in the plan. If Mr. Gore is serious about achieving other goals he has announced, however, the lower taxes would only be temporary; other parts of Mr. Gore's agenda call for large tax increases in the future.

For instance, the Vice President has said he thinks the government should control the financing of health care in America, although he believes it politically necessary to move there incrementally rather than all at once. The problem from a tax perspective is that a government takeover of one-seventh of the U.S. economy would be enormously expensive. It would require huge tax increases. For example, when the Clinton Administration attempted to nationalize health care financing in 1993-1994, its proposed tax increases (most of which it insisted should be called premiums) would have been the largest in U.S. history.[48] (Actual costs would have been higher still because the Administration implausibly assumed that a government takeover would produce substantial cost saving due to the supposed efficiency with which legislators and government bureaucrats manage large programs.) Although Mr. Gore's gradual approach would spread out the tax increase, it would do nothing to reduce its eventual, immense size.

Another financial problem in Vice President Gore's agenda is Social Security. His plan to have the U.S. Treasury create trillions of dollars of IOUs to give to the Social Security Trust Funds would do nothing to increase the real resources available to the government to pay future benefits. Instead, it would lull some people into a false sense of confidence, delay needed reforms, and ensure that the eventual financial crisis will be severe. Mr. Gore would add further strains by increasing benefits for some groups. In the end, Mr. Gore's strategy of papering over Social Security's problems

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[48] See Michael Schuyler, "Monumental Revenue Increases in the Clintons' Health Plan," *IRET Congressional Advisory*, No. 28, March 1994, and Congressional Budget Office, *An Analysis Of The Administration's Health Proposal*, February 1994.

for as long as possible would most likely lead to heavy government borrowing, large benefit cuts, and large tax hikes. In the words of Senator Bob Kerrey (D-KS), the Clinton-Gore proposal to substitute IOUs for real reform "has a great deal of pain ... a hidden pain in the form of income tax increases that will be borne by future generations of Americans."[49]

There is tremendous income mobility in the United States... Thus refusing to address a tax problem because it is mainly seen on the tax returns of people with median or higher incomes will directly hurt many of today's low-income individuals several years from now.

Mr. Gore's environmental positions are a third part of his agenda that sets the stage for major tax increases. In his environmental manifesto *Earth In The Balance*, he declared that "the rescue of the environment" should be "the central organizing principle for civilization."[50] Warning that this will involve "a set of choices as difficult as any in history,"[51] Mr. Gore dismissed "minor shifts in policy, marginal adjustments in ongoing programs, [and] moderate improvements in laws and regulations ... [as] all forms of appeasement."[52] Instead, he said, "our approach to economic policy must be transformed,"[53] and "the emphasis on the rights of the individual must be accompanied by a deeper understanding of the responsibilities to the community."[54] Among the "difficult comprehensive changes [that] are needed,"[55] he announced, is "completely eliminating the internal combustion engine over, say, a twenty-five-year period."[56] According to Mr. Gore, the internal combustion engine — on which much of modern industry and personal transportation depends — is "a mortal treat to the security of every nation that is more deadly than that of any military enemy we are ever again likely to confront."[57] The U.S. government should "take the leading role"[58] in

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[49] *Congressional Record*, March 17, 1999, p. S2788, cited in Senate Budget Committee, "Analysis of Vice President Gore's Proposals," *op. cit.*, p. 12.

[50] Al Gore, *Earth In The Balance: Ecology And The Human Spirit* (Boston: Houghton Mifflin Company, 1992), p. 269.

[51] *Ibid.*, p. 270.

[52] *Ibid.*, p. 276.

[53] *Ibid.*, p. 346.

[54] *Ibid.*, p. 277.

[55] *Ibid.*, p. 270

[56] *Ibid.*, p. 326.

[57] *Ibid.*, p. 325.

[58] *Ibid.*, p. 314.

bringing change to the planet, and among its actions should be "tax incentives for the new [low polluting] technologies and disincentives for the old."[59] Two of the disincentives he recommended are a "CO_2 tax" based on "the carbon content of the fuels produced" and a "virgin materials fee" based on "the quantity of nonrenewable, virgin materials built into the product."[60]

The tax reductions would be smaller than advertised... Moreover, because Mr. Gore's tax targeting bears little relation to existing tax liabilities, many of the people with the heaviest tax loads would obtain meager tax relief from the Vice President's proposals; more than half of taxpayers are outside Mr. Gore's targets and would receive no tax relief.

Given this background, it is unsurprising that Mr. Gore was a vigorous backer of the BTU tax (i.e., energy-use tax) that the Administration tried unsuccessfully to enact in 1993. Nor is it surprising that he supports the unratified Kyoto Protocol, which would require the United States to reduce its emissions of CO_2 by the year 2010 by 35% from the baseline projection, to 7% below what they were in 1990. What is surprising is that Vice President Gore now claims the changes he demands, including elimination of the internal combustion engine, will not be difficult to achieve after all, but easy and almost painless. Technology will do most of the work, he now says, if it just receives a friendly little push from government. "[W]e can clean up pollution, make our power systems more efficient and more reliable, and move away from dependence on others [i.e., foreign oil] — all with no new taxes... In fact, we will cut taxes to help families and businesses buy the clean technology of the future...[T]ax credits can make ... [the new technologies] competitive and then mass production will bring the prices down even further."[61] The carrot of tax credits is still there, but the stick of new taxes is no longer in sight. Even so, the credits would have to be paid for by keeping existing taxes higher than necessary. There is no free lunch.

In fact, while technology has made remarkable progress in the last 30 years in cleaning the air, land, and water, the biggest, easiest-to-make changes were already in place when *Earth In The Balance* was published. If Mr. Gore attempts to implement the transformative changes in people's production and consumption that he previously said should be "the central organizing principle for civilization," he would almost certainly be drawn to the sweeping government regulations and the high new taxes on energy and materials he previously said were necessary. It is not credible that tax credits for purchasing products that would otherwise be too expensive or too unreliable would, by themselves, somehow produce the vast changes he seeks.

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[59] *Ibid.*, p. 320.

[60] *Ibid.*, p. 349.

[61] Remarks as prepared for delivery by Al Gore, Energy Security and Environmental Trust, June 27, 2000, accessed at www.algore2000.com.

Conclusion

The Vice President's tax package would, if enacted in its present form, result in a modest net tax cut, with reductions more than offsetting numerous revenue raisers. The tax reductions would be smaller than advertised, however, because a good share of what the Vice President calls tax cuts would actually be spending increases. Moreover, because Mr. Gore's tax targeting bears little relation to existing tax liabilities, many of the people with the heaviest tax loads would obtain meager tax relief from the Vice President's proposals; more than half of taxpayers are outside Mr. Gore's targets and would receive no tax relief.

Other parts of Mr. Gore's agenda, including delaying real Social Security reform while increasing benefits, moving toward nationalization of health care financing, and implementation of the Kyoto Protocol, would set the stage for large future tax increases.

On the whole, the Vice President's proposals would not reduce tax biases against work, saving, and investment. While some provisions would lessen tax biases, the revenue raisers included in the plan and the plan's many phaseout rules would increase tax biases. Nor would the Gore plan simplify existing tax rules. To the contrary, the introduction of many new and expanded credits, each with detailed tests regarding who qualifies and who does not, would add complexity. The tax increase provisions would bring further complexity. A related shortcoming is that few of the provisions deal with the areas of the tax code that have usually been identified as those most in need of reform; the real emphasis appears to be on income redistribution. Thus, Mr. Gore's plan would miss the opportunity to enact reforms that would create a better tax climate for productivity, growth, and personal freedom. Other parts of Mr. Gore's agenda, including delaying real Social Security reform while increasing benefits, moving toward nationalization of health care financing, and implementation of the Kyoto Protocol, would set the stage for large future tax increases.

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