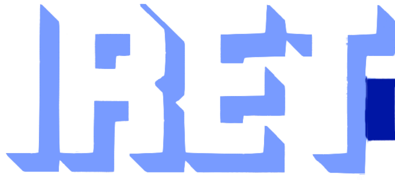

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A PRINCIPLED ANALYSIS OF JOHN KERRY'S TAX PROPOSALS

Introduction and Summary

Senator John Kerry (D-MA) calls for major tax and spending changes if he is elected President. The aim of this paper is to measure Senator Kerry's tax proposals against sound and consistent tax principles, and to determine whether his proposals would help or harm the economy and meet or fail to meet his goals of paying for expanded spending.

Senator Kerry's tax plan combines more aggressive income redistribution with greater use of the tax system to assist various government-favored activities. He would hike taxes sharply on a relatively small number of firms and individuals to finance lower taxes and substantial tax rebates for a much larger number of firms and individuals.

In an effort not to increase the deficit, he seeks to enact tax increases sufficient to pay for his spending proposals. For example, he expects that the revenue raisers directed against upper-income taxpayers will collect an extra $860 billion over 10 years to finance his health care and education initiatives.

Senator Kerry proposes to increase taxation of upper-income individuals and to expand tax credits for lower- and middle-income individuals. He would repeal for people in the top two tax brackets the provisions of the 2001 and 2003 Tax Acts that gave tax rate relief and that provided capital gains and dividend tax relief. He would also repeal the provisions that eliminated the phase-outs of itemized deductions and personal exemptions. He supports continuing the middle-class elements of the tax cuts. He would continue to impose the estate tax on large estates.

Senator Kerry charges that the foreign operations of U.S. companies hurt employment in this country and that loopholes in the tax code encourage those foreign operations. He recommends higher corporate taxes on U.S. companies with foreign operations and reduced corporate taxes for U.S. companies that stay at home.

Although the Senator has promised not to raise most people's Social Security taxes or cut their benefits, he has left the door open to cutting the benefits of seniors who have significant non-Social Security income.

Institute for Research on the Economics of Taxation

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How do these proposals stack up against the fundamental tax principles of neutrality, efficiency, simplicity, and fairness? What would their impact be on the economy?

Senator Kerry's proposed increases in marginal tax rates on upper income workers and on income from capital would repeal those provisions of the 2001 and 2003 Tax Acts that most strongly encouraged economic growth. The repeal would increase existing tax biases against saving and investment, raise the cost of capital, discourage investment, and slow the growth of productivity and wages across the board.

The Senator's international provisions would complicate enforcement and compliance, cripple the ability of U.S. firms to compete abroad, and reduce, not increase, domestic investment and employment.

Curtailment of Social Security benefits for existing retirees who have a comfortable amount of non-Social Security income would constitute a large de facto tax increase on that other income for many seniors who have saved for retirement or who continue to work.

Senator Kerry has used static revenue scoring of his tax proposals, which ignores the adverse economic effects and the tax avoidance behavior that would be triggered, and that would eliminate much of the expected revenue. In particular, his $860 billion in upper income tax increases that he dedicates to his health and education initiatives would fall about $475 billion short of their revenue target.

In addition, according to one estimate, he has understated by more than $600 billion the cost of his health care program during his budget window. Collecting enough additional taxes to pay for the $600 billion-plus cost underestimate would require either extending tax increases to everyone, or drastically raising upper-income taxes, such as by tripling the rate increases he has proposed in the top two brackets, resulting in a top individual income tax rate of nearly 50%. Allowing for the negative economic feedback of his proposed tax increases, the rate increases would have to be several percentage points higher, with a top rate of about 53%.

Senator Kerry is assuming that his proposed tax increases would not cause those being taxed more heavily to work less, save less, or respond in other ways damaging to productivity and growth. This assumption is not valid. Senator Kerry's tax policies would tend to reduce productivity, hurt the job market, weaken United States based businesses internationally, and slow growth. On net, they would harm workers and savers at all income levels, and damage the U.S. economy.

Regrettably, in developing his tax proposals, John Kerry has given short shrift to marginal tax rates and other determinants of tax efficiency, has assumed tax redistribution is equivalent to tax fairness, has neglected the effect of tax shifting on ultimate tax burdens, has brushed aside tax simplification, and has ignored tax transparency.

Principles of sound taxation: a standard against which to judge a tax plan

The basic purpose of taxation is to collect revenue for the government. In carrying out that task, taxes should be designed so that they do not cause unnecessary damage to individuals and the economy. A well designed tax will have several attributes.

One key principle of good taxation is ***neutrality***, by which it is meant that a tax should distort economic incentives as little as possible. When a tax favors one activity over another, it causes people to make economically inefficient choices, which destroys potential output and reduces the value of economic activity. For example, a person who wants to save for the future and sees an attractive investment opportunity may, nevertheless, decide to forgo saving and investment in favor of immediate consumption if the tax system has a bias that penalizes savers relative to consumers. The income tax distorts the labor/leisure choice, because using time to earn income to buy goods and services is taxed, while using time for leisure is not. Marginal tax rates should be kept low to minimize this distortion.

The tax system also distorts the saving/consumption choice. The income tax falls more heavily on income used for saving than on income used for consumption, by taxing the income used for saving when it is earned and then taxing the returns on the saving. By contrast, if the income is used for consumption, there would have be no additional federal tax in most cases, except for a few excises. The remedy for this basic tax bias against saving is to give all saving the treatment accorded pensions and IRAs: either allow a deferral for saving and tax the returns, as in a pension or ordinary IRA; or tax the income saved up front but exempt the returns from tax, as in a Roth IRA or tax exempt bond. Neutral treatment of direct investment in plant, equipment, and structures would be provided by immediate expensing in lieu of depreciation. These steps would create a "consumed income" tax in lieu of the current "broad-based" income tax. In addition, the income tax is imposed a second time on corporate earnings before they are distributed to shareholders, and the estate and gift tax adds another layer of tax to savings that have already been hit repeatedly. The estate and gift tax should be eliminated and the corporate tax should either be eliminated or "integrated" with the personal income tax to tax the income at one level or the other but not both.

Recent tax reductions have reduced tax biases in the income tax by lowering marginal rates, by expanding pension and IRA treatment of saving, by relieving the double taxation of dividends and the capital gains that arise due to retained after-tax corporate earnings, and by moving toward immediate expensing of investment outlays. Steps to extend or expand such provisions move toward tax neutrality. Steps to roll back such provisions increase tax distortions. To be sure, all real-world taxes distort economic incentives to some extent, but the goal is to design the tax so that tax biases are held to a minimum and the economy can operate as efficiently as possible.

Another important objective is ***simplicity***. Tax paperwork costs should be kept low because they are a waste to society: they consume resources that could otherwise be spent on productive activities. The current U.S. income tax system is notorious for the armies of accountants, tax

attorneys, and IRS agents it requires and the billions of hours of taxpayer time it takes away from production and leisure. Some tax complexity is unavoidable, but a rule of thumb is that a simple tax provision should be chosen over a complicated one unless the complicated provision is much better at meeting other desirable tax objectives.

Taxes should also be as ***fair*** as possible. This is an important objective, but a subjective one because fairness, like beauty, is often in the eye of the beholder. Reasonable people can disagree strongly about what they regard as fair. For instance, if the tax base is income, most people would agree that a high-income person should pay more tax than a low-income person. But how much more? One person might believe it would be fair if the tax rises at the same rate as income (known as proportional taxation). Another person might believe the tax should rise faster than income (known as progressive taxation). And for the person who believes progressivity is fair, how much progressivity is enough? At what point does additional progressivity take away so much of the reward for working and saving that it becomes unfair? These concerns about going far enough but not too far are quite different than the assumption often made in media stories that more progressivity is always fairer than less.

An important but often overlooked principle is ***visibility***. Taxes should be highly visible so that citizen/voters can see the cost of government services. Transparency helps citizen/voters make better informed decisions about what level of government and which government services are worth the money. Unfortunately, elected officials often find it politically expedient to enact hidden taxes. For example, all taxes collected at the business level are ultimately paid by people as owners, employees, or customers, but business-level taxes, especially complicated ones, have the political attraction that many people falsely think the taxes are on someone else.

It is also desirable that ***all citizen/voters pay taxes except the very poor***. Exempting large numbers of voters from taxes will tend to result in an inefficiently large government. Voters who do not pay a tax will naturally find it in their self-interest to favor government programs that the tax finances, even if the programs' benefits are small relative to costs. In the last 15 years, both major political parties have ignored this principle and strongly endorsed tax changes that have removed a significant share of voters from the income tax rolls.

Both the tax base (what is taxed) and the tax rate (the rate at which it is taxed) are important in determining whether a tax performs well or poorly in meeting these criteria. For example, the 1986 Tax Act was advertised as improving tax efficiency by reducing marginal tax rates for individuals. To keep the legislation from losing revenue, however, the bill's authors broadened the tax base by scaling back deductions, exemptions, and credits and by expanding the individual and corporate alternative minimum taxes (AMTs). Most of the base broadening applied to income derived from saving and investment. Income used for saving and investment was already being taxed more heavily than income used for consumption. The base broadening actually worsened tax biases against saving and investment and reduced economic efficiency. Further, because many of the changes were extremely complicated and/or involved business taxation, both simplicity and visibility suffered.

To judge how a tax affects efficiency, one should look at the marginal tax rate (the tax on the last unit of the taxed activity), not the average tax rate. Changes are sometimes proposed that would affect the tax on the initial units of the taxed activity but have no effect on the tax bite at the margin (examples are tax rebates and some tax credits). Because such changes do not alter tax biases when a taxpayer is considering whether to undertake more or less of the taxed activity, they have little impact on taxpayer behavior.

The person who pays a tax, either at the individual or business level, is often not the person who ultimately bears the burden of the tax. Taxes are shifted by tax-induced changes in supply and demand. For example, taxes on capital are largely shifted to labor. A capital tax reduces investment, which is very sensitive to its after-tax real return. As the capital stock falls, the value in production of each remaining unit increases, which raises the before-tax real return on capital and partially offsets the tax for capital owners. On the other hand, the tax-driven fall in the capital stock reduces labor productivity because labor has less capital with which to work. Because real wages are largely based on productivity (an employer cannot stay in business if it pays workers more than they add to the value of output), the end result is that real wages fall, and much of the tax is shifted to labor. Discussions of tax fairness often ignore tax shifting and naively assume that the person from whom a tax is collected is the same person who ultimately bears the tax. A recognition of real-world tax shifting can have a dramatic impact on whether a proposed tax change is perceived to be fair or not.

Description of Senator Kerry's tax proposals

Senator Kerry's plan includes tax increases and decreases. The proposals involve personal income taxes, corporate income taxes, the estate tax, and the resurrection of some business taxes that expired in 1995. The suggestion Senator Kerry has floated about altering Social Security benefits would also, in its effect, be a tax change.

Individual and Estate Taxes

<u>Increase rates in the top two individual income tax brackets to 36% and 39.6%.</u> These tax brackets were added at the start of the Clinton Administration in 1993. Their rates were cut to 33% and 35% under President Bush. Senator Kerry's campaign says he intends to take them back "to their levels under President Clinton."[1] Although Senator Kerry describes this proposal (and some of the others mentioned below) as designed to "roll back *only* Bush's tax cuts for those making over

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[1] Kerry-Edwards Campaign, "A Plan To Restore Fiscal Discipline," accessed on the Internet at http://www.johnkerry.com/issues/economy/fiscal_discipline.html. Also see Kerry-Edwards Campaign, "The Kerry-Edwards Plan To Keep Spending In Check While Investing In Priorities And Cutting Wasteful Spending," accessed on the Internet at http://www.johnkerry.com/pdf/pr_2004_0803.pdf. Many proposals are mentioned in multiple campaign documents. Generally, the documents provide little detail, and they often repeat the same few sentences or phrases. These footnotes will cite at least one Kerry-Edwards document mentioning each proposal.

$200,000 a year"[2] [emphasis added], it would actually begin at lower income levels if it were in effect in 2004. Based on IRS tax tables for 2004, it would start at a taxable income of $178,650 for a couple filing jointly, $162,700 for a head of household, and $146,750 for a single filer.[3]

Deny higher-income taxpayers 15% tax rate on capital gains and dividends. The 2003 Tax Act reduced the maximum tax rate on capital gains and dividends to 15%. Senator Kerry says he would repeal that cut "for families making over $200,000 on income earned above $200,000."[4] Under the Kerry plan, the maximum tax rate on qualifying long-term capital gains would rise to 20%; and the maximum tax rate on dividends would jump to 39.6%, which is over 2.5 times its current level. Although the Kerry campaign describes these tax increases as beginning at an income of $200,000 for families, the campaign cites as an authority on its tax plan a study which assumes the higher rates would actually apply to people in the top two tax brackets.[5] If so, these tax increases would begin at taxable incomes (measured in 2004 dollars) of $178,650 for a couple filing jointly, $162,700 for a head of household, and $146,750 for a single filer.

Continue phasing out itemized deductions and personal exemptions by repealing a scheduled tax cut. Since the early 1990s, higher-income taxpayers have been subject to phase-outs of their itemized deductions and personal exemptions. Under the terms of the 2001 Tax Act, these two complicated phase-outs, which are really implicit increases in marginal tax rates, will be repealed over the period 2006-2010. Senator Kerry, however, would nullify this portion of the 2001 Tax Act so that higher-income taxpayers will continue to lose itemized deductions and personal exemptions with rising income. Although these are among the tax increases that Senator Kerry says are targeted to those making over $200,000 yearly, the phase-outs actually begin at much lower income levels in most cases. The itemized deduction limitation starts at an adjusted gross income (AGI) of $142,700 in 2004, and the personal exemption phase-out starts at an AGI of $214,050 for a couple filing jointly, $178,350 for a head of household, and $142,700 for a single filer.[6]

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[2] Kerry-Edwards Campaign, "A Plan To Restore Fiscal Discipline," *op. cit.*

[3] For official income thresholds for tax brackets in 2004, see Internal Revenue Service, Revenue Procedure 2003-85, section 3, accessed on the Internet at http://www.irs.ustreas.gov/pub/irs-drop/rp-03-85.pdf. It is appropriate to use the official income thresholds in deducing where this proposed tax increase would begin because Senator Kerry does not call for changing any of the brackets' income thresholds.

[4] Kerry-Edwards Campaign, "A Plan To Restore Fiscal Responsibility," *op. cit.*

[5] The campaign document is Kerry-Edwards campaign, "John Kerry And John Edwards' Pro-Jobs, Pro-Family Tax Cuts," accessed on the Internet at http://www.johnkerry.com/pdf/pr_2004_0812.pdf. It cites a Tax Policy Center study titled "Senator Kerry's Tax Proposals" and dated April 9, 2004. For an updated version of that study, see Leonard E. Burman and Jeffrey Rohaly, "Senator Kerry's Tax Proposals," Tax Policy Center, revised July 23, 2004, accessed on the Internet at http://www.taxpolicycenter.org/UploadedPDF/1000634_KerryPlan.pdf.

[6] IRS Revenue Procedure 2003-85, *op. cit.*

Retain estate tax for large estates. The 2001 Tax Act gradually scales back and ultimately repeals the estate tax over the years 2002-2010. Senator Kerry proposes to block further reductions in the estate tax rate and freeze to the exemption amount at $2 million, with the result that the estate tax would continue to apply to estates exceeding $2 million.[7] For family businesses and farms meeting certain conditions, the estate tax would apply to estates exceeding $5 million. (The Kerry campaign uses the numbers $4 million and $10 million. That refers to a married couple and assumes both spouses do careful estate tax planning so that each estate can claim the maximum exemption amount.)

Extend middle class tax relief enacted during the Bush Administration. The 2001, 2002, and 2003 tax laws provided substantial tax relief to Americans at the household and business levels. Due to arcane procedural rules in the Senate, most of those provisions will expire on an irregular schedule over the period 2005-2010. The Bush Administration seeks to extend and make permanent much of that tax relief. In September 2004, with the Administration's encouragement, Congress voted to extend several provisions aimed mainly at the middle class that would otherwise have expired at the end of the year, including the $1,000 child credit, enhanced marriage tax relief, the expanded 10% rate bracket, and AMT relief. Senator Kerry endorses retaining those provisions in the earlier tax bills that he identifies as being targeted towards poor and middle class individuals.[8]

Increase the Child Care Tax Credit and make it partially refundable. Currently, this credit, which was substantially increased by the 2001 Tax Act, can be claimed on expenses of up to $3,000 per child and for up to two children. With a maximum credit rate of 35%, the maximum credit is $1,050 per child. (The credit rate declines with rising income; it is 20% for taxpayers' whose AGIs exceed $43,000.) Senator Kerry would increase the maximum expenses on which the credit is computed to $5,000 per child[9], implying the maximum credit would rise to $1,750. His plan would also make this credit partially refundable so that people who do not owe income taxes could claim it, and extend it to in-home parents of infants.

Earned Income Tax Credit (EITC). The 2001 Tax Act simplified the EITC and increased the income threshold at which it begins phasing out for married couples. Senator Kerry indicates that expanding the EITC is part of his agenda and specifically mentions further increasing the income

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[7] The Kerry campaign describes this as a rise in the amount exempt from the estate tax. That would be true if the Kerry proposal took effect in 2004 or 2005, but not in later years. Under current law, the exemption amount is slated to increase to $2 million in 2006, from $1.5 million in 2004 and 2005.

[8] See Kerry-Edwards campaign, "John Kerry And John Edwards' Pro-Jobs, Pro-Family Tax Cuts," accessed on the Internet at http://www.johnkerry.com/pdf/pr_2004_0812.pdf. According to that document, Senator Kerry wishes "to extend the middle-class tax cuts [contained in the 2001, 2002, and 2003 tax bills] and make them permanent."

[9] Kerry-Edwards campaign, "Pro-Jobs, Pro-Family Tax Cuts," *op. cit.*

at which it begins phasing out for married couples.[10] However, he has not provided any numerical details regarding this proposal or other changes he might make to expand the EITC.

College Opportunity Tax Credit. This proposal would establish a new income tax credit for college tuition costs. The credit, which would replace existing but less generous federal tax credits for college tuition costs, would be up to $2,500 per college student per year.[11] (It would be 100% of the first $1,000 of tuition and 50% of the next $3,000.) The credit could be claimed for up to four years of college. Unlike existing college tuition credits, this one would be refundable, meaning that someone who does not pay income tax or owes less income tax than the credit could, nevertheless, claim the credit and receive a check from the government through the income tax system. This credit would presumably be phased out with rising income, as are the current Hope Scholarship and Lifetime Learning credits, but the documents released by the Kerry campaign do not provide details.

Health insurance tax credits for individuals. Certain individuals who agree to purchase the "Congressional Health Plan" that Senator Kerry proposes could obtain partially refundable income tax credits to cover a portion of their premiums. If their income is less than 300% of the poverty level, people ages 55-64 would be eligible for a 25% credit . People between jobs would be eligible for a 75% credit if their income is less than 300% of the poverty level. Some other workers would qualify for a credit limiting their premiums to 6% of income if they are below the poverty level and no more than 12% of income at 300% of the poverty level.[12]

Business Taxes

International taxation. U.S. owned businesses usually do not pay U.S. tax on the income of foreign subsidiaries as long as the income stays abroad. They must pay U.S. tax on the foreign income, though, if they bring it into this country (repatriate it). The tax owed to the United States is reduced by a credit for income taxes paid to foreign governments on the income. Senator Kerry claims that deferring U.S. tax until the foreign-source income is repatriated is a tax loophole and that it encourages U.S. companies to move operations abroad. He proposes to end deferral on future foreign income.[13] (U.S. owned businesses could continue deferring U.S. tax on previously earned foreign income. Also, as an exception to the new rule, deferral would still be permitted if a subsidiary of a U.S. owned business produces in a foreign country for sale in the same foreign

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[10] See, for example, Kerry-Edwards campaign, "John Kerry And John Edwards' Opportunity Agenda," accessed on the Internet at http://www.johnkerry.com/pdf/pr_2004_0722.pdf.

[11] Kerry-Edwards campaign, "John Kerry And John Edwards' Pro-Jobs, Pro-Family Tax Cuts," *op. cit.* Based on the limited information the Kerry campaign has released, it is not clear whether the Lifetime Learning Credit would remain available in cases where the new credit could not be used.

[12] Kerry-Edwards campaign, "Pro-Jobs, Pro-Family Tax Cuts," *op. cit.*

[13] Kerry-Edwards campaign, "The Kerry-Edwards Pro-Jobs Tax Reform Plan," accessed on the Internet at http://www.johnkerry.com/pdf/tax_reform.pdf.

country.) To encourage speedy repatriation of past foreign income and raise revenue, Senator Kerry would offer U.S. owned businesses a one-year window in which they could bring past foreign-source income into this country at a reduced tax rate of 10%, provided the income is in excess of what the business normally repatriates and is directed into U.S. investment. The Senator would raise additional revenue by changing the U.S. tax treatment of corporate inversions and unidentified international business transactions he characterizes as tax loopholes.

Lower the corporate income tax rate. The corporate income tax rate is currently 35%. Senator Kerry says he would use the revenues from his proposed changes in international taxation to reduce the corporate tax rate by 1.75 percentage points, to 33.2%.[14] (The Kerry campaign often describes this as a 5% reduction, meaning it is 5% of the 35% rate.)

Tax credit to small businesses for certain health insurance provided to employees. If small businesses offer their employees the "Congressional Health Plan" that Senator Kerry proposes and pay at least 50% of the premiums, they could qualify for a new refundable tax credit. The tax credit would be a maximum of 50% of the small businesses' payments for their low- and moderate-income employees.[15]

Zero percent capital gains tax rate for qualifying investments in small businesses held at least 5 years.[16] Current law already provides a partial tax exclusion for long-term gains on certain small business stock (Internal Revenue Code, section 1202). Although Senator Kerry provides too few details to be sure, a reasonable guess is that he is referring to the existing provision and would increase the exclusion to 100%.

New Jobs Tax Credit. This temporary (2005 and 2006) tax credit would pay the employer's share of payroll taxes for additional employees that a firm hires in the United States above a firm-specific employment baseline. To qualify, a business would have to be a manufacturer, a small business, or classified as affected by outsourcing.[17]

Broadband Tax Credits. This proposal envisions two temporary (5 year) tax credits. One would be a 10% tax credit for broadband investments in rural and inner-city areas. The other would be

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[14] Kerry-Edwards campaign, "The Kerry-Edwards Pro-Jobs Tax Reform Plan," *op. cit.*

[15] Kerry-Edwards campaign, "Pro-Jobs, Pro-Family Tax Cuts," *op. cit.*; Kerry-Edwards campaign, "A Plan For Stronger, Healthier Businesses," accessed on the Internet at http://www.johnkerry.com/issues/v health_care/business.html; and Kerry-Edwards campaign, "John Kerry's Plan To Make Health Care Affordable To Every American," accessed on the Internet at http://www.johnkerry.com/issues/ health_care/health_care.html.

[16] Kerry-Edwards campaign, "John Kerry's Plan To Create Millions Of High-Wage Jobs In The Industries Of The Future," accessed on the Internet at http://www.johnkerry.com/pdf/pr_2004_0624b.pdf. In most cases this exemption would be claimed when filing the individual income tax, but it is so closely linked to a certain type of financing for certain businesses that it is listed here as a business tax.

[17] Kerry-Edwards campaign, "Pro-Jobs, Pro-Family Tax Cuts," *op. cit.*

a 20% tax credit for "next-generation" broadband investments (i.e., operating at much higher speeds than current broadband).[18]

Extend the R&D Tax Credit. Part of Senator Kerry's plan is to "work with the Congress to find a way to pay for extending [the credit] ... with the goal of making it permanent."[19]

"Green" tax incentives. The Kerry campaign describes its energy plan as including "tax incentives for the purchase of hybrid cars, energy-efficient building equipment, and to help auto plants transition to build more fuel efficient vehicles."[20] It calls for extending until 2020 the tax incentive that subsidizes the use of ethanol in gasoline. Further, it advocates a 5-7 year extension of the renewable-resource electricity production tax credit with the credit's expansion to the "full array of renewable technologies" (as part of an effort to generate 20% of electricity from renewable sources by 2020). The Kerry campaign also recommends tax credits for new clean-coal power plants.

Resurrect "Superfund" taxes. Before they expired in the mid 1990s, there were two "Superfund" taxes. One was an excise tax assessed on petroleum, chemicals, and certain imported substances. The other, additional "Superfund" tax was a levy of 0.12% on a company's taxable income, with income computed according to the rules of the alternative minimum tax (AMT) subject to certain modifications. Every company whose modified AMT income exceeded $2 million had to pay this "Superfund" tax. Senator Kerry is a longtime supporter of these taxes, and he wants to reinstate them and use the revenue to help pay for some of his spending initiatives.[21]

Raise business taxes by $75 billion over 10 years by changing the tax treatment of certain activities deemed to be tax shelters or loopholes. Under this heading, the Kerry campaign lists changes that are estimated to increase business taxes by $20 billion over 10 years (the main one would "codify the economic substance doctrine"), but the campaign has not identified any of the "additional tax loopholes" on which it says the government should raise another $55 billion.[22]

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[18] Kerry-Edwards campaign, "Pro-Jobs, Pro-Family Tax Cuts," *op. cit.*

[19] Kerry-Edwards campaign, "Create Millions Of High-Wage Jobs In The Industries Of The Future," *op. cit.*

[20] Kerry-Edwards campaign, "Pro-Jobs, Pro-Family Tax Cuts," *op. cit.* For a listing of the main "green" provisions, see Kerry-Edwards campaign, "The Kerry-Edwards Energy Plan: Making America Safer Stronger And More Secure," accessed on the Internet at http://www.johnkerry.com/pdf/pr_2004_0806.pdf.

[21] See Kerry-Edwards Campaign, "Plan To Keep Spending In Check While Investing In Priorities And Cutting Wasteful Spending," *op. cit.*

[22] Kerry-Edwards Campaign, "Plan To Keep Spending In Check While Investing In Priorities And Cutting Wasteful Spending," *op. cit.*; and Kerry-Edwards campaign, "The Kerry Edwards Plan To Honor Work And Family," accessed on the Internet at http://www.johnkerry.com/ issues/economy/workfam.html.

Social Security

Possibility of reduced benefits for those with non-Social-Security income. The Kerry campaign pledges, "As president, John Kerry will not raise Social Security taxes, raise the retirement age, cut benefits *for people that rely on Social Security*, or privatize Social Security. *He will consider making sure that high-income beneficiaries don't get more out than they pay in.*"[23] [Emphasis added.] In short, Senator Kerry's position is that Social Security should remain as it is, except perhaps for higher-income seniors. He provides no details on how much income or wealth a senior would need before he might consider that the person does not merit full benefits.

Economic Analysis of Senator Kerry's tax proposals

A theme running through John Kerry's tax proposals is that the wealthy have received huge, undeserved tax cuts, and that their tax cuts came at the expense of the middle class. In one speech, for example, Senator Kerry declared:

> "When tax cuts for the wealthiest are your only priority, you don't have anything left for middle-class Americans – and it's middle-class Americans who end up paying the largest share. I will be a president who stands with the middle class and stands for fairness... I have a comprehensive economic plan ... And, most importantly, it includes tax cuts that will create jobs and provide relief for middle-class families struggling to make ends meet..."[24]

Before turning to specific tax proposals, it may help separate myth from reality to examine whether this charge is true. The reality is that the 2001, 2002, and 2003 Tax Acts provided substantial tax relief to all income groups, including the middle class. Some of the provisions that lowered middle class taxes were the new 10% bracket, the expanded child credit, the expanded standard deduction for married couples, the expanded 15% bracket for married couples, and the lower capital gains and dividend tax rates (some middle class people do own stock). In a recent study, the Congressional Budget Office (CBO) estimates that, in 2004, the three tax acts will lower the percent of income that the middle 20% of households pays in federal individual income taxes by a third (1.7 percentage points), from 5.2 percent to 3.5 percent.[25] CBO further estimates that

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[23] Kerry-Edwards campaign, "A Plan To Protect And Strengthen Medicare And Social Security," accessed on the Internet at http://www.johnkerry.com/issues/health_care/medicare.html.

[24] Kerry-Edwards campaign, "'A Stronger America Begins at Home: The Path to Prosperity' Kick Off, Remarks of Senator John Kerry," Carson, CA, August 12, 2004, accessed on the Internet at http://www.johnkerry.com/pressroom/speeches/spc_2004_0812.html.

[25] Congressional Budget Office, "Effective Federal Tax Rates Under Current Law, 2001 to 2014," August 2004, Table 4, accessed on the Internet at ftp://ftp.cbo.gov/57xx/doc5746/08-13-EffectiveFedTaxRates.pdf. For a fuller analysis of CBO's results, see Stephen J. Entin and Michael Schuyler, "Congressional Budget Office Study Shows Tax Cuts Helping All, Including The Middle Class," *IRET Congressional Advisory*, No. 179,

in all other years in which the acts are in effect, they will lower both individual income taxes and total federal taxes for the middle 20% of households. With regard to tax shares, CBO estimates that, in 2004, the top 20% of households will pay 82.1% of the federal individual income tax while the middle 20% will pay 5.4%.[26] Looking at changes in tax shares, CBO estimates that in all years in which the acts are in effect, they will lower the share of individual income taxes the middle 20% pays, and in all but one year they will either lower or leave unchanged the share of total federal taxes (income plus payroll and other taxes) the middle 20% of households pays.[27]

In short, the facts directly contradict Senator Kerry's assertion that the 2001, 2002, and 2003 tax relief bills exclude the middle class. The Senator, himself, contradicts his charge that "tax cuts for the very wealthiest Americans are ... [the Administration's] first, second, and only priority"[28] when he refers to the middle class tax cuts included in the 2001, 2002, and 2003 tax bills, says he supports them, and says they should be made permanent (which is a goal of the Bush Administration).

In evaluating the Senator's tax proposals, several general features related to principles of taxation are worth pointing out. The plan seeks to change the distribution of tax liabilities, which is reflected in average tax rates, while ignoring the importance of marginal tax rates, which affect incentives. It is marginal tax rates that relate to tax neutrality and economic efficiency. In the Kerry proposals, the concept of tax neutrality (taxes should distort pre-tax incentives as little as possible for the sake of efficiency) is overlooked, except with regard to international taxation, where it is applied incompletely and incorrectly. Fairness is equated baldly with higher tax bills for upper-income individuals and lower tax bills for middle-income individuals. There is no recognition that people's responses to taxation may shift much of the burden of a tax supposedly on upper-income individuals to lower-income individuals. There is little mention and certainly no emphasis placed on simplification of the tax code. Tax visibility is ignored as an objective.

Individual and Estate Taxes

<u>Increase rates in the top two individual income tax brackets to 36% and 39.6%.</u> Congress and the Bush Administration were on solid economic ground when they reduced these rates. By discouraging work, saving, and investment, high marginal tax rates lead to a weaker economy with less output and lower incomes. Cutting the top two rates had particularly strong pro-efficiency

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September 1, 2004, available on the Internet at ftp://ftp.iret.org/pub/ADVS-179.PDF.

[26] *Ibid.*, Table 2.

[27] *Ibid.*, Table 4. CBO's distributional estimates are static in that they assume there is no tax shifting, and the estimates ignore people's income mobility (between income ranges) over time. When those factors are considered, even tax changes that might appear in a standard distributional analysis to benefit mainly upper-income individuals may actually benefit people at all income levels.

[28] Kerry-Edwards campaign, "'A Stronger America Begins at Home: The Path to Prosperity' Kick Off," *op. cit.*

effects because tax biases are greater in the upper tax brackets than in lower ones. Senator Kerry's proposal to push these rates back up goes in exactly the wrong direction on efficiency grounds.

Senator Kerry defends his proposal as striking a blow for fairness, but his argument falters when one recognizes as fiction the notion that the 2001, 2002, and 2003 tax bills provided tax relief exclusively to the wealthy. Of course, fairness is subjective. If one believes greater progressivity is good or that soak-the-rich taxes are fair taxes, then the Senator's proposal will seem fair and moderate. However, if one believes either that taxes should be proportional or that the current level of progressivity is sufficient, then the Senator's proposal is contrary to fairness. An important additional consideration is that while those in government might like to believe they can dictate who pays taxes, tax-induced changes in behavior can, and often do, shift the ultimate tax burden.[29] For instance, the owner of a successful small business might respond to a rise in the top tax rates by hiring fewer workers and charging more to customers, thereby shifting some of the tax to the poor and middle class. Highly productive professionals might retire early or work less, leading to reduced productivity, wages, and job opportunities for those who work with them. Taxes on the wealthy often hurt the poor and middle class. Is that fair?

Senator Kerry claims this tax increase would be a hefty revenue raiser: $337 billion over 10 years.[30] However, he is forgetting that when a tax reduces market-based incentives to work, save, and invest, it destroys part of the potential tax base by decreasing production, incomes, and jobs. It further lowers the tax base by increasing people's motivation to shift income from taxable to nontaxable forms. Because of those dynamic, negative feedbacks on the tax base, this proposed revenue raiser would collect much less than Senator Kerry estimates. A reasonable guess is that the shortfall would be at least a third, creating a hole in the Senator's budget from this one item of well over $100 billion.

Individuals in these brackets also face a 2.9 percent Medicare tax (employer and employee share) on additional labor income, and state income tax rates of 5 to 9 percentage points on labor income and earnings from saving. Assume 7% as a typical state and local tax rate. These taxpayers currently face a combined marginal tax rate of nearly 43 percent to just under 45 percent on labor income (or nearly 40 percent and 42 percent for capital income). They take home roughly 55 cents to 57 cent per dollar of additional earnings (and about 3 cents more for interest income).

If the tax rates are boosted to previous levels, the combined tax rates will rise to roughly 46 percent and 49.5 percent, and take home pay will drop to 50.5 cents to 54 cents per dollar of additional labor income. These reductions in the amounts kept after tax would represent a drop

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[29] For a detailed explanation of tax shifting, see Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" *IRET Policy Bulletin*, No. 88, September 10, 2004, available on the Internet at ftp://ftp.iret.org/pub/BLTN-88.PDF.

[30] Kerry-Edwards Campaign, "The Kerry-Edwards Plan To Keep Spending In Check While Investing In Priorities And Cutting Wasteful Spending," *op. cit.*

of between 5 and 9 percent in the reward to working (and nearly as much for saving). (Retention of the limitations on personal exemptions and itemized deductions, described below, would add another 1 to 4 percentage points to the tax rates, depending on family size, and reduce incentives further.) Reducing the incentive to earn added income by a given percentage will result in about a third as much reduction in work effort and earnings, lowering reported earnings by about 1.5 to 3 percent for the affected taxpayers. The reaction would be sharper, nearly one for one, with respect to taxable interest income. Consequently, one should expect that these tax increases will lose at least a third of the total static revenue gains predicted for them.

<u>Deny higher-income taxpayers 15% tax rate on capital gains and dividends.</u> Reduced rates under current law attempt to mitigate multiple taxation of the same income. Assets have value because of their expected future income. That future income will be taxed in most cases. Capital gains arise due to changes in the expected discounted value of that future income. Taxing both the future income and changes in an asset's capitalized value due to that future income (the capital gains tax) is multiple taxation. With regard to dividends, they are eligible for a reduced tax rate at the individual level if they have already been taxed at the corporate level. Senator Kerry acknowledged that the tax on dividends is a double tax when he said in December 2002, "We should encourage the measurement of the real value of companies by ending the double taxation of dividends." By 2003, however, he opposed easing the double tax "except in the context of tax reform."[31] Because multiple taxation of the same investment income results in very high cumulative tax rates that discourage saving and investment, reducing that tax bias is good for output, incomes, productivity, jobs, and economic growth. Unless one believes that the same income ought to be taxed multiple times, resulting in prohibitive rates, the capital gains and dividend tax relief enacted in recent years are fair and limiting it for people in the top two rate brackets would be unfair. They are also fair because more saving and investment lead to a larger and newer capital stock, which raises labor productivity and wages. Hence, the benefit is spread throughout the economy and not confined to capital owners. A bonus from capital gains tax relief is that there is much evidence a lower tax rate on capital gains actually increases government revenues (due to more capital gains realizations, higher stock prices, and a generally stronger economy). Under old law, dividends were taxed at a higher rate than capital gains. A bonus from dividend relief is that it promotes good corporate governance by alleviating this tax bias that had encouraged corporate managers to retain earnings even when they could not invest the earnings very productively internally.[32] At several levels, then, Senator Kerry's proposal violates sensible tax principles.

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[31] Quotes from William Saletan and Avi Zenilman, "The Flip-Flops Of John Kerry," *Slate*, September 17, 2003, accessed on the Internet at http://slate.msn.com/id/2088214.

[32] A recent study found evidence the reduced tax bias against dividends is having this effect and over time will boost dividend payouts by 20%. The study also estimated that the recently enacted dividend and capital gains relief together have increased the value of the stock market about 6%. Even if one focuses exclusively on the middle class, that is good news because many middle class people own stock, especially through retirement plans. (See James Poterba, "Taxation and Corporate Payout Policy," National Bureau of Economic Research, Working Paper, No. 10321, February 2004.)

The static revenues of $223 billion over 10 years[33] the Senator is counting on from these provisions are unlikely to be met. A reasonable estimate is that they would collect only half that, falling about $110 billion short. Dividend and capital gains taxes are factored into the price of assets. Lowering these taxes increased stock and property values. Raising them would lower these values, and reduce the amount of capital gains outstanding. Lowering the capital gains rate has also increased realizations of the outstanding gains (trading of assets leading to reportable taxable gains), and lowering the tax rate on dividends has encouraged firms to begin paying or to increase dividends. Raising these tax rates would reduce asset values, reduce gains realizations, and trim dividend payments.

If history is a guide, the capital gains rate increase might reduce revenue rather than raise it. The 1977 Steiger Amendment reduced the capital gains rate effective in 1978, and the 1981 Economic Recovery Tax Act cut the rate that year. These capital gains rate reductions appear to have increased realizations and revenues even at the lower rates. The 1986 Tax Reform Act raised the capital gains rate effective in 1987. Realizations and revenues roughly doubled in 1986 as people sought to avoid the rate increase, but then collapsed, falling below the 1985 level by 1991, and not recovering in real terms to pre-reform levels until 1995. The dividend hike would also not bring in nearly the revenue expected under static analysis. In addition to the adverse responses of the taxpayers, the increase in the cost of capital and the reduction in investment, productivity growth, wage growth, and employment would reduce other income and payroll tax revenue.

Continue phasing out itemized deductions and personal exemptions by repealing a scheduled tax cut. The limitation on itemized deductions for upper-income taxpayers and the phase-out of their personal exemptions are contrary to a variety of tax principles. The effect of these phase-outs is to create a marginal tax rate spike within the income range in which these allowances are being reduced. With higher marginal tax rates, the tax system becomes less efficient. Arbitrarily denying people itemized deductions and personal exemptions merely because of increases in their income is arguably contrary to the principle of tax fairness. The phase-outs are complicated to compute, which conflicts with the goal of tax simplicity. Because the phase-outs operate as stealth tax increases, they also violate the principle that taxes should be as visible as possible. Further, by discouraging the most productive individuals from working and saving as much, they weaken the economy, and that drags down productivity and incomes for everyone else. The drag on economic activity would also hurt the tax base, which means the proposal would collect perhaps $20 billion less than the $69 billion over 10 years[34] that the Senator expects. Senator Kerry's proposal would be a step backward in terms of good tax policy.

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[33] Kerry-Edwards Campaign, "The Kerry-Edwards Plan To Keep Spending In Check While Investing In Priorities And Cutting Wasteful Spending," *op. cit.*

[34] Kerry-Edwards Campaign, "The Kerry-Edwards Plan To Keep Spending In Check While Investing In Priorities And Cutting Wasteful Spending," *op. cit.*

Retain estate tax for large estates. In contrast to Senator Kerry's plan to retain the estate tax for larger estates, basic tax principles indicate that the estate tax should be abolished for all estates.[35] The estate tax exerts a powerful anti-saving bias for several reasons. It is a tax solely on saving (the accumulated value of saving at the time of death). It has very high marginal rates for those who pay it (substantially higher than the marginal rates of the individual or corporate income taxes). It comes on top of up to three previous layers of tax on saving (individual income tax on income when it is earned, individual income tax on returns to saving, and corporate income tax on returns to saving if the saving is invested in corporate equity). It specifically targets the people who contribute the most to the nation's saving pool. And it further reduces saving because an easy way to avoid the tax is just to save less. The estate tax also discourages work effort, if the income from the work is to be saved for the purpose of increasing bequests. In addition, the estate tax is complicated and leads to expensive and time consuming estate-tax planning, with many small business owners reporting that they cannot hire as many workers and invest as much because of those costs. The estate tax is often cited as an obstacle in trying to pass small businesses and family farms from one generation to the next. Given that it retaxes (at a very high marginal rate) income that has already been taxed, a further drawback of the estate tax is that it is unfair tax; it is the epitome of soak-the-rich taxation. Although the estate tax might seem to be paid by only a small minority of taxpayers, it ultimately hurts people at all income levels because the harm it does to saving, investment, and productivity leads to fewer jobs, lower real wages, and less economic growth.

The old estate tax probably cost the government revenue, static revenue estimates notwithstanding. To avoid the tax, parents have given money to children each year to take advantage of the annual exempt amounts, instead of hanging onto the assets until death. This shifts income on the assets from the parents' higher tax brackets to the children's lower tax brackets, costing revenues. In addition, to the extent the tax cannot be avoided, it imposes prohibitive tax rates on added saving and reduces capital formation, which lowers wages and employment. This cuts into income and payroll tax revenues. It is as certain as such things can be that the estate tax has cost revenue rather than increased it. Hence, while Senator Kerry counts on extra tax revenues of $232 billion over 10 years from his estate tax proposal[36], it would probably yield a revenue loss. Keeping part of the estate tax to hurt the rich may play well to class envy, and it may sound like it helps the poor, but it will actually hurt the poor and the government as well as the rich.

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[35] For a detailed discussion of why the estate tax should be repealed, see Stephen J. Entin, "Repeal Of The Estate Tax: Good For The Budget As Well As The Country," *IRET Congressional Advisory*, No. 156, June 26, 2003, available on the Internet at ftp://ftp.iret.org/pub/ADVS-156.PDF.

[36] Kerry-Edwards Campaign, "The Kerry-Edwards Plan To Keep Spending In Check While Investing In Priorities And Cutting Wasteful Spending," *op. cit.*

Extend middle class tax relief enacted during the Bush Administration. These provisions enjoy the strong support of both major political parties. Senator Kerry expresses his support for them.[37] A weakness of these provisions, notwithstanding their bipartisan popularity, is that they mostly reduce taxes on the first dollars of income rather than the last and, therefore, do not lower marginal tax rates. Accordingly, their incentive effects are weak, and they do little to promote efficient choice between labor and leisure or saving and consumption. When these provisions do reduce taxes at the margin, they often remove people from the income tax rolls entirely, which violates the principle that all citizen/voters except the very poor should pay taxes.

Increase the Child Care Tax Credit and make it partially refundable. When a person needs to obtain child care services as a result of working, the child care costs are incurred in order to generate income. For that reason, the costs need to be deducted in order to measure net income accurately. A credit against tax is not the same as a deduction against income, though.[38] If the aim is to measure income accurately (that is, receipts net of expenses incurred in producing the revenues) and then tax that correctly measured income, a credit, except by chance, will produce an adjustment that is either too small or too large. Senator Kerry's recommendation that maximum allowed expenses per child be increased is realistic given child care costs and is a follow-up to the increase contained in the 2001 Tax Act. However, his recommendation that the credit be made partially refundable (if the credit exceeds your before-credit tax, you would be entitled to a check from the government instead of having to pay tax) veers away from using the credit to adjust tax liability for a work-related expense. If a person can receive money from the government, instead of paying tax, by filing a tax return, the "tax" has been transformed into a spending program. For transparency in government, tax and spending programs should be kept separate. The Senator's proposal that the credit also go to in-home parents of infants is inconsistent with the credit's purpose, which is to make an adjustment for a work-related expense when taxing the income from work. If an allowance is provided to in-home parents of infants, the allowance should be enacted as an explicit spending program, rather than hidden in the tax system.

Earned Income Tax Credit (EITC). Senator Kerry's proposal to increase the income range over which the EITC phases out for married couples takes a page from the 2001 Tax Act, which increased the phase-out range for couples, compared to singles, by $1,000. However, the Senator does not say how much of an increase he might seek, and he does not elaborate on his hint about

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[37] Taxpayers in the two top brackets have lower tax bills because of provisions such as the new bottom bracket of 10% and the statutory rate reductions in the middle brackets to 25% and 28%. Senator Kerry does not mention trying to take back those savings through a surtax on income in the top two brackets. If such a phase-out were introduced, it would be economically damaging. It would further push up marginal tax rates for taxpayers in the top brackets, giving those taxpayers yet more of a tax reason to work and save less and further reducing the amount of labor and capital supplied for production.

[38] With a deduction, expenses are netted out to find income, and tax is then computed on income. With a credit, tax is computed on "income" without netting out expenses (that is, tax is computed on a base that overstates true income), and the credit is then subtracted from the tax.

expanding the EITC in other ways. Notwithstanding the lack of details, basic tax principles indicate the Senator is on the wrong track. The EITC should be rethought, not expanded yet again.

When the EITC was enacted in the mid 1970s, it was a modest credit widely seen as partially offsetting Social Security taxes for the working poor. Since then, it has undergone several major expansions with the enthusiastic support of both major parties. The IRS reports that in 2002, 21.9 million income tax filers claimed $38.7 billion in EITC credits, with 88% of that taking the form of refundable credits (i.e., checks from the government to people who do not owe income tax.)[39] This year, an income tax filer with two or more qualifying children can claim an EITC of as much as $4,300, and obtain at least some of the credit up to an income of about $34,500 for a single filer and $35,500 for a married couple.

The EITC has grown so large that its phase-out creates a double-digit marginal tax rate spike over an extended income range for recipients moving towards middle-class incomes, which sends the perverse message to many lower income people that working harder is barely worth it. Although the EITC does draw more people into the workforce over its relatively short phase-in range, it probably deters more work by those in the long phase-out range than it encourages by those at lower levels of income. The credit's large size also creates a significant revenue drain. With most of the credit going as government checks to people who do not owe income taxes, it is primarily a government income-support spending program. It lacks the transparency of a normal spending program, though, because it is delivered through the tax system. Due to the attraction of the EITC's large payments, the fraud rate is very high, and other types of overpayments are also a serious problem. If the EITC remains on the tax side, it should at least be integrated with the child tax credit and the child care tax credit, because the three are mainly directed at people with children; at present, the three tax credits are not integrated.

College Opportunity Tax Credit. Tax deductions are allowed for investments in physical capital because they are expenses incurred to generate future income. (To measure income accurately, expenses must be netted out.) A strong case can be made that similar deductions should be allowed for investments in human capital because those expenses are also incurred (in large part, anyway) to generate future income. As mentioned earlier, a credit provides a less accurate adjustment than a deduction, although both major political parties seem to prefer using a credit. Senator Kerry's recommendation that the credit be refundable is troubling because the credit may then operate primarily as a spending program lodged in the tax system. Government activities will be more transparent if spending programs are labeled as such and the tax system is reserved for collecting revenue. The danger of fraud is also high when a credit is refundable, if the experience with the refundable EITC is any guide.

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[39] In 2002, 19.0 million filers claimed refunds (87% of filers claiming the EITC), and refunds totaled $34.2 billion (88% of total credits). See Internal Revenue Service, "Individual Income Tax Returns, Preliminary Data, 2002," *SOI Bulletin*, Winter 2003-2004, p. 16.

One of Senator Kerry's main arguments for an expanded college tuition tax credit is that the cost of college tuition has been rising rapidly. He charges that the federal government, at least for the past four years, has done little to remedy the problem. Before an audience of college students he said, "It's your tuition and your loans that keep rising and rising every day while this President spends all your money on tax cuts for the wealthy."[40] As discussed above, the accusation that recent tax relief has all gone to the wealthy is factually wrong, soak-the-rich rhetoric. The suggestion that the government has done little to help college students with their expenses is also blatantly contrary to the facts.

An extensive array of government programs exist; a partial list includes, on the spending side, Federal Pell Grants, Federal Supplemental Educational Opportunity Grants, the Federal Work-Study Program, Federal Perkins Loans, Federal Stafford Loans, and PLUS loans, and, on the tax side, the Hope Scholarship Tax Credit, the Lifetime Learning Tax Credit, the above-the-line student loan interest deduction, the above-the-line tuition and fees deduction, the Coverdell Education Savings Account, the exclusion from income of U.S. Savings Bond interest used for higher education expenses, and the exclusion from income of employer-provided education assistance. Indeed, it is likely that this growing array of government benefits has contributed to the rapid climb in college costs. By insulating students from the full costs, they have allowed colleges and universities to charge more than the market would otherwise bear. Another tax credit might slightly lower students' costs, but it is likely to fuel further tuition hikes that will eat up much of the intended benefit. It should also be realized that while the proposed credit might lower college costs for students, it would not lower total college costs (and, as mentioned, might actually raise them); it would merely shift more college costs to the government, where it would create fiscal pressure to raise other taxes or cut other government spending.

Insofar as government education credits and grants exceed the value of a straightforward deduction, they constitute a subsidy for the recipients. Given that higher education greatly increases one's expected lifetime income, a legitimate question regarding fairness is whether government education benefits are in a sense regressive because they are redistributing income from the general population to individuals who may expect higher-than-average lifetime incomes.

Health care tax credits. The health care tax credits that Senator Kerry plans to offer at the individual and business levels (both will be examined here) are part of his sweeping and expensive plan to broaden government financing of health care costs. The credits are intended to encourage people to join the program by subsidizing membership. At the individual level participation would be voluntary. At the business level the decision of whether to join would be made by the employer, which means that employees could be switched into the government program whether they like it or not. The credits would phase out with rising income, which would create a potentially large marginal tax rate spike that would penalize people for additional work and saving within the phase-out income range. The credits would lack visibility in two senses: they would

[40] John Kerry, "College Tour Kick-Off Rally," April 12, 2004, accessed on the Internet at http://www.johnkerry.com/pressroom/speeches/spc_2004_0412.html.

be a disguised spending program packaged as a tax cut, and they would hide from people the full cost of their health care coverage.

Compared to current law, health care tax credits could be an improvement — if designed to give people more personal control and more incentive to shop carefully for cost-effective health care. The current tax system heavily subsidizes employer provided health coverage by making premiums deductible at the business level and tax exempt at the individual level. That tax subsidy creates a bias towards expensive health care plans and makes millions of workers dependent on their employers for coverage. Health Savings Accounts (HSAs) are an example of an alternative that still furnishes a tax subsidy for health care but encourages greater price awareness by patients. HSAs are high-deductible policies that provide financial protection against catastrophic medical costs but, because they do not cover the first dollars of coverage, show patients the full costs of routine treatments and procedures.

Unfortunately, Senator Kerry's plan provides no incentives for more careful shopping at the individual level. Nor would features like seeking to enroll most children in troubled State Medicaid and Medicaid-like programs increase personal control. The overall health care plan does project some large costs savings, but they come from such improbable items as assuming that health care providers will save billions of dollars annually by being forced to switch to government mandated electronic recordkeeping. If cost savings like that really existed, health care providers would already have switched without needing a government order to do so. The Kerry campaign is using a cost estimate prepared by Kenneth Thorpe, formerly with the Clinton Administration and now at Emory University, which concluded that many of the hypothesized savings could be realized and estimated the program's 9-year cost would be $653 billion.[41] However, a team of researchers led by Joseph Antos, formerly with the Congressional Budget Office and now at the American Enterprise Institute, concluded in another study that the plan would be more than twice as expensive — $1.5 trillion over 10 years.[42] If the higher cost estimate is more realistic — and new government entitlement programs have a history of costing much more than their proponents initially promise — that would open a huge gap in Senator Kerry's budget plan and would likely lead to a combination of aggressive price controls and large tax increases.

Given Senator Kerry's pledge that all his initiatives will be paid for, a sensible question to ask is how much of an additional tax hike would be needed, above those he is already proposing, if Antos's cost estimate is closer to the mark than Thorpe's estimate. Over the period 2007 - 2014

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[41] Kenneth E. Thorpe, "Federal Costs and Savings Associated with Senator Kerry's Health Care Plan," August 2, 2004, accessed on the Internet at http://www.sph.emory.edu/hpm/thorpe/kerry8-23-04.pdf.

[42] Joseph Antos, Roland King, Donald Muse, Tom Wildsmith, and Judy Xanthopoulos, "Analyzing The Kerry And Bush Health Proposals: Estimates Of Cost And Impact," American Enterprise Institute, September 13, 2004, accessed on the Internet at http://www.aei.org/docLib/20040913_KerryBushHealthPlans.pdf. The Antos study noted that some features of Senator Kerry's proposal differ slightly from Thorpe's but concluded that the differences would have little effect on program costs.

(the 8 years in Senator Kerry's 10-year budget window in which his government health plan would be in full swing), the cost overrun would be $616 billion if the Antos estimate is accurate.

How large a tax increase would be needed over those 8 years to cover a $616 billion cost overrun? One possibility is that a Kerry Administration would seek to push the top two individual income tax brackets even higher. A preliminary analysis suggests that the second highest bracket, which is now 33% and the Senator wants to raise to 36%, would have to increase another 6 percentage points to about 42%, and the top bracket, which is now 35% and the Senator proposes to increase to 39.6%, would have to jump another 9 percentage points to about 49%.[43] These are static estimates in that they ignore the work, saving, and jobs that are destroyed by higher tax rates, and they also ignore the increases in tax avoidance and evasion that higher marginal rates encourage. If it is assumed that one-third of potential revenues are lost to negative feedbacks, the tax rate increases would need to be even steeper to cover the cost shortfall: the second highest bracket would have to climb to about 45% and the top bracket would have to soar to about 53%.

If Senator Kerry is reluctant to raise rates in the top two income tax brackets beyond what he has already proposed, another option would be to increase rates in all the lower brackets. Suppose a Kerry Administration tries to finance a $616 billion cost overrun in its health program in the period 2007 - 2014 by increasing rates proportionally in all income tax brackets except the top two. A rough estimate suggests each rate would have to increase by about 8% of its initial value.[44] The 10% rate would have to rise to about 11%, the 15% rate to about 16%, the 25% rate to about 27%, and the 28% rate to about 30%. These are static estimates. When dynamic effects are considered, the across-the-board tax rate increases would need to be somewhat larger.

Many other tax increases would be possible. For example, suppose a Kerry Administration decides to make all wage earners pay for the cost overrun by increasing the Hospital Insurance (HI) portion of the payroll tax. The HI tax is currently 2.9% of payroll (employee and employer shares). A plausible estimate is that this tax on every worker's payroll would need to increase by 1.2 percentage points, to approximately 4.1%, to make up for the cost overrun.[45]

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[43] Calculations by author. The estimates were derived by comparing the size of the cost overrun with an estimate of how much the Kerry campaign assumes it can obtain over the period 2007 - 2014 by increasing the 33% and 35% brackets to 36% and 39.6%. The additional rate increases in the top two rate brackets were calculated to be in the same ratio as the increases that Senator Kerry is already proposing.

[44] Calculations by author. These estimates were prepared by comparing CBO's individual income tax baseline (September update) over the years 2007 - 2014, modified by tax features likely to be extended, to the size of the cost overrun. The share of taxes collected in the income tax brackets below the top two was estimated based on their share in 2001. (See David Campbell and Michael Parisi, "Individual Income Tax Rates And Shares, 2001," *SOI Bulletin*, Spring 2004, Table 2.)

[45] Calculations by author. This estimate was prepared by deriving the projected HI tax base for the years 2007 - 2014 from projections of HI tax revenues reported in the latest Trustees Report and comparing those projections to the amount of the cost overrun for the same period. An adjustment was made for the deductibility of the employer share of the tax.

The possible tax increases discussed here are ***additional tax increases*** to cover just the cost overrun in just one of Senator Kerry's proposed spending initiatives. Other overbudget programs and other phantom cost savings would worsen the deficit hole.

Paying for the college and health credits

Even before considering cost overruns, the Kerry plan has a large shortfall on the revenue side. To pay for his health and education provisions, which he estimates would cost $860 billion through 2014, Senator Kerry would dedicate $860 billion in expected revenues from the marginal rate increases in the top two brackets, the capital gains and dividend rate hikes, retained phase-outs of itemized deductions and personal exemptions, and the partial retention of the estate tax. However, as discussed earlier, the adverse economic effects and the tax avoidance behavior that would be triggered by these proposals would eliminate much of the expected revenue gain. Reasonable estimates of the dynamic leakages are at least a third of the revenue from the upper bracket rate hikes and phase-outs, at least half the revenue from the capital gains and dividend provisions, and all of the expected revenue from the estate tax retention. He will fall about $475 billion short of his revenue target.

Business Taxes

International taxation. When a business owned in one country also has operations in other countries, the question arises of whether the home country should try to tax the foreign income. Many countries have adopted a policy close to territorial taxation, which means taxing income derived from activities at home but not taxing income from activities in other nations. The United States's policy is closer to worldwide taxation, which means taxing worldwide income, regardless of whether the income is generated at home or abroad. Worldwide taxation raises sovereignty issues because it involves a country extending its legal reach into other countries. It also generates double taxation problems because the host country is the primary taxing authority and in most cases has already taxed the foreign activities that the United States then tries to tax.

Because of such concerns, the United States moderates its worldwide taxation policy in several respects. One is that it does not usually tax U.S. owned businesses on the income of foreign subsidiaries while the income stays abroad. The Kerry campaign, however, charges that deferral is a "substantial tax break for companies that move investment and jobs overseas" and promises in most cases in the future to disallow that "tax incentive ... to move jobs overseas".[46]

Senator Kerry's position would be compelling economically if it is assumed that U.S. owned businesses undertake a fixed amount of investment and provide a fixed number of jobs, with the only question being what share of investment and jobs go to U.S. operations and what share go abroad. If investment and job totals are predetermined (and if sovereignty issues are brushed aside), it can be argued that locational neutrality is all that matters and that the U.S. tax code

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[46] Kerry-Edwards campaign, "The Kerry-Edwards Pro-Jobs Tax Reform Plan," *op. cit.*

should make no distinction between U.S. and foreign operations. In reality, though, total business investment and employment are not fixed, but are strongly influenced by taxes. For that reason, ending deferral may backfire. It used to be that foreign tax rates were usually greater than the U.S. rate. Hence, U.S. taxation of foreign-source income did not raise much revenue and ending deferral would not have had much impact on the competitiveness of U.S. owned businesses in foreign markets. Now, however, foreign business tax rates are usually lower than the U.S. rate. An increase in effective U.S. business tax rates would make it harder for U.S. owned businesses to compete for business in foreign markets by intensifying their tax handicap relative to foreign owned businesses.

Instead of doing less investment and job creation abroad but more at home, U.S. businesses may simply loss the customers served by the foreign operations to foreign competitors and have to retrench and become smaller. (A related non-neutrality is that higher U.S. taxes on foreign source income will encourage savers to invest more in foreign owned businesses and less in U.S. owned businesses.) Moreover, the financial strength and synergies U.S. owned businesses had previously obtained from the forgone foreign operations will also be lost, which may hurt their ability to invest and create jobs in this country. Foreign production to satisfy the former customers of the U.S. firms will still occur, but it will be undertaken by foreign companies totally outside the U.S. tax system. (Another non-neutrality is that the end of deferral will encourage U.S. businesses to escape U.S. worldwide taxation on their foreign operations by selling the foreign operations — or the whole company — to foreign businesses, which are often taxed according to territorial rules by their home countries.)

A recognition that it is not in the United States's interest to drive U.S. owned businesses from foreign markets probably explains why the Kerry plan would still allow deferral for subsidiaries of U.S. owned businesses that produce in a foreign country for sale in the same foreign country. That same logic, however, indicates that deferral is a sensible policy and should not be ended for sales to third countries or back to the United States.

The Kerry campaign observes that U.S. taxation of foreign-source income "has become so complicated that the system is almost broken." The Kerry campaign worries that complexity spawns tax loopholes[47], but fails to recognize that complexity places burdensome paperwork costs on U.S. individuals and businesses with foreign-source income. Instead of using international tax complexity as a justification for tighter foreign taxation, it would be better economic policy to use it as a reason for reducing taxpayers' paperwork costs by moving towards territorial taxation, which tends to be much simpler than worldwide taxation.

The Kerry campaign recognizes that "foreign [business] taxes have fallen sharply in the last twenty years" and are now "one-third lower than U.S. [business] taxes."[48] The Organization for

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47 Kerry-Edwards campaign, "The Kerry-Edwards Pro-Jobs Tax Reform Plan," *op. cit.*

48 Kerry-Edwards campaign, "The Kerry-Edwards Pro-Jobs Tax Reform Plan," *op. cit.*

Economic Cooperation and Development (OECD) reports that, in 2003, the United States's combined federal and state corporate income tax rate of 39.4% was the fourth highest among its 30 members.[49] A few of the countries to which the United States compares unfavorably with respect to the combined corporate income tax rate are Belgium (34%), the United Kingdom (30%), and Ireland (12.5%). Even Sweden, which is notorious for very high taxes in many areas, imposes a lower combined corporate tax rate (28%) than the United States. The heavy corporate taxation puts U.S. businesses at a tax disadvantage relative to businesses in other nations. The way to respond in order to strengthen the U.S. economy and create more and better paying jobs at home would be to lower substantially this country's very high business taxes. Instead, Senator Kerry's response to foreign tax competition would be to erect a barrier through tougher taxation of U.S. businesses operating abroad, accompanied by a slight reduction in the corporate tax rate at home (see below).

Lower the federal corporate income tax rate from 35% to 33.25%. If it were not tied to Senator Kerry's proposed increase in international taxes, a reduced corporate tax rate would lift the economy's efficiency. The corporate income tax is biased against a particular business structure and the economic sectors that business structure dominates, which distorts the investment mix and lowers the total amount of investment. Cutting the tax's marginal rate by 1.75 percentage points would lessen the severity of the bias and, thereby, allow the economy to operate more efficiently. However, it would not be enough of a cut to offset the damage done by loss of deferral and the advantage that accrues now to foreign-owned businesses in countries with 15%, 20%, or even 30% corporate tax rates. Advocates of greater tax progressivity often call the corporate income tax "fair" because standard tax distribution tables show it being borne by capital owners. Apart from questions about whether more progressivity is necessarily fair, the premise that the tax is borne by upper-income individuals is wrong. Because of tax shifting, it is ultimately borne by business owners, employees, and consumers in varying proportions, which means that a lower rate would produce benefits across the income spectrum. In fact, since savers are more responsive to taxation than workers, the bulk of the tax is probably borne by labor.[50] Cutting the rate of this largely hidden tax would also improve tax visibility.

H.R. 4520 preempts some Kerry proposals. At the time of this study's release, the House has just passed and the Senate appears about to pass legislation (H.R. 4520, The American Jobs Creation Act of 2004) intended to bring the United States into compliance with World Trade Organization (WTO) rulings regarding taxation of domestic production intended for export. The bill is

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[49] Organization for Economic Cooperation and Development, OECD Tax Database, Table I.5, "Corporate Income Tax Rates," accessed on the Internet at http://www.oecd.org/document/60/0,2340,en_2649_34897_1942460_119656_1_1_1,00.html. Two higher taxed countries have since lowered their rates below the U.S. rate. Our rates are now the second highest.

[50] See Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" *op. cit.*

complicated and this is not the place to analyze it[51], but several provisions bear on Senator Kerry's international-business-taxation proposals.

To encourage domestic production (but not production abroad), H.R. 4520 will lower the tax rate on domestic production by about 3 percentage points. This proposal has three advantages over Senator Kerry's proposed combination of ending deferral while lowering the corporate tax rate by 1.75 percentage points. First, it is a larger marginal tax rate reduction, which will do more to combat U.S. tax biases against saving and investment. Second, it will be available to domestic producers whether or not they are organized as corporations, whereas Senator Kerry's proposed lower rate would only be available to corporate businesses. Third, although the foreign operations of U.S. businesses will not be eligible for this marginal tax rate cut, at least they will not be penalized by the U.S. tax system more than they are already when they compete abroad against foreign businesses. One disadvantage of H.R. 4520, though, is that it will only lower tax rates for domestic business activities classified as production (mainly manufacturing), whereas the Senator's proposal would apply to all lines of business.

To encourage reinvestment of foreign earnings in the United States, the bill includes a one-year repatriation holiday, during which repatriated income would be eligible for a reduced U.S. tax rate of 5.25%, subject to various limitations. The idea of a repatriation holiday has been percolating on Capitol Hill for several years. If H.R. 4520 becomes law, this provision will supersede Senator Kerry's suggestion for a one-year repatriation holiday with a (less generous) reduced tax rate of 10%. Although the Joint Committee on Taxation (JCT), which is Congress's official revenue scorer, estimates the repatriation holiday will lose money, more sensible assumptions suggest that the provision will raise revenue.[52] Hence, Senator Kerry's estimate that it will be a revenue raiser over the budget window seems reasonable. However, if Congress finalizes adoption of a repatriation holiday in connection with the WTO legislation, Senator Kerry will no longer have that revenue raiser to use for his spending initiatives.

H.R. 4520 also includes new tax rules that will strongly discourage corporate inversions, which renders moot Senator Kerry's call for restricting them. It also means that Congress has already used the revenues he had counted on from imposing such a restriction.

<u>Zero percent capital gains tax rate for qualifying investments in small businesses held at least 5 years.</u> Because of tight eligibility restrictions, this is a "niche" provision that only applies to a small share of investments under current law, and that would remain the case under Senator Kerry's proposal. While the change that Senator Kerry endorses would lead to more capital formation in a single narrow type-of-business, type-of-investment category, its positive effect would be very

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[51] For an analysis, see Stephen J. Entin, "ETI Repeal Should Be Passed And Moved To Conference," *IRET Congressional Advisory*, No. 168, March 22, 2004, available on the Internet at ftp://ftp.iret.org/pub/ADVS-168.PDF.

[52] Stephen J. Entin, "Let Companies Repatriate Their Foreign Income," *IRET Congressional Advisory*, No. 162, October 31, 2003, available on the Internet at ftp://ftp.iret.org/pub/ADVS-162.PDF.

small compared to the negative effect of his other capital gains provision that, in general, would raise the capital gains tax rate for people in the top two income tax brackets.

New Jobs Tax Credit. Jobs credits have typically been of limited effectiveness. Sometimes employers are unaware of the credits; sometimes they do not want to bother with the paperwork; sometimes employers are unsure which workers will be eligible until after the workers have been hired, in which event the credits come too late to do much good. Credits will probably be most effective if they are easy for employers to understand and do not involve much paperwork. Senator Kerry's stipulations that his credit only cover new hires above a baseline and only apply to employers in certain industrial categories suggest it would lean in the other direction with regard to simplicity, which would lessen its effectiveness. Restricting the credit to new hires above a baseline also means that businesses which are doing well and planning on hiring more workers in any case could qualify while businesses going through tough times and having to retrench would automatically be disqualified. That effect is surely unintentional, but it is not efficient or fair.

Broadband Tax Credits. The government is much less successful than private-sector competitive markets in distinguishing between winning and losing industries and technologies. If broadband is as promising as it seems, market forces will quickly increase its availability and reduce its costs — as market forces have been doing for the last several years. It would be a mistake for the government to jump on the bandwagon with tax credits for several reasons. The credits are not needed if broadband is the wave of the future. Subsidizing specific technologies may delay the emergence of other, superior technologies. The credits may lead to inefficiency. Households and businesses will adopt broadband on their own provided its benefits exceed its costs; by artificially lowering costs, government tax credits will promote overuse by encouraging broadband even where (pre-credit) costs exceed benefits. The real barrier to broadband investments in recent years has been the government's trampling over the private property rights of providers through bungled implementation of the 1996 Telecommunications Act.[53] The correct response would be the free-market solution of greater respect for investors' property rights, not a tax credit to try to undue a problem the government itself created.

Extend the R&D Tax Credit. Like President Bush and most members of Congress, Senator Kerry supports extending the R&D credit and thinks it should be made permanent. (It has not been made permanent because Congressional budget rules favor repeatedly extending a provision instead of making it permanent.) Economists have generally concluded that although the credit could be better designed and may be a tax subsidy, its benefits exceed it costs. One of its strengths is that the government does not try to micromanage which industries and technologies receive R&D

[53] South Korea's experience illustrates the power of a deregulatory approach based on respect for investors' private property rights to speed the adoption of a new technology. Following well-designed deregulation in the mid 1990s, broadband capacity and use soared: 78% of South Korean households now receive broadband, which is over twice the U.S. rate. See Thomas W. Hazlett, "Broadband Miracle," *The Wall Street Journal*, August 26, 2004, p. A12.

funding but leaves those choices to the private sector. Senator Kerry is right that the credit would be more effective if investors could count on its continuance when they plan their future R&D.

"Green" tax incentives. "Green" incentives have a history of being used to subsidize methods of energy production and use that are almost always much more expensive and often less dependable than free-market choices.[54] Although the hope is often expressed that the costs of "green" technologies will plunge when tax incentives encourage larger scale use, costs in most cases have remained stubbornly high. "Green" incentives also have a history of being used to mask political pork. For example, the ethanol subsidy, which Senator Kerry supports, is usually defended on environmental grounds, but ethanol requires more energy to produce than it later releases[55], increases farm-related pollution, pushes up food prices, does little for air quality[56], and costs the government lots of money. John Kerry could lend backbone to his promise to cut corporate welfare by $300 billion if he opposed many of the "green" initiatives that he now supports.

Resurrect "Superfund" taxes. Although Senator Kerry claims that the "polluter pays" principle supports bringing back the long-gone "Superfund" taxes, one reason they were allowed to lapse is that they are unrelated to actual pollution. For example, a producer that uses petroleum and chemicals following careful environmental safeguards would pay just as much of a "Superfund" excise tax on those substances as a producer that uses the petroleum and chemicals carelessly, and would pay more "Superfund" tax than a producer that does not use the petroleum and chemicals but pollutes in other ways. The other "Superfund" tax on modified AMT income, which was assessed regardless of a company's inputs, output, or industry, had even less to do with pollution than the "Superfund" excise tax on petroleum and chemicals. The "Superfund" taxes were also allowed to expire because many members of Congress wanted the "Superfund" program to be reformed before considering whether to reauthorize its special taxes. They were concerned that the "Superfund" program is poorly crafted legislatively and has often delivered disappointing results at very high cost.

Raise business taxes by $75 billion over 10 years by changing the tax treatment of certain activities deemed to be tax shelters or loopholes. While there are certainly some loopholes in the tax code, calling a feature a tax shelter or loophole does not automatically make it one. With an income tax,

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[54] Wind power illustrates these problems. Its costs are high per unit of electricity generated. It is undependable, requiring a wind speed that is neither too slow nor too fast. Because tax credits and government demands in this country and elsewhere have led to the construction of many wind farms, despite their inefficiency, empirical evidence has also accumulated that these supposedly environmentally friendly energy generators are really not so friendly. Among their problems, they cause noise pollution, mar landscapes, and kill large numbers of migratory birds.

[55] David Pimentel, "Ethanol Fuels: Energy Balance, Economics, And Environmental Impacts Are Negative," Natural Resources Research, Vol. 12, No. 2, June 2003, accessed on the Internet at http://www.acfa.ws/Support/Pimentel_Nat'l%20Resour%20Res_Jun%202003.pdf.

[56] U.S. General Accounting Office, "Effects Of The Alcohol Fuels Tax Incentives," GAO/GGD-97-41, March 1997, accessed on the Internet at http://www.unclefed.com/GAOReports/ggd97-41.pdf.

a provision is not a loophole if it is needed to measure income accurately, regardless of whether tax liabilities would rise if the feature were arbitrarily disallowed. It is impossible to analyze the merits of Senator Kerry's proposal when the bulk of his "loophole" closers are unidentified. The lack of specificity also undercuts the proposal's credibility as a revenue raiser.

Social Security

No reform of retirement benefits; no personal accounts. Senator Kerry has taken the position that the Social Security system is basically sound. He rejects privatization, by which he means a move towards worker-owned personal retirement accounts. He also rejects the option of raising the normal retirement age, although the average senior today can expect to live much longer than the average senior in the 1930s, when Social Security was created, and life expectancy is projected to rise by several years in the next decade. He promises not to cut benefits, except perhaps to higher-income seniors, and he calls for raising the benefits of some government retirees who also receive government pensions.[57] Senator Kerry does acknowledge there is a demographic challenge, but he characterizes it as a distant problem because, as one of his campaign documents puts it, "There is enough money in the Social Security Trust Fund now to cover full benefits for the next forty years."[58]

The problem with Senator Kerry's sanguine attitude is that Social Security is ***not*** a saving system. Its "trust fund" contains ***no*** real assets; the trust fund "money" on which the Senator says we can rely consists only of IOUs the government has written to itself. Although the government has made Social Security look in some respects like a saving system, it is actually a government run tax-and-transfer system. The government taxes current workers and transfers their tax dollars to retirees. When Social Security's payouts begin exceeding its tax collections, which the program's trustees project will start happening in 2018[59], the government will not be able to finance the shortfall by dipping into the "trust fund". The government will have to either cut Social Security benefits or other government spending, raise Social Security taxes or other taxes, or borrow more.

The excess of outflows over tax collections will quickly grow because of demographics: over time the number of people working and being taxed will drop sharply relative to the number of seniors receiving transfers. In the mid 1990s, a bipartisan Presidential Commission warned that, in the absence of program changes, the costs of Social Security, other government "entitlements",

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[57] Kerry-Edwards campaign, "Social Security For A Stronger America," accessed on the Internet at http://www.johnkerry.com/pdf/seniors/seniors_socialsec.pdf.

[58] Kerry-Edwards campaign, "Social Security For A Stronger America," *op. cit.*

[59] The Board Of Trustees, Federal Old-Age And Survivors Insurance And Disability Insurance Trust Funds, "The 2004 Annual Report Of The Board Of Trustees Of The Federal Old-Age And Survivors Insurance And The Federal Disability Insurance Trust Funds," p. 3, accessed on the Internet at http://www.ssa.gov/OACT/TR/TR04/tr04.pdf.

and net interest will demand an ever increasing share of government revenues and eventually leave no revenues available for other government functions (national defense, court system, etc.).[60]

If the attempt were made to increase taxes sufficiently to pay promised benefits while maintaining other government services, taxes as a share of national output would have to be boosted to a much higher level than ever before experienced in the United States. Such high taxes would pose severe efficiency problems because they would strongly discourage work, saving, and investment. Those taxes would also be suspect on fairness grounds because they would involve a massive, forced transfer from a younger generation to an older generation.

In 2001, another bipartisan Presidential Commission concluded that Social Security's tax-and-transfer system should be replaced, at least in part, by a saving system, with worker-owned saving accounts: "Social Security will be strengthened if modernized to include a system of voluntary personal [retirement] accounts."[61] Undertaking this reform soon would be beneficial, both because it will give people more time to plan and because it will allow more time for the savings to accumulate. In addition, coupled with better tax treatment of business fixed investment in the United States, the added saving would boost capital formation and raise wages and employment.

Senator Kerry's stance, which is to leave the current tax-and-transfer system in place, perhaps cut benefits for the wealthy, and perhaps try to shore up the system's finances with an infusion of general tax revenues, is simply not viable in the long run. By delaying reform, his strategy would make the eventual adjustment to financial reality more sudden and costly than it need be.

With regard to Senator Kerry's suggestion that the Social Security benefits of high-income seniors might be limited to what they paid in (presumably without interest or inflation adjustments), Professor Martin Feldstein of Harvard University calculated it would produce a drastic reduction in benefits for those affected.[62] Because the benefit reduction would be triggered by rising income, it would be a tax on income, in effect, and would create a large spike in marginal income tax rates, which would reduce work, saving, and productivity.[63]

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[60] Bipartisan Commission on Entitlement and Tax Reform, *Interim Report to the President* (Washington: Government Printing Office, August 1994). Notice that this bipartisan Commission held its hearings and issued its report early in the Clinton Administration. As that date indicates, it has been recognized for many years that the entitlement-program benefits the government has promised to future generations are unsustainable.

[61] President's Commission to Strengthen Social Security, "Strengthening Social Security And Creating Personal Wealth For All Americans (The Final Report Of The President's Commission To Strengthen Social Security)," December 21, 2001, p. 8, accessed on the Internet from http://www.csss.gov/reports/.

[62] Martin Feldstein, "Fact vs. Fancy: The Skinny On Social Security," *The Wall Street Journal*, August 17, 2004.

[63] Feldstein added that such means testing would lower Social Security payouts only slightly if it were confined to just the top percent or two of seniors. To produce larger outlay reductions, the limitation might end up being directed at a much broader group of seniors: those who have built up substantial nesteggs in their

Senator Kerry's "fiscal responsibility" theory of taxation

In classical economic theory, the effect of a tax can be found by adding up the effects it has on household and business behavior by altering the prices received for labor and capital services and the costs of goods and services purchased within the economy. The macroeconomic effects can be deduced from the microeconomic price effects. For instance, a tax with nonneutralities that seriously distort the production and consumption decisions of individual households and businesses will hurt the economy's ability to produce output, generate income, provide jobs, and grow. A complicated tax that burdens taxpayers with high administrative costs will be a drag on the economy by diverting potentially productive resources into unproductive tax-related paperwork. A corollary is that reforming a bad tax system to make it less distorting, perhaps by lowering marginal tax rates and better defining the tax base, can quickly generate large gains in output, income, jobs, and growth. The rediscovery of these classical insights provided the foundation of the fiscal policies of the Reagan Administration in the United States and the Thatcher era in Britain. These policies were so successful in promoting real growth without fueling inflation that they have had a worldwide influence since then; many governments have lowered marginal tax rates at the individual and business levels and sought to reduce tax biases against saving and investment.

Senator Kerry claims these issues are of secondary importance. His position is that the size of the federal budget deficit matters much more. "[I]f left unchecked," he says, federal budget deficits "can become a fiscal cancer that will erode any recovery and threaten the prospect of a lasting prosperity. Ultimately, as deficits drive up long term interest rates, they will dry up investment..."[64] Conversely, he asserts that falling deficits and a budget surplus are the key to a strong economy.[65] The links in the argument are that lower taxes and higher government spending raise the federal budget deficit, the higher deficit pushes up interest rates, the higher interest rates choke off investment and consumption, and the economy then withers.

Politically, this argument is often used to criticize tax reductions, and Senator Kerry relies on it when he charges that recent tax cuts were "unaffordable".[66] However, the theory's advocates rarely invoke it to argue against spending increases, although lower taxes and higher spending should have similarly damaging effects if the theory is correct. When the theory is mentioned at

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401(k)s and IRAs. Of course, when millions of middle class people realize that their 401(k)s and IRAs may cost them Social Security benefits, they will save less, which will hurt the economy, and they will also question the fairness of the limitation.

[64] Kerry-Edwards campaign, "A Return to Fiscal Responsibility, Remarks of John Kerry," April 7, 2004, accessed on the Internet at http://www.johnkerry.com/pressroom/speeches/spc_2004_0407.html.

[65] See *Ibid.* and Kerry-Edwards campaign, "Kerry Pledges a Return to Fiscal Responsibility," April 7, 2004, accessed on the Internet at http://www.johnkerry.com/pressroom/releases/pr_2004_0407a.html.

[66] See, for example, Kerry-Edwards campaign, "'A Stronger America Begins at Home: The Path to Prosperity' Kick Off, Remarks of Senator John Kerry," *op. cit.*

all in the context of spending proposals, it is usually cited as a rationale for higher taxes to keep pace with higher spending. Senator Kerry follows this pattern when he calls his extremely expensive health and education proposals fiscally responsible because he intends to increase taxes to finance them.

As an economic matter, there are serious conceptual and practical flaws in the theory that the economy revolves around the federal budget deficit and that higher taxes are generally good and lower taxes are generally bad. It entirely ignores the tax principles of neutrality, simplicity, visibility, and equity. It falsely assumes that the economy will be better off if marginal tax rates are, say, 70% and the budget is balanced (very high taxes matching very high government spending) than if marginal tax rates are, say, 20% and the budget is slightly in deficit. It implies the disastrous policy prescription that when the deficit rises during an economic slump, taxes should be raised to try to narrow the deficit. That was the economic policy actually followed by the Herbert Hoover Administration when it pushed through major tax increases during the early phase of what developed into the great Depression. The theory falsely assumes that higher taxes never depress private saving. It neglects international capital flows. And it naively imagines that higher taxes will be used to reduce the deficit, even though elected officials have a habit of boosting government spending in response to higher taxes.

A readily observable defect is that a key step in the theory is flat out wrong: empirically, deficits do not have much effect on interest rates. For example, in the summer of 2000, when the federal budget was in surplus and the surpluses were expected to continue, the 3-month Treasury bill rate was above 6% and the 10-year Treasury bond rate was close to 6%. If the deficits-drive-the-economy argument were correct, the federal budget's subsequent shift into deficit should have pushed interest rates much higher. Instead, the 3-month Treasury bill rate has been well below 2% this summer, and the 10-year Treasury bond rate has mostly been below 4.5%.[67]

Internal inconsistencies and puzzling juxtapositions in the Kerry plan

Many elements of Senator Kerry's plan are difficult to reconcile with each other. Four examples are cited here.

• Senator Kerry claims that his plan will cut taxes for 98% of all Americans, by which he means reduced individual income tax liabilities and, for people who do not owe income tax, bigger government checks provided through the tax system. However, if one adds up the percentage of Americans who would be eligible for his new or expanded credits on the individual side (e.g., college credit, child care credit, health care credit, some "green" credits), the number is not 98%;

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[67] For an excellent review of the empirical evidence and underlying economic theory, see Alan Reynolds, "Deficits, Interest Rates, And Taxes; Myths and Realities," Cato Institute, *Policy Analysis*, No. 517, June 29, 2004, accessed on the Internet at http://www.cato.org/pubs/pas/pa517.pdf. Reynolds also examines the increasingly complicated and contradictory modifications that the theory's defenders have resorted to in the face of the evidence.

it is not even a majority; it is probably in the 15% - 25% range. Where does Senator Kerry get his 98% figure? The answer seems to be that he is counting large parts of the Bush tax cuts (the "middle-class" provisions) as though they were his own. The Bush tax cuts reached most people paying the individual income tax with elements like the new 10% bracket, the expanded child credit, and marriage penalty relief. Although Senator Kerry now says he supports those provisions, he is using dubious logic when he claims credit in his tax plan for the tax cuts engineered by his opponent.

• Senator Kerry assumes that individuals as consumers and producers are highly sensitive to government-created incentives when he wishes to influence their behavior through tax policy, such as with "green" credits. However, he assumes that individuals pay no attention whatsoever to incentives when he proposes changes that would discourage work, saving, and investment, such as retaining the estate tax for larger estates and hiking marginal tax rates for taxpayers in the top two income tax brackets. Although governments would certainly have more control over human activity if people reacted (or did not react) in exactly the ways policymakers would like, the Senator's two different assumptions about whether people respond to incentives are mutually contradictory.

• The Senator says his plan will cut taxes for 99% of businesses. That may be true if one looks only at taxpaying corporate businesses and his corporate income tax proposals, and does not bother to weight the corporations by size. Because most of the companies that would pay higher taxes under his plan are large companies, they account for a substantial share of production and employment. Further, millions of businesses are organized as sole proprietorships, partnerships, S corporations, and certain other forms. Those businesses pay income tax at the individual level, on their owners' individual income tax returns. Senator Kerry's proposals to increase rates in the top two individual income tax brackets would push up the marginal and average tax rates of many of those businesses.

• Senator Kerry has talked about "cutting the deficit in half by rolling back the Bush tax cuts for the wealthy."[68] Elsewhere he has talked of "rolling back" the same tax cuts to"invest in health care, education, and job-creation,"[69] that is, to finance his health and education proposals. His campaign has also suggested that budget deficits threaten Social Security benefits and that "rolling back the tax cuts for the wealthiest Americans" is a "way to solve the deficits ... without cutting Social Security."[70] Whether one thinks the tax-increase proposals are good or bad ideas, the same revenue raisers cannot be used in three different ways. A related puzzle is that while the Senator insists the 2001, 2002, and 2003 tax cuts have spawned deficits which have done terrible things

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[68] John Kerry, "Rally For A Stronger America," June 21, 2004, accessed on the Internet at http://www.johnkerry.com/pressroom/speeches/spc_2004_0621.html.

[69] John Kerry, "'A Stronger America Begins at Home: The Path to Prosperity' Kick Off," *op. cit.*

[70]Kerry-Edwards campaign, "Bush's Broken Promises: Social Security and Medicare," March 7, 2004, accessed on the Internet at http://www.johnkerry.com/pressroom/releases/pr_2004_0307b.html.

to the economy, he offers an economic plan with a number of proposed "middle-class" tax cuts and some large spending programs. If he believes deficits are as damaging as he says, shouldn't he delay or cancel his spending proposals and oppose some of the tax relief he says he supports?

Are more tax-increase proposals waiting in the wings?

The disconnect between Senator Kerry's ambitious spending proposals, the tax increases he has so far proposed to pay for them, and his warnings about deficits have prompted some former Clinton Administration officials to wonder if more revenue raisers will have to be added after election day to make the numbers add up.

Former Treasury Secretary Robert Rubin views Senator Kerry's proposed revenue raisers as a "beginning", but thinks that leadership on the budget front may demand "some extremely difficult political decisions" ahead. Asked whether more tax increases will be needed, Mr. Rubin replied, "I don't think you can make proposals to try to dig out of this hole until you've gotten elected..."[71] The Clinton Administration's first budget director, Leon Panetta, commented, "You have to begin with the premise that the steps you need to take to reduce deficits are almost diametrically opposed to the steps you need to take to win elections. " He believes there will need to be so far unidentified tax hikes and spending cuts after the election and notes "I didn't believe Clinton's numbers, either, when he was running. But what was passed was not what he campaigned on."[72]

With the revenue raisers he has suggested up to now, Senator Kerry has paid little attention to marginal tax rates and other aspects of tax efficiency, has essentially equated fairness with tax redistribution, has ignored the effect of tax shifting on ultimate tax burdens, has bypassed tax simplification, and has seemed unconcerned with tax visibility. One would hope that any future revenue raising proposals will be more in line with sound tax principles, but one does not know.

Conclusion

John Kerry's tax proposals are disappointing when measured against core principles of sound taxation. Instead of combating tax distortions that reduce the economy's efficiency, his proposals would, on the whole, intensify tax biases, especially biases against saving and investment. Although Senator Kerry calls for a stronger, more internationally competitive economy with more and better jobs for workers, his proposals would generate tax inefficiencies that would move the

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[71] Business Week Online, "Online Extra: Robert Rubin: Embrace Kerry," August 2, 2004, accessed on the Internet at http://www.businessweek.com:/print/magazine/content/04_31/b3894006_mz001.htm?mz.

[72] Jonathan Weisman, "Kerry's Dueling Promises On Economy; Position On Reducing Deficit Conflicts With Campaign Commitments," *The Washington Post*, Aug 25, 2004, p. A8.

economy in the opposite direction, towards less output, lower incomes, fewer good jobs, and slower growth.

Nor would the Kerry proposals simplify the tax code. His package basically ignores the billions of dollars and billions of hours in ***compliance*** costs imposed on millions of taxpayers at the individual and business levels. Bizarrely, he portrays tax complexity mainly as an ***enforcement*** issue related to what he calls tax shelters, and his proposed solution is to restrict tax shelters.

With regard to tax visibility, the Kerry package's heavy use of tax credits, including a number of refundable ones, would reduce transparency, rather than increase it.

Fairness is subjective, but to conclude that the Kerry package is fair, one must believe that even though the federal tax system is already very progressive and redistibutional, greater progressivity and still more income redistribution would be fairer. After all, the Senator seeks to increase federal taxes for the people already paying the highest taxes relative to their incomes and to decrease taxes for selected groups whose members usually pay lower taxes, no net taxes, or receive rebates. (A common misunderstanding is that people in upper income brackets generally pay low taxes. Tax data show the opposite.) Also, while Senator Kerry is correct that his proposed tax increases would mainly be collected from people with higher incomes, the people being taxed more heavily would respond by changing their behavior, with the result that much of the ultimate tax burden would be shifted to people at all income levels.

Senator Kerry has overstated the revenue raising ability of his proposed tax increases. He relies on static revenue estimates even though the real world is dynamic. People respond to higher taxes on work and saving by working and saving less and by shifting more income into nontaxable forms. Tax revenues would increase, but by much less than the Senator is predicting. When this is combined with his implausibly low cost estimates for his spending initiatives (based on past experience with new government spending programs), the fiscal discipline that John Kerry promises vanishes. Either future budget deficits will be much higher than otherwise or getting his budget numbers to add up will require large additional tax increases that he has not yet put on the table.

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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.